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# Cash Pooling

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# Introduction

Cash pooling enables corporate groups to minimise expenditure incurred in connection with banking facilities through economies of scale.

Under a cash pooling arrangement, entities within a corporate group regularly transfer their surplus cash to a single bank account (the “master account”) and, in return, may draw on the funds in that account to satisfy their own cash flow requirements from time to time. The master account is usually held by the parent company or by a “treasury company” established specifically for this purpose.

Depending on the type of cash pooling arrangement, the participating entities may transfer either their entire cash surplus (“zero balancing”), or cash exceeding a certain surplus level (“target balancing”). In general, all entities participating in the cash pooling arrangement will be liable for any negative balance on the master account, irrespective of the amount they have contributed.

Transfers and draw-downs of funds to and from the master account by the participating companies have the nature of the grant and repayment of intra-group loans.

In addition to physical cash pooling, there is also “notional” (also known as “virtual”) cash pooling. This does not involve the physical transfer of funds, but rather the set-off of balances of different companies within the group, so that the bank charges interest on the group’s net cash balance. This optimises the position of the group as regards interest payments, but does not achieve optimal allocation of liquid funds as between the group members.

Notional cash pooling will not result in the creation of intra-group loans, since funds are not physically transferred. As such, many of the risks outlined in this brochure do not apply to a purely notional cash pooling arrangement. In practice however, a notional cash pooling arrangement will frequently involve the grant of cross-guarantees and security by the participants to the bank, in order to maximise the available overdraft facility. To this extent, many of the risks outlined in this brochure could be relevant, even if the cash pooling arrangement is predominantly notional in nature.

The specific structure of individual cash pooling arrangements can vary. For example, transfers to the master account may be undertaken by each participating group member individually or may instead be undertaken automatically by the bank on the basis of a power of attorney given by the relevant group company.

In addition to the facility agreement with the respective bank, each participating group company will usually enter into a “cash pooling agreement”. These agreements must be carefully structured in order to minimise the risks of civil or criminal liability of the participating group companies and their officers. Tax issues must also be carefully considered when structuring cash pooling agreements.

This brochure provides an overview of the risks of civil/criminal liability associated with cash pooling in the various jurisdictions in which CMS is represented and discusses the various means by which such liability may be avoided.

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# Austria

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## 1. Legal framework for cash pooling

In Austria, risks of liability in relation to cash pooling arrangements arise if one of the companies involved becomes insolvent or if capital maintenance provisions are not complied with. The legal framework governing cash pooling in Austria comprises statute on the one hand and jurisprudence of the Supreme Court (“OGH”) on the other.

### a) Capital maintenance

A cash pooling arrangement must comply with the principle of capital maintenance and the resulting legal requirements. As a general rule, capital companies (i.e. limited liability companies (*GmbHs*) and stock corporations (*AGs*)) may not reduce their share capital by repaying contributed capital to the shareholders. Such a repayment will constitute an unlawful distribution under section 52 of the Limited Liability Companies Act (*GmbH-G*) and section 52 of the Stock Corporation Act (*AG*). Shareholders are only entitled to receive proceeds in the form of distributed profits (dividends) or funds (if any) remaining after satisfaction of liabilities to creditors on a liquidation of the company.

### b) Disguised unlawful distribution

A company is not permitted to make payments to shareholders (other than the distribution of the net profit as shown in the annual financial statements) or perform services to a shareholder in respect of which the company does not receive adequate remuneration (disguised unlawful distribution). If the shareholder receives

a benefit merely by virtue of his position as a shareholder, this constitutes a breach of the rule of capital maintenance. Transactions between the company must be conducted at arm’s length. The relevant test here is whether the directors are acting with the due care which a prudent businessman would have acted with if he made the same deal in the same circumstances with a third party not affiliated to the company.

The general terms and conditions of banks in Austria often require the grant of guarantees by affiliated companies. A company which guarantees the debts of the parent or another affiliated company could be breaching the rule of capital maintenance if such guarantee is not justified. In order to assess whether such guarantee is justified, the directors of the company providing the guarantee must rate the credit standing of the parent/treasury company. Furthermore, a company granting loans to – or guarantees in respect of the obligations of – other group companies or shareholders must receive adequate consideration. It is unclear what is deemed adequate. Standard interest rates are generally the minimum but may not always be appropriate, since the company in question is not normally a bank and therefore has a different risk structure.

In a decision in 2005, the Austrian Supreme Court ruled that such a guarantee may be justified by the specific internal/operational characteristics of a company. In this case, a limited liability company and its minority shareholder took out a loan together. Both were liable for the complete repayment, even though the

funds were used solely by the individual and not the company. The company, acting as co-debtor, essentially performed the function of a guarantor. The Court decided that although the company had not received adequate remuneration for acting in this capacity, the close economic collaboration between the company and the shareholder (close to interdependence) justified the transaction and the risk incurred.

### c) Equity substitution law

If a shareholder grants a loan to a company in financial difficulty (i.e. loss of creditworthiness or need for an additional equity contribution), such loan will be regarded as equity capital. As a consequence, the shareholder is not entitled to repayment of the loan for as long as the company remains in financial difficulty. Any such repayment constitutes a disguised unlawful distribution.

In 2004 the Equity Substitution Act was enacted. This Act imposes a freeze on the repayment of equity-substituting loans granted by a shareholder who has a controlling position (as defined in section 5 of the Act), an indirect shareholder or an affiliated company. Equity-substituting loans are loans granted by such persons during a period of financial difficulty (defined as insolvency, over-indebtedness or an equity capital ratio below 8%) together with a fictive period for the satisfaction of debt of more than 15 years).

## 2. Liability risks

If payments are made in breach of the principle of capital maintenance by way of a (disguised) unlawful distribution, the company will have the right to claim repayment. Such breach also leads to personal liability of the directors and possibly also of the (indirect) shareholders of the companies involved. The risks of liability become particularly significant in the event of insolvency of the companies concerned or where any of the companies concerned are sold.

### a) Liability of directors

The directors of a company are liable for any losses incurred by the company which arise from their failure to apply the due care of a prudent businessman in managing the company's affairs. In relation to cash pooling, the requirement to act with the due care of a prudent businessman means that the company should only participate in the cash pooling arrangement if it can be ensured that the company's liquidity will not be adversely affected by its participation and that the funds the company transfers will be repaid. This requires regular, up-to-date information on the financial situation of all participating companies to be available. If the group has solvency problems, then the cash pooling agreement should be terminated. Furthermore, as mentioned above, the directors are personally liable if, in contravention of the capital maintenance provisions, payments are made out of company assets in favour of a shareholder without the company receiving equivalent remuneration.

In respect of stock corporations, it is unclear whether the company may waive such claims by unanimous resolution of the shareholders (if this can be obtained). In any event however, claims by creditors cannot be waived by the company and will not be affected by any such resolution. In general, a director's liability cannot be waived before five years have elapsed.

The directors of limited liability companies are bound by any instructions issued by the shareholders' meeting. Directors acting in accordance with such instructions are generally not liable unless the instruction – and therefore its implementation – contravenes the law. Furthermore, directors remain liable to the extent that compensation is needed to settle claims of creditors.

### b) Liability of the parent company's directors

The directors of the parent company may be personally liable in the event of insolvency of a subsidiary if they have

interfered in a manner threatening the company's existence or, in the case of a limited liability company, they have issued unlawful instructions (by way of shareholders' resolutions).

### c) Extent of due diligence to be conducted by the pool bank

In case of collusion in relation to a disguised unlawful distribution, the company has the right to refuse the repayment of a loan to the bank. The Austrian Supreme Court has stated in a decision in 1996 (*Fehring* case) that a participating third-party loan creditor (such as the pool bank) has a general duty to make enquiries. Such duty would be fulfilled by the bank requesting information from the boards of the company. However, the decision of the Austrian Supreme Court in 2005 (referred to above) limits this duty to cases where there is strong suspicion of disguised unlawful distribution.

### d) Further risks

Under Austrian law, cash pooling may trigger stamp duties in the amount of 0.8% of the loans granted. Furthermore, it is unclear to what extent the grant of shareholder loans constitutes a banking operation requiring a banking licence. This is particularly relevant for the parent company (or any special treasury company) and its directors.

## 3. Legal structure to reduce liability risks

### a) Cash pooling agreement

In order to reduce the risks of liability arising from a cash pooling system, it is necessary for the cash pooling agreement to contain information and termination rights for each Austrian company involved. However, despite the 2005 ruling of the Austrian Supreme Court mentioned above (which only defined some crucial points), several issues remain open. Therefore the preconditions and the limits of a cash pooling arrangement are not clearly established.

### **(i) Risk evaluation before signing the cash pooling agreement**

In order to reduce their liability risks, the directors of the participating companies must satisfy themselves in advance that the benefits of the cash pooling arrangement (e.g. more favourable banking terms, better liquidity management etc.) outweigh the possible risks. It is particularly important to consider the solvency of the parent/treasury company and the other companies involved. A company planning to participate in a cash pooling arrangement should, at least, have access to the latest balance sheets of the other participating companies and obtain information in relation to the present and expected future profitability and financial situation of the group.

### **(ii) Rights to information while participating in the cash pooling arrangement**

The participating group companies will only be able to ensure timely repayment of the funds they transfer if they are continuously given information about the financial situation (in particular, the situation as regards liquidity) of the parent/treasury company and of the group. The cash pooling agreement should therefore include rights to information and of inspection in relation to matters affecting the cash pool.

### **(iii) Adequate interest payment and cost distribution**

The companies involved are either granting loans by transferring the liquid funds or they become borrowers by drawing upon the liquid funds. To ensure that such loans are issued on arm's length terms (to avoid disguised unlawful distribution), the receiving company must pay an adequate rate of interest. Furthermore, the costs of the cash pooling arrangement and moderate remuneration for the administrative services performed by the parent/treasury company should be split evenly between the members of the group.

### **(iv) Right to terminate the cash pooling arrangement**

The termination clause is essential. Austrian companies participating in a cash pooling arrangement should reserve the right to immediately terminate the cash pooling arrangement in respect of themselves and to be repaid funds they have contributed to the cash pool – even at very short notice – if the repayment of such contributions is (seriously) endangered by the financial situation of other participants. Furthermore, it should be agreed that payments from and to the participating companies may be set off against each other.

### **b) Facility agreement with the bank**

The facility agreement of the group with the bank should reflect the terms and conditions of the cash pooling agreement (namely the termination rights of each company) in order to reduce the risk of liability. Modifications of the conditions concerning the pool bank should only be permitted if all the participating companies agree – not just the parent company.

#### **(i) Limitation wording in respect of cross-guarantees**

In general, banking agreements include a provision that all participating group companies are liable jointly and severally for the balance on the master account or that they have to provide adequate security for their obligations. In addition, the general terms and conditions of banks always provide for a lien covering all accounts of each of the group companies with the bank. The group companies involved should avoid such joint and several liability. If this is not possible – due to the requirements of the account-holding banks – the liability should at least be restricted to the amount of funds drawn from the cash pool by the respective company. The liability of a company should be fully excluded to the extent that a claim jeopardises the existence of such company.

### **c) Warranties and representations in the event of the sale of a group company**

Where a group company which has been involved in a cash pooling arrangement is sold, the seller should ask for an indemnity regarding potential liabilities of the seller and the remainder of its group arising from the cash pooling arrangement. The seller should avoid any guarantee or indemnity with regard to capital maintenance provisions.

The buyer should ask for representations and warranties that the capital maintenance rules have been complied with (and for an indemnity in the case of contravention), since as a new shareholder, the buyer could be liable for payments previously made in contravention of the capital maintenance provisions.



# Belgium

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Although there are no specific provisions of Belgian law governing cash pooling agreements, a cash pooling arrangement could trigger the application of the Belgian corporate law provisions on social interest, capital maintenance, directors' obligations and corporate capacity.

## 1. Social interest

Under Belgian law, directors must exercise their function in accordance with the interests of the company. Should they fail to consider the company's interests, they may be held personally liable.

In various cases however, the Belgian courts have been willing to balance the interests of the company against those of the group as a whole and, increasingly, case law and literature recognises the concept of the "interest of the group." According to this concept, an individual group company is not to be treated in isolation without regard to the links which unite it with other companies in the group.

Whilst there is no strict legal definition of "interest of the group", a definition has been roughly outlined in case law and doctrine, and was confirmed by a judgment of the Court of Appeal of Brussels dated 29 June 1999. This judgment (which in fact related to a criminal law matter) outlines the circumstances in which a group company may incur a financial detriment to ensure the best possible coordination of the group's activities and the best possible results of the group as a whole. The case established that a group company can provide

financial support to another group company which finds itself in financial difficulty, provided that such support is justified taking into account the interest of the group as a whole does not endanger the existence of the company providing the support and is only provided temporarily.

However, the principle of "interest of the group" is subject to the following limits:

- ▮ The group cannot forfeit one of its subsidiaries in the sole interest of the group;
- ▮ The group cannot impose a long-term imbalance between the respective commitments of the companies in the group;
- ▮ The group must be well organised and structured and its members must have common financial and commercial objectives.

Furthermore, it remains at all times essential to maintain the balance between the interest of the group and that of the company providing the financial support.

## 2. Capital maintenance rules and directors' obligations

Article 633 of the Belgian Company Code provides that if the net assets of a company fall to a level below half its share capital, a shareholders' meeting must be convened by the directors within two months of their becoming aware of this fact, to consider whether the company should be put into liquidation. If the directors fail to

convene a meeting within the requisite time period, they will be responsible for losses to creditors which arise from transactions they enter into with the company after the latest date on which the meeting should have been called. The damages suffered by third parties are deemed to flow directly from this failure, unless evidence can be provided to the contrary. This is a significant risk that Belgian directors need to consider.

Article 634 of the Belgian Company Code applies when the net assets of a company fall below the legal minimum of € 61,500. In such circumstances, any interested party can make an application to the court under this article for dissolution of the company. The Court can grant the company a period in which to increase its assets to the legal minimum.

The obligation of the directors to convene a general meeting pursuant to article 633 applies not only at the time the annual accounts are prepared but endures throughout the financial year – for example on preparation of the interim accounts. However, this does not impose an obligation on the directors to take positive steps to check at any particular time whether or not the net assets of the company have fallen below the relevant thresholds.

As mentioned above, the directors of the Belgian company need to ensure that, when entering into a cash pooling arrangement, the balance is maintained between the interests of the company on the one hand and the interests of the group on the other. The interests of the company and the group will cease to be balanced if the Belgian company finds itself in either of the situations referred to in articles 633 and/or 634 of the Company Code. In several cases, the courts have been of the opinion that in such circumstances, the interests of the Belgian company may not be compromised for the benefit of the interest of the group.

### 3. Corporate capacity – objects clause

The articles of association of a Belgian company should include the objects of the company. The authority of the company's board of directors is limited by such corporate objects, i.e. the board of directors may only act on behalf of the company if their actions fall within the scope of the company's objects. If the board takes any action that is outside the scope of the company's objects, then the directors may be held liable to the company and third parties. Under Belgian law, cash pooling activities need not be expressly included in the company's objects. However, it is necessary that the objects clause allows the company to lend and borrow monies to and from other companies, and (if applicable) grant guarantees.

### 4. Interest rate

If the Belgian company contributes to the cash pool (rather than simply benefiting from funds contributed by others), then it is absolutely necessary that the cash pooling agreement specifies the interest rate at which the Belgian company contributes such funds. This interest rate should not be lower than the official interest rate, since an interest rate which is lower than the official rate might not be considered to be in the corporate interest of the Belgian company.

### 5. Rules restricting companies' indebtedness for creditor protection purposes

Although there are no specific rules restricting the extent of a Belgian company's indebtedness (i.e. no thin capitalisation rule), the directors of a Belgian company have a specific duty to preserve the company's assets and to refrain from entering into transactions that may adversely affect the financial viability of the company or its assets. The directors of a Belgian company must therefore carefully evaluate all possible consequences of the company's

participation in a cash pooling arrangement in order to ensure that they comply with this duty. In particular, the directors must consider – with reference to the contractual structure of the cash pooling arrangement – the extent of the risk that the Belgian company will be unable to recover sums it has contributed to the cash pool.



# France

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## 1. Legal framework for cash pooling

In France, the legal framework in which cash pooling operates consists of rules imposed by banking regulations and by company law.

### a) Requirements imposed by banking regulations

At first sight, cash pooling would appear to fall within the activities reserved exclusively to banks in France under the Monetary and Financial Code (*Code monétaire et financier*). However, Section L 511-7,1,3° of the Monetary and Financial Code sets out some exceptions to this rule. In particular, the section provides that an enterprise, whatever its nature, may “undertake cash transactions with companies which have with it, directly or indirectly, ties by way of share capital which confer on one of the affiliated enterprises an effective power of control over the others.”

Whilst space does not permit a full analysis of this provision here, disputes in relation to the application of this provision have been rare in recent years.

### b) Requirements imposed by company law

Three requirements arising from French company law are usually considered in connection with cash pooling arrangements:

▮ The first is the requirement relating to corporate capacity. A French company must have the power under its corporate objects to enter into a cash pooling arrangement. In practice,

French companies usually have extensive objects, allowing all types of activities. It is therefore difficult to imagine this issue giving rise to litigation in connection with a cash pooling arrangement.

▮ The second matter to consider is whether the cash pooling agreement requires approval of the company’s board of directors as a “regulated contract” in accordance with Section L 225-38 of the Code of Trade (*Code de Commerce*). This section provides that “every contract entered into directly or through an intermediary between the company and its general manager, one of its delegated general managers, one of its administrators, one of its shareholders holding a proportion of voting rights higher than ‘10%’ or, where it is the matter of a shareholder company, the company controlling it within the meaning of Section L. 233-3 must be subject to the prior consent of the board of directors.”

Only current contracts entered into under “normal requirements” are beyond this procedure. A cash pooling arrangement will be entered into under normal requirements if the participating companies receive interest at the market rate on cash which they transfer to the pool.

Further, it must be considered whether the cash pooling arrangement qualifies as a current contract. Whilst some case law affirms this, there is still some scope for doubt.

Finally, it is necessary to ensure that the cash pooling arrangement is in the corporate interest of the participating French companies. This is a matter which must be carefully assessed. The difficulty associated with establishing a corporate interest has been eased by recent case law recognising the concept of a “group interest” (see below).

## 2. Risks of directors’ liability

There are a number of liabilities which the directors of a French company participating in a cash pooling arrangement should consider:

### a) “Abuse of majority” and consequences

A contract can be declared void for “abuse of majority” if it becomes contrary to the interests of such company. This annulment of a decision of a general meeting can give rise to a claim for damages on behalf of the minority shareholders against the directors who originate the operation.

However, it is difficult to find examples in case law of contracts declared void on these grounds.

### b) “Abuse of corporate property”

The major risk for directors of French companies participating in a cash pooling arrangement is potential liability for “abuse of corporate property”, i.e. use by the directors of corporate property or funds in bad faith in a way which they know is contrary to the company’s interest. This is a risk which particularly concerns French directors, due to the heavy sanctions which can be imposed – namely imprisonment for up to five years and/or a fine of up to € 375.000.

This raises the question of whether the director of a subsidiary, who approves the transfer of funds by such subsidiary to another group entity under a cash pooling scheme, is guilty of abuse of corporate property. If only the individual interests of each participating group

member are to be considered, the criminal risk is significant since the transfer of funds to another entity is made in the interest of the other participating group companies. On the other hand, the operation may appear perfectly lawful if one takes into account the interests of the group as a whole.

Case law has developed a number of criteria to be considered in this respect. In the well-known “Rozenblum” case, the Court of Criminal Appeal (*Chambre Criminelle de la Cour de Cassation* – French Supreme Court) set out three criteria to be considered when deciding whether cash advances between companies within the same group will constitute an abuse of corporate property:

Cash advances between companies within the same group must be remunerated with a sufficient rate of interest and permitted within the framework of a policy developed in respect of the group as a whole. However, this must be a genuine group and it is necessary that the group complies with these requirements in practice – it will not suffice that such requirements are only fulfilled “on paper”;

Further, it is essential that any financial detriment incurred by one company for the benefit of another must have been incurred for the economic, corporate and financial interests of the group as a whole, for the purposes of preserving the balance of the group and the continuation of the policy developed for the group as a whole;

Finally, a company cannot incur a financial detriment for the benefit of another if, in incurring such detriment, the existence or the future of such company is threatened.

The Court of Criminal Appeal (*Chambre Criminelle de la Cour de Cassation* – French Supreme Court) has followed this precedent in all subsequent cases on this matter.

### c) Risk of failing to provide market with requisite information

Whilst there is little case law on this point, the Court of Appeal of Paris ruled in a decision dated 2 March 2004 that a cash pooling arrangement could have the effect of masking a state of financial dependence of a subsidiary on its parent company. In the judgment, the court reproaches the director of the subsidiary for having breached its duty to provide exact, precise and sincere information to the public by failing to disclose the true situation.

### d) Risk of insolvency and compulsory winding-up

The mixing of funds in a cash pool can cause a risk of uncertainty as regards ownership of such funds and can ultimately lead to insolvency proceedings instigated against one company being extended to other members of the group. Obviously, the existence of a cash pooling arrangement does not automatically result in such uncertainty. Such uncertainty will generally only arise where the flow of funds between participants in the pool is affected by a significant number of unusual transactions or circumstances (for example default on repayments or debt waiver).

The trend of judges in France, and notably those of the *Cour de Cassation* (French Supreme Court), is to set a high standard for compliance in respect of the aforesaid provisions.

## 3. The reduction of the liability risk

Generally speaking, there are three ways in which the risk of liability can be reduced. These include the appropriate choice of a centralising entity, formalisation of the cash pooling arrangement in a written agreement and the observance of certain precautions when drafting the cash pooling agreement.

### **a) The choice of a centralising entity**

There are several options in relation to the choice of centralising entity.

The centralising entity could be the parent company. The disadvantage of this is that the interest of this company may appear excessively enhanced in comparison with the interests of other entities. This solution is likely to significantly strengthen the position of the parent company.

We can also envisage the use of an Economic Interest Grouping, a structure of cooperation which is more egalitarian.

Whatever the choice of centralising entity, the involvement of a bank in the cash pooling arrangement is advisable, since a bank will be able to provide real-time information about the balances on the sub-accounts of the various companies participating in the cash pooling arrangement.

### **b) Formalisation of the cash pooling arrangement in a written agreement**

It is generally considered that for evidence reasons, rights and obligations of the companies participating in a cash pooling arrangement should be set out in a written cash pooling agreement. In the absence of a written document, it may be difficult to provide evidence of the participating companies' respective rights and obligations.

### **c) Precautions to be taken in relation to written agreements**

As mentioned above, the cash pooling agreement must specify that interest is payable to the companies contributing funds to the cash pool.

In addition, a cash pooling agreement should clearly state its duration and include provisions governing the ability of each French company to withdraw from the agreement if participation in the cash pool ceases to be in such company's interests. Finally, it is important that the circumstances in which a company will become automatically excluded from the cash pooling operations are defined.



# Germany

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In Germany, the risks associated with cash pooling have increased considerably in recent years as a result of the decision of the Federal Court of Justice in the *Bremer Vulkan* case in 2001.

Cash pooling arrangements must now be carefully structured in order to minimise the risk of civil and criminal liability of the shareholders and officers of the participating companies.

## 1. Legal framework for cash pooling

The risk of civil or criminal liability is particularly great where one of the companies participating in a cash pooling arrangement has insufficient liquidity or where certain capital maintenance requirements are not met.

### a) Liquidity protection

In the *Bremer Vulkan* case, subsidies received by a group company were pooled for the benefit of other members of the group. In subsequent insolvency proceedings relating to the group, the court held that the pooling of the subsidies in this way constituted a “plundering” of the relevant group company’s assets by the members of the group who benefited from the pooled subsidies. The court held that not only the parent company, but also its shareholders, were personally liable to the creditors of the insolvent company in accordance with the general German principal of “interference threatening corporate existence”. The court also held that the members of the board of directors and the supervisory board of all companies,

including the parent company, were criminally liable for failing to act in the company’s best interests.

### b) Capital maintenance

In a further decision in 2003, the Federal Court of Justice held that a German private limited liability company (*GmbH*) may not provide loans to its shareholders where it has a “sub-balance”, i.e. where the net assets of the GmbH have fallen to a level below the registered amount of share capital (in the case of a GmbH, the registered share capital must not be below € 25,000). Whilst this decision did not directly concern a loan provided in connection with a cash pooling arrangement, it clearly has implications for loans provided in a cash pooling context.

### c) Significance of the case law in the context of cash pooling

The principles outlined in a) and b) above apply even where the cash pooling arrangement aims to serve the well-being of the group as a whole. If either the group as a whole or individual group members subsequently become insolvent, it will always be possible to argue that the companies which provided funds were “plundered”.

In the context of a corporate group, the 2003 decision means that a subsidiary in the form of a GmbH which has a sub-balance may not issue any further loans to its shareholders. The repayment by the GmbH of existing loans made to it by a shareholder on terms which are not arm’s length is also prohibited in such circumstances. As a result, it will be necessary to exclude a

GmbH with a sub-balance from cash pooling arrangements, unless the cash pooling arrangement has been entered into at arm's length.

Unless the latest accounting reference date is fairly recent, a new balance sheet must be drawn up for the purposes of ascertaining whether the GmbH has a sub-balance.

It is unclear if and how the above decisions apply when the parent company has good financial standing, and/or it has concluded a control, profit and loss transfer agreement with the subsidiary in question (i.e. they are "conjoined companies"). Nor is it clear whether the prohibition on the grant of loans to shareholders applies only in circumstances where there is a pre-existing sub-balance which is increased by the loan, or whether it also applies where the loan is the cause of the GmbH's sub-balance.

#### **d) Relaxation of restrictions in the case of a conjoined company group**

In the case of cash pooling arrangements between German public companies (*Aktiengesellschaften*), the capital maintenance requirements described in b) above do not apply, provided that the companies concerned have entered a control, profit and loss transfer agreement with the parent company. It is not currently clear whether this relaxation of the capital maintenance provisions also applies to GmbHs. The majority view is that it does.

The liquidity protection provisions described in a) above will apply regardless of whether a control and profit and loss transfer agreement exists.

## **2. Liability risks**

A breach of the capital maintenance or liquidity protection requirements results in personal liability of the officers, and possibly also the direct, indirect and ultimate shareholders, of the companies involved. In contrast to liability for other

failures to act in the interests of the company, it is not possible for shareholders to vitiate this liability in a general meeting. The risk of liability becomes particularly significant if one of the participating companies becomes insolvent, or is sold, since it is at this point that an insolvency administrator or the incoming directors of the sold company may pursue such claims.

#### **a) Liability of directors of subsidiaries**

The directors of a company are liable for any loss to the company which occurs as a result of their failure to manage the affairs of the company with the care of a prudent businessman. In the context of cash pooling, this standard will only be met if the company has taken adequate steps to ensure the repayment of the funds it has contributed to the cash pool. This necessitates termination of the company's participation in the cash pooling arrangement if there is a risk of the group becoming insolvent.

Furthermore, the directors have a specific obligation to compensate the company if, in contravention of the capital maintenance provisions, payments are made which result in a sub-balance of the company. It is not possible for the shareholders to vitiate this liability in the name of the company, either in general meeting or otherwise. However, a shareholder could agree to indemnify the directors in such circumstances.

#### **b) Liability of the parent company and its directors**

The direct and indirect shareholders of a company are liable to the company's creditors to the extent that, as a result of the cash pooling arrangement, the company no longer has sufficient liquidity to satisfy its obligations to its creditors.

In addition, the directors of the parent company could be personally liable in the event of insolvency of a German company participating in the cash pooling arrangement.

## **3. Legal structure and reduction of risks**

### **a) Facility agreement**

In order to reduce the risk of liability associated with a cash pooling arrangement, careful consideration must be given to the rights of the participating companies as regards provision of information and termination (see below). However, given that the law relating to cash pooling in Germany is still being developed, it will not be possible to eliminate all risk entirely.

#### **(i) Right to information**

The companies participating in a cash pooling arrangement require continuous up-to-date information relating to the liquidity of the parent/treasury company and the other participating companies if they are to ensure that funds they contribute to the cash pool will be repaid.

One common arrangement is for the parent/treasury company to provide the participating companies with monthly financial statements for the parent and the group as a whole (usually by the 10th day of each subsequent month), and with liquidity plans on a weekly basis (usually by midday on the preceding Friday).

#### **(ii) Right to terminate the cash pooling arrangement**

The right of a company to terminate the cash pooling arrangement at any time in respect of itself and to be repaid any funds it has been provided to the cash pool within 24 hours is of vital importance.

#### **(iii) Option to set off payments for periods against amounts owed under profit and loss transfer agreements**

As a result of the most recent case law in this area, it is advisable to agree from the outset that payments made by the parent company to its subsidiaries under the cash pooling arrangement may be set off against any existing (or

future) obligation of the parent under any profit and loss transfer agreement to transfer funds to cover losses of the subsidiary.

#### **b) Cash pooling agreements with the individual participating companies**

In addition, the agreement(s) entered into by the individual participating companies will need to back-to-back with the facility agreement if liability is to be avoided.

##### **(i) Termination rights of individual participating companies**

Cash pooling arrangements will often envisage that only the parent company may submit valid legal notices to the bank in respect of the cash pooling arrangement. It is important that this general rule does not prevent an individual participating company from terminating the individual cash pooling agreement to which it is party. Moreover, it is important that this termination right is synchronised with a corresponding right of the individual company in the facility agreement to terminate the facility agreement in relation to itself.

##### **(ii) Joint and several liability and security**

As a rule, individual cash pooling agreements provide that the participating group companies are jointly and severally liable for any negative balance on the master account and require them to provide security. In addition, the standard terms and conditions used by banks in Germany contain provisions creating liens over all accounts of each of the group's companies with the bank. If possible, the participating companies should avoid such joint and several liability and security and should seek an exception from the lien-creating provisions of the standard terms and conditions. If this is not possible, then the

company's liability should be restricted at the very least to the lesser of (i) the actual amount of funds drawn from the cash pool by the company at any one time and (ii) the amount by which its net assets exceed its minimum required level of share capital as prescribed by law at any one time. The liability of a company should also be fully excluded to the extent that a claim jeopardises the existence of such company.

##### **c) Restructuring of the group**

It may be possible to reduce liability risks by restructuring the group (for example, by structuring the group as a conjoined company group consisting only of public companies, by reducing its minimum permitted share capital to the legal minimum level of € 25,000 or by merging individual companies).

##### **d) Liability on a sale of a group company**

If a company which has participated in a cash pooling arrangement is sold, the seller will usually ask for an indemnity regarding potential liabilities arising from the cash pooling arrangement which the seller and the remaining members of the group may have in respect of the target company.

The buyer will usually request an indemnity in relation to capital maintenance matters, since it will be liable as an incoming shareholder for any payments previously made in contravention of capital maintenance provisions. A seller will usually try to resist such indemnity.

#### **4. Tax issues**

In the case of physical cash pooling, interest may be payable on sums lent and borrowed by the participating companies. Such interest payments will be subject to the usual tax rules regarding interest – in particular, taxation of interest earned on sums

lent, deductibility of interest incurred on sums borrowed and thin capitalisation issues.

Moreover, a cash pooling arrangement may give rise to hidden distributions if interest on sums lent or borrowed is not payable or is payable at less than market rate (or if additional non-remunerated services are provided in connection with the cash pooling arrangement).

#### **5. Discussed legislation reform**

At the moment an amendment of the German Limited Liability Companies Act (GmbH-Gesetz) is under discussion. One of the amendments regards cash pooling: the strict rules of capital maintenance, in particular since the decision of the Federal Court of Justice in 2003, shall not be applicable if cash pooling is in the interest of the company and if the claim arising from the cash pool is fully recoverable. It is not foreseeable at the moment if this amendment will become law or if the case law will accept this rule.



# Italy

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Although there are no specific provisions governing cash pooling arrangements under Italian law, a cash pooling arrangement could trigger the application of Italian corporate law provisions on capital maintenance, financial assistance, inter-company loans and group “direction and coordination” activities.

## 1. Corporate objects and benefit, financial assistance and recovery of funds

Every transaction which an Italian company enters into must be permitted by the company's articles of association and, in particular, must fall within the company's objects as set out in the articles of association. It is therefore important that the objects of the Italian company allow the company to lend and borrow monies to and from its affiliates and provide the guarantees often required in connection with a cash pooling arrangement.

In addition, Italian law prevents an Italian company from entering into an agreement for the provision of financial support to its parent company and/or another company in its group (including the provision of guarantees to third parties in respect of obligations of such other company), unless it receives some kind of consideration in return or it can be reasonably expected that it would gain some other direct or indirect benefit from the transaction. As such, a company joining a cash pooling arrangement cannot contribute funds to the cash pool and/or grant a guarantee or security over its assets in connection with such arrangement

(including over its commercial accounts receivable), unless it has an immediate and autonomous interest in doing so. If the company does not have such an interest, this may result in:

- ▮ the company's directors being liable to the company, its shareholders and its creditors for any damages or losses they may suffer as a consequence; and
- ▮ the relevant agreement(s) being declared void.

It should also be noted that where an Italian company contributes funds and/or provides guarantees or has obligations which are in some way connected to the financing or the repayment of debts incurred for the acquisition of such company, then such contribution and/or guarantee and any connected security granted may constitute financial assistance in contravention of Article 2358 of the Italian Civil Code and as a result may be declared void.

Finally, it should also be noted that if the Italian participating company contributes funds to the cash pool (rather than simply benefiting from contributions made by other participating companies), the cash pooling agreements between the participating group companies must enable the Italian participating company to easily and promptly recover funds transferred to the various other participating companies under the arrangement.

As a result of the above, it is necessary for the directors and the internal auditors (*membri del Collegio Sindacale*) of the Italian participating company to carefully consider (i) whether the

company has an interest (direct or indirect) in entering into the cash pooling arrangement and in providing any connected guarantee; and (ii) the circumstances in and conditions on which the relevant arrangements can be entered into.

Directors who have a conflict of interest in the cash pooling arrangement (e.g. directors who sit on the board of more than one participating company) must disclose this conflict and refrain from voting in the relevant board meeting of the Italian participating company.

## 2. Capital maintenance rules

A cash pooling arrangement could also trigger the application of Italian corporate law provisions on capital maintenance.

Particularly relevant here are Articles 2467 and 2497 *quinquies* of the Italian Civil Code, which relate to loans granted to an Italian company by its shareholder(s)/controlling company. These provisions apply when either:

- ▶ with regard to the type of business undertaken by the Italian borrowing company, the debt/equity ratio of such company appears unbalanced; or
- ▶ the financial condition of the Italian borrowing company is such as to merit a capital contribution.

If either of the above circumstances apply:

- ▶ the rights of the shareholder(s)/controlling entity to repayment of such loans will rank behind claims of any other creditors of the Italian borrowing company; and
- ▶ if an insolvency order is made in relation to the Italian borrowing company, then any repayment made in respect of such loans by the Italian borrowing company in the year preceding the insolvency order will be automatically revoked and any sum received by the lender must be repaid by the lender to the liquidator of the Italian borrowing company.

In the context of cash pooling therefore, if the Italian participating company is subject to enforcement, liquidation and/or insolvency proceedings, the rights of any shareholder(s)/controlling entity of the Italian company to repayment of funds provided to the Italian company under the cash pooling arrangement will rank behind the other debts of the Italian company and, in the case of insolvency of the Italian company, all repayments made by the Italian company to its shareholder(s)/controlling entity under the cash pooling arrangement in the previous year must be repaid to the liquidator.

Although there are no precedents on this matter, it is generally considered that “shareholders” in this context means direct shareholders of the company and that therefore the above requirements do not apply to loans granted to the Italian company by persons who have only an indirect shareholding in the company and who do not exercise control over it.

## 3. Rules restricting companies’ indebtedness for creditor protection purposes

Although there are no specific rules restricting the companies’ indebtedness, directors of Italian companies have a specific duty to preserve the company’s assets and to refrain from entering into transactions that may adversely affect the financial viability of the company or its assets.

In light of this, the directors of an Italian company must carefully evaluate all possible consequences of the company’s participation in a cash pooling arrangement in order to ensure that they comply with this duty.

In particular, the directors must consider – with reference to the contractual structure of the cash pooling arrangement – the extent of the risk that the Italian company will be unable to recover sums it contributes to the cash pool (e.g. in the case of insolvency of the group company which holds the master account).

In practice, the cash pooling agreement will commonly provide that the Italian participating company will only contribute such funds to the cash pool as exceed its net asset value (as stated on the latest annual financial statements), in order to preserve the rights of its creditors.

Other solutions (e.g. the provision of security by third parties such as banks or third-party companies) may however be adopted in order to limit the risk that the Italian company becomes unable to meet its obligations where funds it contributed in the cash pooling system become irrecoverable.

## 4. Direction and coordination

Under the provisions of Article 2497 et seq. of the Italian Civil Code, if a controlling company “induces” (i.e. forces, procures, causes, etc) an Italian subsidiary to enter into a transaction that is not in the best interests of such subsidiary, then the controlling company and any other person (legal or natural) involved in the transaction could be jointly liable towards the creditors of the subsidiary for any loss such creditors suffer as a result of such transaction.

In addition, any persons who benefited from, or took advantage of, the transaction may be liable to indemnify the creditors of the subsidiary, although only to the extent of the advantage or benefit they derived from such transaction. In other words, the rules of the Civil Code referred to above may enable the creditors of the Italian subsidiary to bring a claim against any group entity that participated in or benefited from the transaction, if such transaction is contrary to the Italian subsidiary’s interest and capable of causing loss to its creditors. In considering whether any other group entity benefited from the transaction it will frequently be necessary to consider the means in which any surplus in the master account is used (for example, it might be invested) and the criteria on the basis of which the participating companies benefit from such surplus. It should also be noted that the decision to enter into a cash pooling agreement is normally taken by the board of

directors, which must consider all implications of the transaction for the company as regards the matters discussed above. In any event, where the board of directors of a subsidiary passes a resolution approving certain action to be taken by that subsidiary which is wholly or partly for the benefit of one of its controlling companies, then the resolution must set out in detail the reasons and benefits which justify the decision taken and must analyse the pros and cons of such decision (Article 2497<sup>ter</sup> of the Italian Civil Code).

Requirements also exist in relation to information to be disclosed in the explanatory notes to the annual accounts and the directors' report.

Finally, if the Italian company is owned by a sole shareholder, then any agreement between the company and this shareholder will be unenforceable vis-a-vis the company's creditors, unless minutes exist of the meeting of the board of directors at which the agreement was approved or the agreement bears a date which is certain at law (e.g. the agreement has been executed and dated before a notary or bears a Post Office date stamp) and such date precedes the commencement of enforcement proceedings against the company.

## 5. Filing obligations

A communication (*comunicazione valutaria statistica*) must be made to the Bank of Italy (which has now incorporated the UIC – Italian Exchange Office) in respect of any cash transaction involving an Italian company and a foreign counterparty. An additional communication must be made in respect of cash pooling arrangements which allow for the set-off of intra-group credit and debt positions.

In addition, for anti-money laundering purposes, Italian laws and regulations require that any transfer of funds exceeding € 12,500 must be notified to the UIC Bank of Italy.

If cash transfers are effected via an Italian bank or any other financial intermediary, then the necessary communication(s) should be made by the intermediary on behalf of the participating companies.



# The Netherlands

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## 1. Legal issues associated with cash pooling

No specific statutory framework exists under Dutch law in relation to cash pooling, nor has cash pooling given rise to discussion in case law. The rules applicable to cash pooling are based on generally applicable provisions of the Dutch Civil Code (“DCC”). The following provides an overview of the provisions of the DCC that may affect cash pooling in the Netherlands. Our overview has been limited to the civil law framework and as such does not extend to regulatory, fiscal and insolvency matters relating to cash pooling.

### a) Corporate objects/*ultra vires*

The authority of the board of directors of a Netherlands company (the “Board”) is limited by the corporate objects set out in the company’s articles of association. Contracts entered into by the Board which are outside the scope of the company’s objects (i.e. *ultra vires*) may be rendered void by the company (or by the company’s trustee in the case of insolvency), if it can be established that the contractual partner was aware, or should reasonably have been aware (without making any further enquiry), that the contract was *ultra vires*.<sup>1</sup>

In general, the fact that a company’s articles of association have been filed with the commercial register will not automatically result in constructive awareness of their content by the contractual party. However, case law suggests that financial institutions may, under certain circumstances, be under a stricter obligation to inquire whether a transaction falls outside the scope of

the company’s objects<sup>2</sup>, for example where a financial institution grants a credit facility to a corporate group (or to a part of such group). In light of this, financial institutions will usually verify the articles of association of the companies involved in a cash pooling arrangement prior to the entering into such an arrangement.

One of the objections raised against cash pooling (particularly zero balancing arrangements) in the Netherlands is that the companies involved potentially worsen their financial positions by giving up their financial independence and that therefore such arrangements may be outside the scope of a company’s objects. Even where, in the context of a cash pooling arrangement, a parent company grants a loan to a subsidiary to enable the subsidiary to pay its creditors (thus benefiting such subsidiary), it cannot be ruled out that the parent company will be acting outside the scope of its objects.

However, in 2003, the Supreme Court of the Netherlands ruled that a credit facility provided to an ultimate parent company by a third party for the purposes of supporting the activities of the group will generally be considered to be for the benefit of all companies within the group.<sup>3</sup> On the basis of this ruling, it can be argued that if the cash pooling arrangement serves to support the activities within the group, then all the companies involved can be deemed to benefit from it (even if it is a zero balancing arrangement) and therefore even if the companies relinquish a certain amount of financial independence in connection with it, it does not necessarily conflict with the corporate objects of the relevant companies.

<sup>1</sup> Note that the other party to the contract does not have a right to claim that the contract was *ultra vires*; this is an exclusive right of the company.

<sup>2</sup> Court of Appeal of Amsterdam, 22 March 1984, NJ 1985, 219 (Nesolas) and 27 November 1986, 1987, 801 (Credit Lyonnais Bank).

<sup>3</sup> Supreme Court, 18 April 2003, JOR 2003/1160.

In establishing whether the Board's actions are ultra vires, all the surrounding circumstances (e.g. commercial and factual matters) must be taken into account – it is not sufficient to simply look at the wording of the corporate objects clause in the articles of association.

If, under the cash pooling arrangement, intra-group guarantees are given (with or without security) by the participating companies, then it is necessary to ensure that (i) the company concerned derives a corporate benefit from the obligation of the third party in respect of which the guarantee is provided<sup>4</sup>, and (ii) such company's existence is not threatened by the provision of such guarantee. In general, a company will be deemed to benefit from the provision of such guarantee if a strong financial and commercial interdependence exists between the company and the other group members and the company's existence is not foreseeably endangered by allowing the bank such recourse.

If and to the extent there appears to be an imbalance between the commercial benefit gained by the company and the detriment it would suffer if the guarantee was called upon, then the company (or its insolvency trustee) will be able to contest the guarantee's validity. This is so, irrespective of the wording of the objects clause in the articles of association.

It should be noted however, that there is no unanimous view in Dutch legal doctrine as to the benefit required. Therefore, it cannot be ruled out that even if there is a strong financial and commercial interdependence referred to above, a transaction might be declared void by the Dutch courts if it is evident that the transaction cannot serve the realisation of the company's objects.

In light of the above, it is always advisable to include wording in the recitals of the cash pooling agreement

which explicitly refers to the economic and commercial benefits for the company in entering into the agreement.

### b) Conflict of interest

A conflict of interest can arise if individuals sit on the Board of more than one of the group companies participating in a cash pooling arrangement<sup>5</sup>.

Dutch law provides that in the event of a conflict of interest between the company and the members of its Board, the company may be represented by the supervisory board<sup>6</sup>, unless the articles of association provide otherwise<sup>7</sup>. Alternatively, the general meeting of shareholders has the power at all times to appoint a person to represent the company in the event that conflict of interest occurs.

In practice, the articles of association would usually provide that if a company enters into a transaction with another company in its group, the members of the Board remain authorised to represent the company. (This does not affect the right of the shareholders to appoint an alternative company representative). Pursuant to Dutch case law, a contravention of the rules regarding conflict of interest will lead to the underlying transaction being voidable at the instance of the company (or its insolvency trustee). The Supreme Court of the Netherlands has ruled that there will be a conflict of interest if a member of the Board cannot safeguard the interests of the company concerned completely and objectively<sup>8</sup>.

It is therefore prudent to arrange for the general meeting of shareholders of the participating Dutch company to specifically appoint a representative of the company for the purposes of the entering into cash pooling arrangements. This representative may also be a member of the Board.

### c) Capitalisation requirements

Under the DCC, a Dutch company may only make distributions to the extent that its "equity capital" (i.e. share capital, share premium and reserves) exceeds the aggregate of its paid-up share capital and its reserves, which in turn must be maintained according to the statutory requirements and any requirements contained in the articles of association of the company. A resolution in respect of a distribution which is adopted by the general meeting of shareholders of the company or its Board in breach of these requirements may be void or voidable.

However, if monies transferred at the end of each business day are construed as a loan under a cash pooling arrangement rather than a distribution of profits, these conditions do not apply.

### d) Fraudulent act (*actio pauliana*)

It could be argued that cash pooling arrangements are detrimental to creditors of the companies involved, since where credit and debit balances of all participating companies are consolidated, the company will no longer receive any interest on any credit balance it might otherwise have had. The creditors of the company (or its insolvency trustee) could annul such a cash pooling arrangement if they can demonstrate that this arrangement constitutes a fraudulent act within the meaning of article 3:45 DCC. Under this article, a legal action is fraudulent if the debtor performed an act without an obligation to do so and knew or should have known that this act would be detrimental to its creditors. Any creditor of the company can then challenge the validity of such legal action, irrespective of whether such creditor's claim arose before or after the legal act was performed.

However, if other arrangements are made between the group companies to

<sup>4</sup> Supreme Court, 20 September 1996, NJ 1997, 149 (Playland) and 16 October 1992, NJ 1993, 98 m.nt. Ma.

<sup>5</sup> In general, a conflict of interest can occur if (i) a company enters into a transaction with a member of the Board or with a party in relation to whom a Board member has a specific interest ("personal" conflict of interest); (ii) a member of the Board is the parent company and both companies enter into a transaction with a third party; or (iii) a member of the Board acts on behalf of several parties to an agreement in its capacity of a Board member ("qualitative" conflict of interest).

<sup>6</sup> Under Netherlands law, the general role of the supervisory board is to supervise the company's management and the course of the company's business generally.

<sup>7</sup> Article 2:146/256 DCC.

<sup>8</sup> Supreme Court, 29 June 2007, C06/041 HR.

compensate the companies with a credit balance, it could be argued that the cash pooling arrangement is not detrimental to the creditors of such companies.

## 2. Board liability

Under the DCC, the Board of a company involved in an intra-group cash pooling arrangement is, in principle, under an obligation to avoid insolvency of that company.

### a) Mismanagement

Under the DCC, each member of the Board has the duty to act in accordance with certain principles of fair management. Non-compliance with these principles may constitute contravention of the corporate objects of the company if such non-compliance results in a serious loss to the company's creditors. This will constitute mismanagement if it can be demonstrated that no other reasonable and rational director would have acted in a similar manner.

In addition, various legal authors are of the view that zero balancing arrangements may under certain circumstances constitute mismanagement by the Board of the company. If a company becomes insolvent due to a lack of sufficient funds as a result of a zero balancing arrangement, members of the Board can be held personally liable.

### b) Tort

The trustee of a company in insolvency can, in exceptional circumstances, hold the Board liable on the basis of tort (*onrechtmatige daad*) to the extent that the company has insufficient funds to satisfy the claims of its creditors. Such exceptional circumstances would include a situation in which the Board knew or reasonably could have known that the solvency of the company would be seriously affected by the transfer of the liquidity to the cash pool

at the end of each business day. This reasoning is mainly based on the general principle of independence of the Board of a company. Under this principle, the Board must ultimately be able to justify any actions it takes which may affect or threaten the existence of the company. The company's participation in a cash pooling arrangement could be justified by the benefit such an arrangement provides to the group as a whole and thereby to the individual participating companies. The Board of the participating company will have to assess continuously whether or not the cash pooling arrangement threatens the solvency of the company.

## 3. Liability of the parent company

In exceptional circumstances, the parent company, as holder of the master account, may be liable to make payments in respect of sums owed to creditors of a participating subsidiary, on the grounds that such parent company has received funds from the participating subsidiary which would otherwise have been available to satisfy the claims of creditors. If payments made by the participating subsidiary to its parent company on an ongoing basis under the cash pooling arrangement could be expected to adversely affect the rights of such subsidiary's creditors, then the parent company may have to undertake actions to avoid or limit the extent of such consequences (including but not limited to filing for insolvency). Contravention of this obligation could lead to liability of the ultimate parent company (or the participating company's shareholder, as applicable) on the basis of tort).

Generally, however, the courts rarely find a parent company liable in tort on this ground and the situations in which liability has been established are typically situations in which the parent company was closely involved in the management of its subsidiary company

or affected the rights of that company's creditors<sup>9</sup>.

Finally, it should be noted that even where the Board/parent company is found liable on one of the grounds described in paragraphs 2 and 3, this does not affect the validity or the enforceability of the cash pooling arrangement itself.

<sup>9</sup> Supreme Court of the Netherlands, 21 December 2001, JOR 2002, 38 (Hurks II) and 12 June 1998, NJ 1998, 727 m. nt. Van den Ingh (Coral-Stalt).



# Spain

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There are no specific laws governing cash pooling activities in Spain. Nor have there been any judicial decisions on cash pooling to date (although decisions made in the context of insolvency proceedings may be applicable by analogy – see below). Instead, one must look to other areas of Spanish law (in particular, banking, corporate and insolvency law) in order to establish the parameters in which cash pooling may operate.

## 1. Banking law

Cash pooling in Spain does not fall within the activities reserved exclusively to financial institutions. In general, the only activity reserved to financial institutions in Spain is the receipt of refundable funds from the public in the form of deposits, loans, temporary transfers of financial assets or the like, for whatever purpose.

In general therefore, no special authorisation needs to be obtained by any of the entities participating in the cash pooling arrangement (other than the bank). This is true even of the treasury company, whose activities may be considered similar in some respects to those of a financial institution.

It should be noted that Spanish residents must notify the Bank of Spain of any accounts which they open abroad. Information concerning payments and receipts in relation to such accounts must also be made available to the Bank of Spain on a periodic basis – annually once the aggregate payments and receipts in relation to the account exceed € 600,000 and monthly once they

exceed € 3,000,000. Information must also be provided in relation to transfers of funds between accounts of Spanish and non-Spanish residents insofar as the amount transferred exceeds € 12,500.

## 2. Corporate issues

There are few corporate law limitations on cash pooling arrangements:

Cash pooling activities need not be listed as a specific corporate object in the articles of association of the company in order for the company to lawfully engage in such activities. Instead, it is treated as an ancillary activity, undertaken in order to further the main objects of the company (in the same way as lending money, granting security and giving guarantees).

Nor does Spanish law generally limit the amount of debt which a company can assume (save insofar as certain thin capitalisation rules may apply – see below)<sup>10</sup>. Furthermore, whilst a company may be subject to compulsory liquidation if its net assets fall to a level below half its share capital, this is unlikely to occur as a direct consequence of a cash pooling arrangement.

However, it should be borne in mind that a cash pooling arrangement could potentially adversely affect the liquidity of a participating company to such an extent that such company is unable to pay its debts as they fall due and therefore faces insolvency.

In general, directors of a Spanish company are required to perform their

<sup>10</sup> The amount a Spanish company may borrow by way of a bonds issue is limited to the amount of the company's paid-up share capital, but this restriction does not apply to borrowings of any other nature.

duties with the diligence of a reasonably prudent businessman acting in the best interests of the company. Breach of such duty by a director will result in him being liable to the company's shareholders and the creditors for any losses they suffer as a result. The directors will be in breach of their duty if, for example, they enter into a cash pooling agreement on terms which may adversely affect the company or if they fail to withdraw from the cash pooling arrangement where the financial viability of the rest of the group deteriorates to such an extent that the company may not be able to recover sums it has contributed.

For this reason, it is usual to first obtain a shareholders' resolution approving the execution of the cash pooling agreements and related documents by the directors – thus at least limiting the directors' exposure to liability to the shareholders.

In addition, criminal liability of the directors (and *de facto directors*) may arise, mainly when they act in the performance of their duties in a disloyal or fraudulent manner (seeking their own benefit or that of a third party and thereby directly causing economic harm to the shareholders), when they cause the company to enter into extortionate agreements in order to cause injury to the shareholders; or in the event of falsifying financial or corporate information.

The question of whether a director has performed its duties with the requisite level of diligence must be evaluated solely with regard to the company itself and not the group as a whole. Therefore, even where a company's participation in a cash pooling arrangement benefits the group as a whole, the company's directors will incur liability (both civil and in some aforementioned circumstances even criminal) if the directors have not fulfilled their duty with regard solely to the company itself.

The directors may also incur liability if they fail to instigate winding-up proceedings in circumstances where the

net assets of the company fall to a level below half its share capital or if they fail to apply for a declaration of insolvency when it becomes legally obligatory to do so. In such circumstances, they may become jointly and severally liable for any debts of the company which subsequently arise. This is in addition to any liability the directors may face on other grounds connected with the company's insolvency.

### 3. Insolvency law

In general, the insolvency of a Spanish company involved in a cash pooling arrangement will not automatically result in the early termination of the cash pooling agreements. Given the nature of cash pooling agreements however, the insolvency trustees will usually ask the court for their termination, at least as between such company and the other participating companies, in accordance with article 61.2 of the Spanish Insolvency Act, provided such termination benefits the procedure and the insolvent company.

It is important that the cash pooling arrangement is clearly structured and properly managed, so as to ensure that the rights and liabilities of each participating company in respect of sums transferred to and from the cash pool is transparent at all times. An insolvency procedure relating to one participating company could have adverse effects for other participants if the financial relationships between the participants cannot be easily determined.

In some insolvency procedures in Spain, inadequate management of the inter-company loans or other similar intra-group legal relationships have resulted in serious difficulties in determining the amounts owed and the exacerbation of the situation which this causes can even result in the insolvency qualifying as having been negligently caused. It could even result in liabilities of the persons involved who were aware of the situation (directors, auditors etc). In such circumstances, they may become liable for the debts of the company.

### 4. Tax law

Where the centralising entity is a Spanish resident, the precise role that it plays may be essential for determining whether any remuneration it receives from participating companies constitutes interest or management fees. Where the centralising entity essentially performs the role of a bank (i.e. receiving physical deposits from the participating companies), then such payments will typically be regarded as interest. Where the centralising entity acts as an intermediary between the group and the bank, then such payments will usually be classified as management fees.

If one or more of the participants of the cash pooling arrangement is a Spanish resident, then there are a number of aspects of Spanish tax law which should be considered. Relationships of the participants and any remuneration they pay/receive in the form of interest/management fees (see above) should be governed by arm's length terms.

In addition, thin capitalisation rules may be applicable if a Spanish member is excessively indebted (i.e. where the debt to equity ratio of the company exceeds 3:1) and the ultimate source of the funding provided to the company via the cash pool is a related party who is a non-EU resident. To the extent that arm's length principles are complied with and the above debt to equity ratio is not exceeded, the financial expenditure of the Spanish member would be regarded as deductible for corporate income tax purposes.

Furthermore, stricter transfer pricing rules were introduced in Spain on 1 January 2007, so care must be taken as regards the level of remuneration the parties pay and receive in the form of interest payments and management fees and the intra-group cash transfers must be documented carefully. If arm's length rules are not complied with, the Spanish Tax Administration is entitled to make the corresponding adjustments, so that deductible expenditure or taxable income is reported under arm's

length basis and the Spanish resident entity is taxed accordingly. Penalties can be imposed if pricing regulations are not complied with.

Finally, it should be borne in mind that interest payments made by a Spanish resident will not be subject to withholding tax as long as the recipient of the interest is an EU tax resident. Otherwise an 18% withholding tax would apply, with the possible benefit of reduced rates under the provisions of an applicable double tax treaty.



# Switzerland

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## 1. Legal framework for cash pooling

There is no specific statutory framework and currently no relevant case law dealing with cash pooling in Switzerland. However, it is generally agreed in the literature on the subject that the rules and limitations contained in the statutory provisions and related case law on capital maintenance and profit distribution will apply in certain circumstances to the contribution of funds to a cash pool.

Theoretically, there are no restrictions on the grant of loans by Swiss companies to their affiliates, and such intra-group loans are not subject to the limitations contained in the statutory provisions on capital maintenance and profit distribution mentioned above – provided, however, that such intra-group loans are granted on terms and conditions which are arm's length in all respects. This requires not only that interest is paid at the market rate, but also that the protections that a commercial lender would usually require apply (in particular, the right of the lender to prematurely terminate the loan if the financial situation of the borrower deteriorates, and an appropriate risk diversification (i.e. no lump sum risks)).

If an intra-group loan (other than a mere downstream loan) is found not to be at arm's length, then any sums transferred to the borrower under the loan will be treated as a profit distribution or – if such payment exceeds the amount of the freely distributable reserves of the lender – as a capital repayment. Both of these situations are subject to balance

sheet limitations and strict formal requirements.

In determining the relevant balance sheet values, in particular the freely distributable reserves, it is not sufficient to simply rely on the last annual financial statements. Reference must instead be made to the values at the time the relevant sums were transferred.

The above applies equally to any intra-group guarantee which is granted in connection with a notional cash pooling arrangement.

In addition, the directors and managing officers of the company are responsible for ensuring that the company at all times has sufficient liquidity to pay its debts as they fall due. There is a risk that sufficient liquidity will not be available if funds paid into a cash pool are suddenly no longer recoverable or an intra-group guarantee given by the company is called upon.

## 2. Liability risks

If the transfer of sums to a physical cash pool or the grant of, or payment under, an intra-group guarantee is made in contravention of the capital maintenance and profit distribution provisions, or as a result of these actions the company becomes insolvent due to a lack of liquidity, the members of the board of directors and the management of the company may become personally liable for the shortfall. In certain circumstances, the immediate parent company and the ultimate group parent company may also become liable.

### 3. Legal structure to reduce liability risks

In practice, it is usually impossible to comply with the arm's length requirement referred to above in all respects. This is particularly so in the case of a cash pool where the intra-group loan relationships are not established directly by the individual group companies but rather through the cash pool bank as an intermediary. Further, the question whether an intra-group agreement complies with market standards is almost invariably open to argument and it is therefore difficult to predict whether a judge will *ex post* confirm that a particular intra-group agreement is arm's length in nature.

It is therefore highly advisable to take the appropriate measures to ensure that the aggregate potential loss that a Swiss company could suffer in relation to a cash pooling arrangement is limited at all times to the amount of the freely distributable reserves. When calculating the freely distributable reserves, the mandatory allocation to the legal reserve and possible withholding tax due on distributions must be taken into account. In the case of intra-group guarantees, such risks can be limited by agreeing with the bank that the exposure under the guarantee shall be limited to the amount of the freely distributable reserves as shown in an audited interim balance sheet as at the date the respective guarantee is called upon.

In a physical cash pool however, the only way in which such limitations can be maintained is by the rather cumbersome manual control of the flow of funds in order to make sure that assets exceeding the freely distributable reserves are at no time blocked in the cash pool.

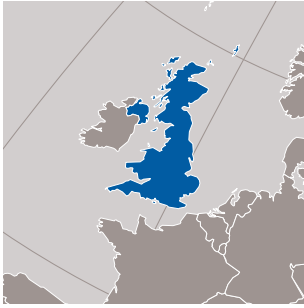
In addition, as discussed above, it must also be ensured that even if all funds contributed to the cash pool or paid under intra-group guarantee are lost, the company still has sufficient liquidity to pay its debts as they fall due.

Finally, it should be noted that both the participation in a physical cash pool and the grant of intra-group guarantee in connection with a notional cash pool, both require the approval by unanimous resolution at a meeting of shareholders.

### 4. Tax aspects

Theoretically, any payment to or – in the case of an intra-group guarantee – for the benefit of affiliates (except for pure downstream payments) made under obligations which are not at arm's length constitute profit distributions for tax purposes, with the result that, firstly, the respective payments cannot be set off as business expenses against taxable profits and, secondly, Swiss withholding tax of 35% becomes due on such payments. (Depending on the domicile of the beneficiary and the applicable double-taxation treaty, the Swiss withholding tax may be partly or fully refundable.) This applies regardless of whether the respective payment is made only out of the freely distributable reserves of the company or not.

In reality however, it is often possible to reach a binding agreement with the Swiss tax authorities (in a so-called "ruling") that payments of a Swiss company under a physical cash pool or an intra-group guarantee system do not qualify as profit distributions (even where such payments are ultimately lost), based on the argument that the cash pool system is sufficiently beneficial for the Swiss company (both directly and indirectly through the advantages to the group as whole) to justify the related payments and loss risks.



# United Kingdom

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## 1. Authorisations etc

In order for a bank to be able to offer a notional cash pooling arrangement, it needs to have a legal right of set-off against a company's credit balances to clear the debit position of the other companies in the pool. This basically means that the bank must have a cross-guarantee structure between the members of the pool.

An English company is able to grant such a guarantee provided that there is *corporate benefit* for it in doing so (it is not sufficient that the arrangement benefits the group as a whole). This is often possible to demonstrate, for example:

- ▮ a subsidiary company may benefit from more competitive rates of interest on its personal account from the pooling bank as well as a better interest rate on the pooled cash;
- ▮ (with regard to physical cash pooling) as the transfer of a credit balance is treated as a loan, therefore the benefit of obtaining better rates on a group basis can be passed on to subsidiaries on the intra-group loans that arise from the arrangements;
- ▮ scope for saving on treasury and back office costs.

In any event, the bank which is a party to the cash pooling arrangement is normally able to assume that corporate benefit is present, at least in terms of deciding whether the relevant companies have corporate capacity to enter into the arrangements. This is by virtue of section 35(1) and 35A(1) of the Companies Act 1985.

The position is however different in an insolvency situation, where the arrangements could be set aside by virtue of such arrangement constituting a "transaction at an undervalue" under section 238 of the Insolvency Act 1986.

## 2. Formalities

The company's board should pass a resolution approving the transactions to be entered into and if upstream or cross-guarantees of sister companies are being given, then it is usual practice to obtain a shareholders' resolution approving such guarantees.

The company's constitutional documents would need to be reviewed to check whether it has the power to provide the guarantee and rights of set-off and to see if there are any other specific requirements, and of course the company would need to comply with its contractual obligations regarding the granting of guarantees/making loans/incurring indebtedness (for example in existing financing agreements) – which may restrict what it can do.

For any notional cash pooling arrangement operating in England, certain requirements must be satisfied to enable the bank to report net exposure to the Financial Services Authority. These requirements include that the "on-balance sheet netting arrangements" must be legally effective and enforceable in all relevant jurisdictions including in the event of insolvency or bankruptcy of a counterparty. However, the general legal issues relating to the granting of guarantees would apply, i.e. the guarantee must be for the commercial

benefit of the company (under English law there is no exact measure of what constitutes a commercial benefit) and the granting of the guarantee must be in accordance with its constitutional documents.

### 3. Insolvency issues

If an English company is subsequently found to have been insolvent at the time it entered into the cash pooling arrangement, or became insolvent as a result thereof, then the arrangement may be attacked as a transaction at an undervalue or a preference provided that the arrangement was entered into within the six-month period prior to the commencement of insolvency proceedings. The period for setting aside such transactions is extended to two years if they were with a "connected person".

Any multilateral netting or pooling arrangements may not be effective following the commencement of a winding-up procedure. Accordingly, if a winding-up resolution is passed by the company or a winding-up petition is presented to the court, there is at least a danger that any multilateral netting calculation would be ignored (except in relation to debts where the netting process had been completed) and (except in relation to such debts) the position would be as if no multilateral netting agreement existed.

If a winding-up order is actually made by the court, then the position would definitely be as if no multilateral netting agreement existed. However, any netting which had actually been completed by the time winding-up commenced (such completion being evidenced by the substitution of one debt owed by one entity for several debts owed by and to several entities) would survive.

### 4. Other liabilities

#### a) Notional cash pooling

Unless the arrangements somehow constituted financial assistance in connection with the acquisition of the

shares of the English company or the arrangements involved misconduct on the part of the directors, then there should be no corporate, civil or criminal liability issues for the English group member or its directors or managers.

If the directors make the company party to an *ultra vires* transaction (i.e. they are acting in breach of their fiduciary duty to the company), then they are therefore liable to indemnify the company for any loss it has suffered arising from the *ultra vires* act and to account to the company for any profit they have made.

Ultimately if the transaction is to the commercial benefit of the company and the shareholders have approved the transaction, then there should be no liability for the directors.

#### b) Physical cash pooling

Similar principles apply, but arrangements in practice are less likely to be attacked as a "transaction at an undervalue", because:

- ▮ the "value" in this context would be expected to consist of the loan which will arise by virtue of each relevant cash transfer;
- ▮ in practice, the company transferring cash is likely (because of its persistent credit balances) to be in a relatively strong, rather than weak, financial position and accordingly the danger of it being insolvent at such time should be small.

### 5. Tax issues

#### a) Interest deductibility

Interest on loans is deductible if the loan is a "loan relationship" i.e. a money debt. The interest will be deductible in accordance with relevant accounting treatment. Any loan relationship entered into for unallowable purposes (which includes tax avoidance) will not be deductible.

There is a further limit on deductibility where interest is paid to a connected party and

- ▮ the full amount of the interest is not assessable on the lender under the loan relationship legislation (i.e. where the lender is outside the charge to corporation tax); and
- ▮ the interest is not paid within 12 months of the end of the accounting period in which it was accrued.

Tax relief in respect of interest payments is also denied (under s.787 of the Income and Corporation Taxes Act 1980 ("ICTA")) when a scheme has been made and the sole or main benefit that might be expected to accrue was the obtaining of a reduction in tax liability by means of the relief. However, relief is rarely denied on these grounds.

Where the recipient of "interest" is not within the charge to UK corporation tax, then:

- ▮ under s.209(d) ICTA any interest that exceeds a commercial rate of return can be reclassified as a dividend;
- ▮ where a debt is more like a share than a debt s.209(e) ICTA equates the debenture interest payments with dividends; and
- ▮ payments of interest on securities which are convertible directly or indirectly into shares of the company are (by virtue of s.209(e)) treated as distributions unless the securities of the company are quoted on a recognised stock exchange.

By virtue of s.74 ICTA, interest payable in respect to a contract debt (i.e., not a money debt) will not be deductible unless it is wholly and exclusively incurred for the purposes of the trade of the company in question.

#### b) Withholding tax

Notional cash pooling possibly reduces withholding tax issues as interest is likely to be treated as interest from the bank rather than another member of the group. Under UK legislation there is

no withholding tax on payments to UK banks and to other UK corporates.

Under physical cash pooling arrangements, intra-group loans will arise on which interest is payable by one group member to another. One would need to look at the relevant tax treaties to see if tax needs to be withheld and whether this can be reduced by making a treaty clearance application.

### c) Thin capitalisation rules

HM Revenue and Customs ("HMRC") generally operate on the basis that they do not like companies being funded by debt from related third parties beyond the level a third-party bank would be willing to contemplate.

Since 1 April 2004, the UK thin capitalisation legislation has been a subset of the UK transfer pricing rules. As a result, much of the basic transfer pricing approach carries over to thin capitalisation cases and like transfer pricing, the thin capitalisation provisions need to be interpreted in accordance with the Organisation for Economic Co-operation and Development guidelines.

The UK's application of thin capitalisation relies upon the arm's length principle – how much the borrower would have been able to borrow from an unconnected third party. In applying this principle, however, it is necessary to consider the borrower in isolation from the rest of the group.

This does not, however, require actual assets or liabilities to be disregarded. For example, shares in subsidiaries and intra-group loans should be taken into account in calculating borrowing capacity to the same extent that they would be taken into account by an unconnected lender. In the case of shares, the practical effect of this rule is thought to be that all assets and liabilities in direct or indirect subsidiaries should be taken into account. Equally, income or expenses arising from intra-group trading contracts should not be disregarded.

HMRC typically accept a 1:1 ratio of debt to equity but will accept a higher gearing if market practice allows.

Under the transfer pricing rules, where a loan exceeds the amount that would have been provided by an unconnected lender, the interest on the excessive part of the loan is disallowed as a tax deduction for the borrower. Nevertheless, the excessive interest can be paid without deduction of tax. This is because the rules provide that the excessive interest is not chargeable under Case III of Schedule D of ICTA, and so the condition in section 349(2) ICTA to deduct tax at source is not met.

Furthermore, under the distribution rules, where an interest payment (or part of it) is recharacterised as a dividend there is also no requirement to withhold tax in respect of it.

### d) Value added tax

Under Council Directive 77/388/EEC (the "Sixth Directive") the general position with regard to transactions involving services is that they are deemed to take place in the jurisdiction where the supplier belongs. Exceptions to the general place of supply rule relate to certain types of services that are deemed to be supplied in the jurisdiction where the recipient is established and other services that are deemed to be supplied in the jurisdiction in which they are effectively used and enjoyed. These exceptions, inter alia, include specific rules in connection with certain international services.

Under UK VAT law, international services that fall within those listed in schedule 5 ("Schedule 5") of the Value Added Tax Act 1994 are deemed to be supplied where the recipient of the service belongs. This is when such services are received for business purposes. Schedule 5 services include banking and financial services. Treasury services being performed by a parent would, therefore, constitute Schedule 5 services.

Where Schedule 5 services are received by a UK taxable person for the purposes of his business from a person established outside the UK, the reverse charge mechanism will apply so that the recipient may have to account for VAT on his receipt of the services. The reverse charge mechanism should not, however, result in any VAT in this case because financial services are generally exempt in the UK.

N.B. there is no stamp duty or other indirect taxes that will be payable on the principal or on the return of the cash transactions.

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