

**THE NEW SOLVENCY TEST
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In the executive summary prepared by the Commerce and Employment Department of the States of Guernsey addressed to the Chief Minister dated 26 January 2007 regarding the revisions of the Companies Law in Guernsey (the "Policy Letter"), one of the most significant proposals was a recommendation that the concept of capital maintenance be discarded in favour of a solvency model as the measure of the ability of a company to make distributions. These revisions came into effect on 1st July 2008 with the introduction of the Companies (Guernsey) Law 2008.

The term 'capital maintenance' was misleading: a company was not required to keep its capital intact and if the capital of a company was lost (for example in the course of the company's trading) the company was under no legal obligation either to make it good or (on that ground only) to wind up its affairs. The rule was not that a company must maintain the capital it raises but that it must raise the capital which it purports to raise and, broadly, a limited company could not return capital to its shareholders other than in compliance with and as authorised by explicit statutory provisions in respect of such returns. Any unauthorised returns were illegal at common law.

These rules were primarily intended for the protection of the creditors. Experience has shown that it is questionable the extent to which the capital maintenance rules provided such protection, especially since the previous company law did not prescribe a minimum capital for a company and there were various wide ranging common law and statutory exceptions. The Commerce and Employment Department recognised this in the Policy Letter stating:-

"The Department proposes to move from capital maintenance as the touch stone of certain corporate action and decision making to a solvency test. Capital maintenance is seen as too unwieldy and artificial. The proceeds of an issue of shares may be spent immediately after receipt, whereas a solvency test at the time action is prepared or a decision is made is much more relevant to the demands of business and the legitimate expectations of those doing business with, or affected by, corporate affairs. Solvency has been increasingly used in Guernsey legislation as the criterion for various decisions. It is proposed to assimilate all these tests into one, to be used for everything from dividend distribution to reduction of capital."

The solvency test is now set in section 527 of the Company Law. It is required to be met in a variety of corporate procedures: it is used in the conversion process either of non-cellular companies or protected cell companies into incorporated cell companies; the transfer of incorporated cells between incorporated cell companies; conversions of non-cellular companies into incorporated cells; conversions of protected cell companies into non-cellular companies; it is referred to in amalgamations and migrations (both in and out of the Island); it is also considered by the Registrar in relation to restorations to the Company Register and also is a consideration that the Royal Court must take into account in making an administration order. Perhaps though the greatest attention needs to be paid to the solvency test and the reference which is made to it in relation to the procedures for making distributions and dividends.

The solvency test and its related sections in the Company Law borrow heavily from New Zealand's Companies Act 1993 (the "NZ Law"). This in turn follows a formula

similar to the solvency test as employed in the United States (particularly the Model Business Corporations Act).

Distributions and Dividends

A “distribution” for the purpose of the Companies (Guernsey) Law, 2008 (s. 301) “in relation to a distribution by a company to a member, means:

- (a) the direct or indirect transfer of money or property, other than the company’s own shares, to or for the benefit of a member, or
- (b) the incurring of a debt to or for the benefit of a member,

in respect of a member’s interests, and whether by means of a purchase of property, the redemption or other acquisition of shares, a reduction of indebtedness, or by some other means.”

The definition of “distribution” in the NZ Law is similar although it uses “shareholder” rather than “member”. There is no definition of “member” in the Company Law. Presumably the change in terminology is to include reference to guarantee members and members with unlimited liability as well as shareholders.

It appears that (under section 301(a)) an allotment of a company’s shares as a bonus issue is not a distribution (but see section 302(1)(a) which adds uncertainty). The transfer of money or property or the incurring of a debt must be linked to the member’s interests as is stated it must be “in respect of a member’s interests”. The question remains as to whether any transaction between a company and a member would be caught by the definition of “distribution”. Whilst there does not appear to be any relevant case law on the issue it seems unlikely it would be caught if it could be demonstrated that the debt arose out of a genuine, arm’s length transaction in which the member was involved solely as a creditor or employee. This question is likely to arise in practice, particularly in relation to shareholder loans and the terms on which these may be entered into.

Section 302(1) defines “dividend” as meaning “every distribution of a company’s assets to its members, except distributions by way of:

- (a) an issue of shares as fully or partly paid bonus shares;
- (b) a redemption or acquisition of any of the company’s own shares or financial assistance for an acquisition of the company’s own shares;
- (c) a reduction of share capital;
- (d) a distribution of assets to members during and for the purposes of its winding up;
- (e) a distribution of assets to members during and for the purposes of an administration order;
- (f) a distribution of assets to members of a cell of a protected cell company during and for the purposes of a receivership order; or

- (g) a distribution of assets to members of a cell of a protected cell company during and for the purposes of the termination of the cell.”

Dividends may be in the form of money or other property.

The declaration of a dividend is treated at common law as the creation of debt recoverable by a shareholder. It is considered that the Company Law may have altered that position. This view is supported by a number of terms within the Company Law. In applying the solvency test the dividend/distribution which is being authorised is not considered a debt under the expanded definition of debts (see below) and a distinction is made between the authorisation of a dividend and its payment. Furthermore, the board can also rescind the resolution authorising the distribution (see below) which would not be possible if a debt recoverable by the shareholder had arisen at the time of the declaration of the dividend.

It is to be noted that the definition of distributions is wide and that certain activities that may not obviously be regarded as distributions fall within the definition such as financial assistance as well as a purchase of the company’s own shares, including a redemption of shares.

It should be noted however the procedure for distributions does not apply to Open-Ended Investment Companies (as defined in the Company Law). An open-ended investment company must not, however, redeem its shares unless it satisfies the solvency test (section 321(2)).

It is to be noted that the abandonment of the capital maintenance doctrine will no longer require court sanctioned reductions of share capital which now will only require sanction in accordance with the company’s constitutional documents.

With both a distribution and a dividend the Company Law has separate sections dealing with procedures; in each case the board of the directors may authorise the activity if:

- (a) the board of directors is satisfied on reasonable grounds that the company will, immediately after payment, satisfy the solvency test; and
- (b) it satisfies any other requirement in its memorandum and articles.

The test requires the Board to make a future assessment by making reference to the solvency test being satisfied immediately after the distribution or dividend is made. This must be an informed decision, not only to satisfy the reasonable grounds criteria but also to comply with the directors’ fiduciary responsibilities to the company.

The board of directors must approve a certificate (implicitly prior to the distribution/dividend and practically usually at the same board meeting on giving its approval) stating:-

- “(a) that in their opinion the company will, immediately after the distribution, satisfy the solvency test, and
- (b) the grounds for that opinion,

and the certificate must be signed on their behalf by at least one of them.”

It is also possible for the company's constitutional documents to prohibit or restrict distributions or dividends in certain instances, for example, distributions or dividends out of capital or non realised profits. It may be that prohibitions of this nature are contained in existing constitutional documents because they were drafted pre 1 July 2008 or at the request of investors or financiers. For ease of references in this article "distributions" will from this point include dividends as the two concepts are treated very similarly.

If, after a distribution is authorised but is not paid, the board ceases to be satisfied on reasonable grounds that the company will, immediately after the distribution is made, satisfy that the solvency test, any distribution made by the company is deemed not to have been authorised (sections 303(3) and 304(3)).

There appears to be an inference from the drafting of the law (although not expressly stated) that the Board must monitor the company's financial position to ensure the solvency test continues to be met following an authorisation. This interacts (but rather awkwardly) with section 309(3) and recovery of distributions (see below).

Recovery of Distributions

Recovery of distributions from directors and members is the corollary for the flexibility of the distribution regime.

A distribution (which definition includes a dividend) made to a member at a time when the company did not, immediately after the distribution, satisfy the solvency test may be recovered by the company from the member except to the extent that (these requirements are conjunctive):

- (a) the member received the distribution in good faith and without knowledge of the company's failure to satisfy the solvency test;
- (b) the member has altered his position in reliance on the validity of the distribution; and
- (c) it would be unfair to require payment in full or at all.

If, in relation to a distribution made to members:

- (a) the procedure set out for distributions (which may include dividends, redemptions or acquisition of shares giving financial assistance for the purpose of the company's own shares) has not been followed; or
- (b) reasonable grounds for believing that the company would satisfy the solvency test did not exist at the time the certificate was signed;

then a director who:

- i. failed to take reasonable steps to ensure the procedure was followed, or
- ii. voted to approve the certificate (as the case may be);

is personally liable to the company to repay to the company so much of the distribution as is not able to be recovered from members.

If a distribution is deemed not to have been authorised (i.e. if after the distribution is approved by the board the board ceases to be satisfied on reasonable grounds that the company will, immediately after the distribution is made, satisfy the solvency test) a director who:

- (a) ceased after authorisation but before the making of the distribution to be satisfied on reasonable grounds for believing that the company would satisfy the solvency test immediately after the distribution is made; and
- (b) failed to take reasonable steps to prevent the distribution being made,

is personally liable to the company to repay to the company so much of the distribution as is not able to be recovered from members.

The Statutory Solvency Test

Section 527 "... the company satisfies the solvency test if:

- (a) the company is able to pay its debts as they become due [NZ Law continues "in the normal course of its business"];
- (b) the value of the company's assets is greater than the value of its liabilities [NZ Law continues "including contingent liabilities"]; and
- (c) in the case of a supervised company, the company satisfies any other requirements as to solvency imposed in relation to it by or under:
 - (i) the Protection of Investors (Bailiwick of Guernsey) Law, 1987;
 - (ii) the Insurance Business (Bailiwick of Guernsey) Law, 2002;
 - (iii) the Insurance Managers and Insurance Intermediaries (Bailiwick of Guernsey) Law, 2002;
 - (iv) the Banking Supervision (Bailiwick of Guernsey) Law, 1994;
 - (v) the Regulation of Fiduciaries, Administration Businesses and Company Directors etc. (Bailiwick of Guernsey) Law, 2000; and
 - (vi) any other enactment prescribed by the Commission for the purposes of this section."

The solvency test therefore comprises two tests known colloquially as:

- (a) the liquidity or cash flow test; and
- (b) the balance sheet solvency test.

The company may be suffering a temporary liquidity crises whilst still solvent within the balance sheet test. Should the board wish to make a distribution in this case directors would need to convert sufficient assets to a readily usable form so the company is in a position to meet all of the debts as they become due and hence satisfy the liquidity test. However a position where there is liquidity whilst the balance sheet

test is not met is not as easily corrected. Asset values would need to increase or shareholders would need to inject further equity capital.

For the purposes of Section 303 (procedure for making distributions other than dividend), Section 304 (procedure for paying a dividend), Section 309 (recovery of distributions), Section 321 (exemption for open-ended investment companies) the definition of “debts” is:

“debts” includes fixed preferential returns on shares ranking ahead of those in respect of which a distribution is made (except where that fixed preferential return is expressed in the memorandum or articles as being subject to the power of the directors to make distributions), but does not include debts arising by reason of the authorisation,”

This definition is concerned only with the liquidity test, as it is only that test that refers to “debts”. Fixed preferential returns (not expressed in the memorandum or articles to be subject to the discretion of the directors) will therefore need to be included in cash flow budgets where appropriate.

The definition of “liabilities” for the same sections is:

“liabilities” includes the amount that would be required, if the company were to be dissolved after the distribution, to repay all fixed preferential amounts payable by the company to members, at that time or on earlier redemption (except where such fixed preferential amounts are expressed in the memorandum or articles as being subject to the power of directors to make distributions) but, subject to [the definition of “debts”] does not include dividends payable in the future.”

This definition is used only in relation to the balance sheet solvency test. It requires the test to include taking into account repayment of the preferential shareholders’ investment and any arrears on it (unless they are expressed in the articles or memorandum to be subject to the powers of the directors) but not future payments.

Issues raised by the Solvency Test

Both the liquidity and the balance sheet solvency tests raise difficult questions regarding:

- (a) cash flows;
- (b) the valuation of both assets and liabilities;
- (c) the use of accounting records or statutory financial statements to determine solvency; and
- (d) the extent to which reliance may be placed on valuations or opinions provided by auditors and professional advisers.

Liquidity Test

The liquidity test concentrates on the present and the future; whether, on the present facts, the company can, in the future, meet its obligations as they mature. The present cannot be viewed in isolation; it is relevant to look at the company's behaviour in the recent past and at obligations maturing in the near future. A failure to pay debts presently due is evidence of a near illiquid position, but it is not conclusive proof of not being able to satisfy the liquidity test. Account must be taken of outstanding debts. The phrase "as they become due" probably means as they become legally due, this is certainly the case under New Zealand case law.

The test concentrates on future cash flows but there is no guide as to how far ahead directors should look, this is a matter for business judgement. Should they be required as a minimum consider cash flows for the company's next business cycle.

Future cash flows (both in and out) are estimated using cash flow forecasts. The accuracy of cash flow forecasts will depend on subsequent events which are not entirely in management's control, and invariables. Such forecasts may often be inaccurate (with hindsight) because they depend on assumptions about future economic events. Such assumptions may not be realised.

Forecasts might be challenged as inadequate if they are not based on reasonable assumptions about anticipated operating conditions or if the forecasts are not compared periodically to actual performance to determine whether prior assumptions were accurate.

Use of Ratios to Determine Solvency

Since the company's most recent financial statements are often used to define company solvency directors may also be tempted to use accounting ratios extracted from the company's financial statements to determine future solvency. Such an approach has severe limitations.

Use of ratios provides an indication of the kind of solvency at the point at which the financial information is presented, which gives a snap shot of the company's position at that time, the limitation is that the information is historic.

Balance Sheet Solvency

In essence, the balance sheet test is a net assets test. After making a distribution the company must have positive net assets. There are however a number of practical difficulties in relation to the implementation of the test. The principal of such difficulties lies in the identification and valuation of assets and liabilities.

The Company Law does not define, "assets". It defines a liability as including "duty, debt and obligation". It is clear however that notwithstanding what accounting standards may be adopted share capital, is not intended to be regarded as a liability.

Valuation of Assets and Liabilities

The valuation of assets and liabilities is critical, since the solvency test requires a calculation of net assets to satisfy the balance sheet test. Guidance is provided by section 527(2) which requires that the directors in determining whether the value of a company's assets is greater than its liabilities,

“(a) must have regard to:

- (i) the most recent accounts of the company; and
- (ii) all other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of the company's liabilities; and

(b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.”

Section 527(4) provides that the solvency test applies to cells and cores of protected cell companies as if references to companies were references to cells or cores (as the case may be) of protected cell companies.

The reference at section 527(2), to the most recent accounts, replaces the reference in the New Zealand Act to “the most recent financial statements of the company that comply with section 10 of the Financial Reporting Act 1993” i.e. audited accounts. “Accounts” is defined in the Company Law as meaning

“either individual accounts prepared in accordance with section 243 (individual accounts) or consolidated accounts prepared in accordance with section 244”.

It is assumed the draftsman has not made reference to audited accounts because there are unaudited companies in Guernsey. The question is raised however as to the position of new companies, it seems clear that there was not a policy to prevent new companies from using the solvency test and therefore to the extent a company does not have audited statements some form of management statements would need to be prepared. It is considered likely to be best practice to make reference to the most recent financial statements (audited if they exist) preferably supplemented by management accounts in making any solvency determination.

There is a problem in determining what value should be ascribed to assets (even more so in the volatile markets of the present day). Should the value be based on historical cost, market value, book value, going concern value or break-up value? They are all possibilities. Valuations are also likely to be difficult where using a comparator if a seller is distressed, or if a secondary transaction is concluded at greater or less than an underlying net asset value. In private equity there are often issues with attempting to find comparables to assist in valuations and particularly how to mark to market. This is where the board of directors' judgement and skill comes into play. Any basis of valuation needs to stand up to the scrutiny of being reasonable.

A three step process in relation to valuation of assets and liabilities, is envisaged for directors, who:

1. must take at face value the figures for assets and liabilities as represented in the company's most recent accounts,

2. must step back and take a wider view to determine whether these figures should be adjusted (because of post balance date events or for any other reason);
3. may, make adjustments to figures and financial statements, valuations or estimates that are reasonable in the circumstances.

Directors need only step beyond the company's current financial statements where:

1. a company's solvency is suspect; or
2. there are doubts about the correctness of the figures contained in the financial statements for example because of an awareness of deterioration in the value of the assets since the statements were produced (this is particularly pertinent in the current economic market and particularly relevant to those funds which may have invested in real estate or other assets which are not easily valued); or
3. there are assets or liabilities not included in the financial statements which should be taken into account.

Contingent Assets

The statutory solvency test makes no reference to contingent assets. Company solvency might be dependent upon the contingent assets such as letters of support from shareholders undertaking to provide financial support for the company when required. When considering these undertakings of financial support the directors need to take into account:

1. the solvency of the supporting party;
2. the terms on which the support is promised, whether it is enforceable or not; and
3. its precise terms.

Contingent Liabilities

There are two types of potential liability:

1. Obligations arising out of an existing legal obligation but dependent upon events which may or may not occur; and
2. Obligations contemplated but not yet incurred.

The first is a contingent liability, which is examined below. The second is not a liability for the purposes of the solvency test.

Contingent liabilities are not specifically referred to in the Company Law. However, they must be taken into account at least in relation to the balance sheet test (in New Zealand statute a board of directors is required to take into account contingent liabilities in relation to the balance sheet test) and also, possibly, the cash flow test. Contingent liabilities are seldom recorded in a company's financial statements, they may be disclosed by notes to the accounts, if at all. The Directors are expected to exercise reasonable judgement as to the likelihood, amount and time of any recovery

against the company, after giving consideration to the extent to which the company is insured or otherwise protected against such loss should it occur.

Conclusion

The commentary accompanying the US Model Business Corporation Act on the solvency test is helpful in addressing the solvency test issues on an operational basis. Such commentary is likely to be of persuasive authority should any issues come before a Guernsey court:

“In most cases involving a corporation operating as a going concern in the normal course, information generally available will make it quite apparent that no particular inquiry concerning the equity insolvency test is needed. While neither a balance sheet nor an income statement can be conclusive as to this test, the existence of significant shareholders’ equity and normal operating conditions are of themselves strong indication that no issue should arise under that test. Indeed, in the case for a corporation having regularly audited financial statements, the absence of any qualification in the most recent auditors opinion as to the corporation’s status as ‘a going concern’, coupled with a lack of subsequent adverse events would normally be decisive.

It is only when circumstances indicate that the corporation is encountering difficulties or is in an uncertain position concerning its liquidity and operations that the board of directors or, more commonly, the officers or others upon whom they may place reliance.....may need to address the issue.....in determining whether the equity insolvency test has been met, certain judgments or assumptions as to the future course of the corporation’s business are customarily justified, absent clear evidence to the contrary. These include the likelihood that (a) based on existing and contemplated demand for the corporation’s products or services, it will be able to generate funds over a period of time sufficient to satisfy its existing and reasonably anticipated obligations as they mature, and (b) indebtedness which matures in the near term will be refinanced where, on the basis of the corporation’s financial condition and future prospects and the general availability of credit to businesses similarly situated, it is reasonable to assume that such refinancing may be accomplished. To the extent that the corporation may be subject to asserted or unasserted contingent liabilities, reasonable judgments as to the likelihood, amount, and time of any recovery against the corporation, after giving consideration to the extent to which the corporation is insured or otherwise protected against loss, may be utilised. There may be occasions when it would be useful to consider a cash flow analysis, based on a business forecast and budget, covering a sufficient period of time to permit a conclusion that known obligations of the corporation can reasonably be expected to be satisfied over the period of time that they will mature.

In exercising their judgment, the directors are entitled to rely.....on information, opinions, reports, and statements prepared by others. Ordinarily, they should not be expected to become involved in the details of the various analyses or market or economic projections that may be relevant. Judgments must of necessity be made on the basis of information in the hands of the directors when a distribution is

authorised. They should not, of course, be held responsible as a matter of hindsight for unforeseen developments. This is particularly true with respect to assumptions as to the ability of the corporation's business to repay long-term obligations which do not mature for several years, since the primary focus of the directors' decision to make a distribution should normally be on the corporation's prospects and obligations in the shorter term, unless special factors concerning the corporation's prospects require the taking of a longer term perspective."

The implementation of the solvency test as a regime considerably enhances the flexibility by which a company can return money to its investors from a position where profits only were distributable to a position where companies have the freedom to distribute capital and earnings to shareholders in ways that have previously not been available. The definition of distributions is wide and includes share redemptions, buy backs and financial assistance and directors should be aware of this extended definition and the particular prescribed procedures for making distributions.

However, there is a price to pay for that flexibility in terms of potential liability for directors. This however is not to be overstated. It has always been the case that the consequences of unlawful distributions could be reclaimed from shareholders when the shareholders knew that the dividend was unlawful. Common law also provided that the directors who paid dividends improperly could be liable to compensate the company for the loss.

The solvency test presents challenges to the board of a company and it is clear that accounts prepared for financial reporting purposes provide only a starting point for determining the solvency test. Directors must use supplementary information extracted from the company's accounting records, together with their own assessment of the company's present position and future trading prospects, before making a considered assessment of the company's solvency.

Directors will not incur liability just because they got the solvency test wrong. They will incur liability if there is no reasonable justification for the stance taken in their assessment of the solvency test.

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Note on this release

The information contained in this client information release is intended as a general guide only. The information is not intended as a substitute for formal legal advice and should be interpreted accordingly. Formal legal advice in all relevant areas should be sought before relying on any of the information contained in this release.

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