Equitable Subordination under Swiss Law: The Federal Supreme Court Draws a Clear Line

In a recent landmark decision (5A_440/2024, dated 31 March 2025), the Swiss Federal Supreme Court addressed long-standing uncertainties surrounding the principle of equitable subordination under Swiss law. The Court clarified that, unless there is either an express subordination agreement or clear and demonstrable evidence of abuse of rights, unsecured loans granted by shareholders or related parties shall not be deemed subordinated in insolvency proceedings.

For many years, the applicability of the common law concept of equitable subordination in Switzerland was shrouded in legal uncertainty. Equitable subordination, which originates in Anglo-American jurisprudence, allows courts to subordinate a creditor's claim (typically in insolvency proceedings) if the creditor has engaged in inequitable or abusive conduct, thereby ensuring a fair distribution among creditors.

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In the case at hand, which involved unsecured loans granted by shareholders and board members of a financially distressed company shortly before bankruptcy, the bankruptcy administration had subordinated the claims on the grounds that the loans were abusive and intended to delay enforcement measures. The Federal Supreme Court examined, through the lens of abuse of rights, whether, and under what conditions, a loan granted by a shareholder or related party to a financially distressed company could be reclassified as an equity contribution or, alternatively, subordinated (on the basis of equitable subordination) below third-class claims pursuant to Article 219(4) of the Swiss Debt Enforcement and Bankruptcy Act.

Although such loans are formally structured as debt, they may enable a company to delay genuine restructuring to the potential detriment of third-party creditors.

The Court ruled that the application of equitable subordination under Swiss law must be strictly assessed in terms of manifest abuse of rights. It clarified that such abuse can only be identified if a related-party loan is granted when the borrowing company is already balance-sheet overindebted, within the meaning of Article 725b of the Swiss Code of Obligations.

Importantly, the Court expressly rejected other doctrinal theories, such as the "third-party test" (i.e., whether an independent lender would have made the loan) and the "restructuring effect" test (i.e., whether only equity could realistically support a turnaround), considering them as insufficient bases for deemed subordination.

The Court concluded that, in the absence of over-indebtedness at the time of the loan, the mere fact that a related party extends financing and then makes a claim in bankruptcy proceedings does not, in itself, constitute an abuse of rights. It emphasised that subordination cannot be inferred from the financial context alone. Instead, the standard of interpretation under Article 18(1) of the Swiss Civil Code must be applied to clearly establish a mutual and discernible intent to subordinate.

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This decision reinforces legal certainty for shareholders and related-party creditors involved in restructurings. In the absence of statutory triggers

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or explicit contractual terms, loans granted in this context should be treated equally with other unsecured third-class claims. The ruling also highlights the importance of robust documentation and careful assessment of the borrower's financial position at the time of lending. These are essential tools for boards and legal counsels to mitigate subordination risk and demonstrate good faith in future insolvency proceedings.

Should you require any further information on this subject, please do not hesitate to contact us.
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