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Debt-equity swaps: will all convertible loan and bond investors in Switzerland soon be required to publicly disclose their identity?

Switzerland's revised corporate law will enter into force at a date yet to be defined in 2023. It will include a new provision on the creation of shares by way of converting debt into equity (*Verrechnungsliberierung*), often referred to as debt-equity swaps. The new provision requires that the identity of the investor converting debt and the amount converted are disclosed. Disclosure will need to be made in the articles of association (*Statuten*) and will be on public record in Switzerland for at least ten years.

The issue with this new disclosure requirement may be twofold: On the one hand, investors may not want their identity and the fact of their investment in a specific entity to be known to the public, on the other, companies may not be able to identify these investors. While the former is likely the case for investments in both privately held and public companies, the latter could predominantly be a problem for public companies.

In the following Advestra Insights, we will look into the various use cases of debt-equity swaps, the current and future legal regimes and finally, the practical impact of the upcoming change in legislation. In particular, we address conditional capital increases and outline why, in our view, they will not be subject to the new disclosure requirements.

1 USE CASES OF DEBT-EQUITY SWAPS

Debt-equity swaps are widely used in Switzerland in different settings. All use cases have in common the basic principle that, from the issuing company's perspective at the time of the "swap", debt on the balance sheet is converted into share capital. The company's creditor thereby becomes one of its shareholders. From a legal perspective, a creditor's existing claim against the company is set off against the company's claim for payment of the subscription price in a capital increase.

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Convertible bonds

Among the most prevalent use cases of debt-equity swaps are convertible bonds. Straight bonds are debt instruments issued by companies, typically to a large number of investors and at the same terms, and often by way of public placements. The convertible element allows for the conversion of debt into shares subject to the bond's terms, which means the instruments are equity-linked. Most frequently, convertible bonds are structured in a way that allows the bondholders to trigger the conversion unilaterally, in absence of which the bonds are repaid by the issuer in cash at the end of their term. For other types of convertible bonds, the conversion is mandatory or contingent on certain triggering events such as distress situations. Generally, the shares for convertible bonds are created out of conditional capital. The conditional capital is specifically designed for convertible bonds and allows for shares to be issued automatically upon conversion and without further actions by the issuer.

Start-up financing

Another popular use of debt-equity swaps is in the context of start-up financing. Early stage and growth phase companies can issue convertible loans (or bonds) to obtain much needed cash in a way that is usually quicker than a full-fledged financing round. These instruments can also help bridge valuation gaps between the company and an investor. The terms of these loans typically provide for a mandatory conversion in the event of a qualified equity round. The shares resulting from the conversion are then issued at a discount which serves as a risk premium for the convertible loan lenders. Debt-equity swaps with convertible loans issued by start-ups may be converted at the occasion of ordinary or authorized capital increases or with conditional capital allowing for a continuous tool for conversion.

Restructurings

Debt-equity swaps can also play a crucial role in restructurings of companies outside of bankruptcy and composition proceedings. The conversion of debt into equity strengthens a company's balance sheet. For lenders to agree to this measure, they will typically ask for a significant dilution of existing shareholders and it is not uncommon to see specialist funds take up stakes in the distressed debt from banks in these situations. In addition, debt-equity swaps are often combined with measures that address the struggling company's liquidity situation as well as other restructuring measures.

So far, a limiting factor to using debt-equity swaps in restructurings may have been the debated requirement that claims to be set-off in a debt-equity swap need to be "valuable" (*werthaltig*) at the time of conversion into equity. We believe this view to be misplaced and the revised corporate law will finally clarify that said requirement does not apply. It clearly states that the set-off against a claim is also permissible if the claim is no longer covered by assets. This emphasizes the important role debt-equity swaps can play in distressed situations.

2 LEGAL FRAMEWORK

2.1 Current regime

Under the current legal regime, debt-equity swaps in ordinary and authorized capital increases involve only limited public disclosure. In essence, the board of directors needs to make a statement in its capital increase report regarding the existence of the debt and confirm that it can be set off. While this includes the converted amounts and often also the names of the investors participating in the debt-equity swap, commercial register authorities also accept reports which do not identify the respective persons. In any case, the capital increase report needs to be filed with the commercial register as part of the capital increase documentation and thereby becomes publicly accessible. However, receiving access to this file in most cantons requires the extra step of requesting it from the authorities and paying a small sum. The debt-equity swap does not need to be specifically reflected in the articles of association and the commercial register excerpt only refers to the set-off by stating the total amount of converted debt and the number of shares issued in exchange.

For convertible loans and bonds issued as part of a conditional capital increase, the starting point is different as the debt-equity swap is an inherent feature of these instruments. They include the right of the investors to unilaterally convert their claims into shares subject to the bond's terms. As such, the setting-off of the relevant claims against the company is not an alternative to paying up the shares in cash (or in kind) but rather the base case. Accordingly, the disclosure requirements for conditional capital increases focus not on the existence of specific debt and its ability to be set off but rather, in a general manner, on the convertible instruments. Conditional capital therefore needs to be reflected in the issuing company's articles of association and commercial register excerpt, however the description of the convertible instruments that may be issued out of the conditional capital is typically generic and no reference is made to the investors' identity. In the absence of mandatory disclosure requirements being triggered upon reaching a certain shareholding percentage, public companies generally do not know and do not have the right or the means to request or find out the identity of sometimes hundreds or even thousands of investors converting these equity-linked instruments.

2.2 New regime

Extended disclosure requirements

The new corporate law provision of art. 634a para. 3. of the Swiss Code of Obligations ("CO") will require the articles of association to disclose the amount of the receivable to be set off, the name of the "shareholder" (i.e. the subscriber of the new shares) and the number of shares received as consideration (see also art. 650 para. 2 al. 5 CO). This information will be on public record in Switzerland for at least ten years (see also the draft of the proposed ordinance for the commercial register, art. 47 lit. e E-HRegV). It follows that unless there is a limitation of the scope of the new provision, investors agreeing to a debt-equity swap, including convertible bond or convertible loan investors, in Swiss companies will have to disclose their identity at the time of conversion together with the notional amount of the bond or loan converted.

The new provision of art. 634a CO simply states that the articles of association must include, in case shares are created by way of set-off of the subscription amount with an existing claim of a creditor (debt-equity swap), the amount of the claim and the name of the shareholder (i.e. the subscriber of the new shares). The responsibility to draft or amend the articles of association are with the company. Hence, there is no direct obligation of a converting creditor or bondholder to disclose its name to an authority in Switzerland. However, the company might argue that there is an indirect obligation of the creditor and hence a right of the company to receive the information required to be included in the articles of association. In any case, the company supposedly won't be able to register the debt-equity swap with the commercial register without the investor providing the information that needs to be disclosed.

Purpose and rationale

The legislator introduced the new disclosure requirement with the intention of creating more transparency and thereby more scrutiny of debt-equity swaps. While there was no noticeable misuse of the instrument in the recent past, legal scholars have called for an alignment in disclosure requirements to contributions in kind (*Sacheinlage*), i.e. instances where assets are contributed to a company against issuance of new shares. Already under existing law, contributions in kind are disclosed in the articles of association including the name of the subscriber and the asset(s) contributed. The revised provision must also be viewed against the backdrop of the legislator finally clarifying that there is no requirement for claims to be "valuable" (*werthaltig*) at the time of conversion into equity in order to be set-off in a debt-equity swap. However, the revised law introduces a new transparency rule in the articles of association. While this regime generally represents a more liberal approach to debt-equity swaps, the transparency rule creates new problems of its own.

3 EFFECTS / IMPACTS

Creditors converting the company's debt into equity may have various reasons not to like disclosure of their names in public records in Switzerland. In certain cases of a debt-equity swap, creditors become forced shareholders as a result of a company's restructuring. This may be indicative of a failed credit analysis and hence nothing to shout from the rooftops. As a consequence, a requirement to disclose their identity upon conversion into equity may even have a chilling effect on creditors' willingness to engage in a debt-equity swap.

In cases of equity linked instruments such as convertible loans or convertible bonds, conversion into equity is an essential and original feature of the instrument itself. In Swiss companies, investors have no duty to disclose their investment publicly, unless the investee company is publicly traded and a threshold of 3% of ownership (including by way of holding derivatives) is reached or exceeded. Nevertheless, the new rule will require investors of equity-linked instruments in both privately held and public companies to have their names and the amount of the investment disclosed in public records upon conversion.

4 LIMITATION OF THE NEW PROVISION'S SCOPE AND POTENTIAL STRUCTURING ALTERNATIVES

4.1 Conditional Capital

In our view, the new disclosure requirements for debt-equity swaps do not extend to conditional capital increases. The setting-off of claims against the company with the company's claim for payment of the subscription price is a fundamental concept of conditional capital increases, in which the claims against the company indeed are created for this purpose. This explains why debt-equity swaps are subject to a separate disclosure framework under the current legal regime and we see no indication as to why this should change under the revised CO. Such is also our reading of the message (*Botschaft*) regarding the revision of Swiss Corporate law which states in relation to conditional capital increases that its current legal regime will fundamentally be maintained and that only selective amendments and clarifications have been made (BBl 2017, 399 ff., 501).

Applying the disclosure requirements for debt-equity swaps to conditional capital increases not only would be a fundamental change to the legal regime of conditional capital. It would also make the way that convertible bonds are issued today in the Swiss capital market unworkable. The issuing companies have no information on the converting investors' identities, unless these are actively disclosed to them by investors requesting to be registered as shareholders. If investors had to actually notify a company of their names when exercising a conversion right, public companies would have to list hundreds or even thousands of investors' names in their articles of association. It does not seem plausible to us that the aim of the revised corporate law was to complicate the instrument of convertible bonds in this way. Quite to the contrary, the legislator made efforts to simplify the process of converting bonds by doing away with the requirement that exercising the conversion right needs to be in writing (see the new wording of art. 653e al. 1 CO).

The same applies in our view where conditional capital is created within the context of the newly introduced capital band, however there is no general exemption available for the capital band itself.

4.2 Beneficial ownership

The new provision does not require the disclosure of the beneficial holder of the bond or loan or other receivable that converts into equity. Disclosure of the holder of record (creditor) of the claim would be sufficient. In our view, this conclusion is mainly driven by the declared legislative goal of aligning the rules on debt-equity swaps with those of a contribution in kind where disclosure of beneficial ownership is not necessary. It would therefore also be possible in our view that a fiduciary or agent steps in to conduct the conversion on behalf of the holder of the bond or loan, whose name would be disclosed in lieu of the names of the converting creditors. This would simplify the conversion process and avoid the registration and disclosure of potentially hundreds or even thousands of holders. However, this conversion by a fiduciary or agent is not straightforward either.

A power of attorney by the creditor in favor of a fiduciary or agent who converts on behalf of the creditor does not seem sufficient to enable the disclosure of the agent instead of the creditors empowering the agent or fiduciary because statutory provision mandates disclosure of the "shareholder". A mere power of attorney does not make the agent a shareholder upon conversion. There would have to be an assignment of the claim to the fiduciary who would formally become a creditor of the company prior to conversion. Such a structure could be based on the established practice for (share for share) exchange offers. Such exchanges qualify as contribution in kind from the company's perspective and are subject to a similar disclosure regime as to the names of the contributor and the contributed assets, but the disclosure of the name of the subscribing exchange agent and of the aggregate assets contributed is deemed sufficient.

In practice, for most cases involving hundreds or even thousands of converting shareholders, the new disclosure regime should not be applicable as the new shares will be sourced from conditional capital. For other cases, the structure outlined above could be a possible solution to be further evaluated and developed.

5 CONCLUSION

The new disclosure requirements for debt-equity swaps will create additional exposure for companies and their investors that may, in many cases, be unwanted. We hope this will not have a chilling effect on the use of the instrument, especially as the new law also strengthens its role as a restructuring measure by finally clarifying that claims to be set-off by a creditor in a debt-equity swap do not need to be "valuable" (*werthaltig*) at the time of conversion into equity.

In our view, the new disclosure requirements for debt-equity swaps do not extend to conditional capital increases and hence in particular not to the base case of companies issuing convertible bonds. This prevents companies from having to identify hundreds or even thousands of converting creditors and reflecting them in their articles of association. For cases other than conversions out of conditional capital, difficulties brought on by the revised law might be addressed by a fiduciary or agent stepping in to conduct the conversion on behalf of the holders of the bond or loan. The fiduciary or agent's name would then be disclosed as shareholder in lieu of the converting creditors' names.

It will be interesting to see in which other ways the Swiss legal practice deals with the new disclosure requirements, especially in situations where they pose serious issues with regard to practicability. Hopefully, pragmatic solutions will prevail.

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