



The Association of Investment Companies

The 'solvency test' under Guernsey company law

AIC guidance for directors of Guernsey
investment companies

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To discuss the issues raised in this paper please contact:

Ian Sayers

Deputy Director General
E-mail: ian.sayers@theaic.co.uk
Tel: 020 7282 5612

Important information

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Introduction

The Companies (Guernsey) Law 2008 introduced a new regime under which companies can make distributions. It replaced the capital maintenance system with a solvency test, in order to provide directors of companies with greater flexibility over distribution policy, whilst at the same time continuing to protect the interests of creditors.

The regime creates new considerations for directors of investment companies when determining whether a distribution can be made. As directors face potential personal liability if distributions are made which do not comply with the terms of the new law, the AIC is keen that Members should be able to demonstrate clearly that the solvency test was complied with, should the legality of the distribution be challenged in the future.

This paper therefore aims to clarify certain aspects of the legislation, and discusses how it applies to the most common situations facing Guernsey investment companies.

Members with feedback or queries on any of the issues raised in this paper should contact Ian Sayers, the AIC's Deputy Director General, on 020 7282 5612 or ian.sayers@theaic.co.uk.

Executive Summary

General

- Boards should ensure that the solvency test is met when they authorise a distribution by the company
- The solvency test is split into two parts, a 'cashflow test' and a 'net assets test', both of which must be met
- Boards must approve a certificate, signed on behalf of the Board by at least one director, stating that the solvency test is met and the grounds for that opinion
- Boards should continue to monitor the position after authorisation to ensure these tests will still be met immediately after the distribution is made
- Boards can be held personally liable for distributions which are made when the solvency test is not met

Cashflow test

- The cashflow test requires that the company must be able to meet its debts as they become due
- Boards should consider all debts for which a legal obligation exists, or which the company is committed to, irrespective of when these become due (there is no 12 month timeframe as with similar regimes in other jurisdictions)
- Boards should give particular attention to any contingent liabilities that exist given the uncertainties over the amount and timing of these potential debts
- Boards should include returns on fixed rate preference share capital (e.g. zero dividend preference shares) in the cashflow test unless it has been established that this is not required

Net assets test

- The net assets test requires that the company's assets are greater than its liabilities
- The starting point for determining the company's assets and liabilities, and their value, should be the most recent accounts of the company
- As a matter of prudence, Boards may wish to ignore all contingent assets for the purposes of the net assets test

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- Boards should give particular attention to any contingent liabilities that exist given the uncertainties over the value of these liabilities
- Boards should include fixed rate preference share capital (e.g. zero dividend preference shares) as liabilities for the purposes of the net assets test unless it has been established that this is not required
- Boards should give particular attention to any other share capital required to be accounted for as a liability and take further advice as to whether such share capital is required to be treated as a liability for the purposes of the net assets test
- Where Boards decide to depart from an 'accounts based' approach for measuring assets and liabilities, the reasons for doing so should be recorded in the certificate of approval

General

The basics of the solvency test

Under Guernsey company law, a Board may only authorise a distribution if it is satisfied on reasonable grounds that the company, immediately after the distribution, will satisfy the solvency test. The solvency test is split into two parts, both of which must be met.

A company satisfies the solvency test if:

1. the company is able to pay its debts as they become due ('the cashflow test'); and
2. the value of the company's assets is greater than the value of its liabilities ('the net assets test')

Directors should note that the two tests are separate and different in nature. Directors should not assume that the principles and assumptions used for one test can automatically be applied to the other.

Factors affecting ease of compliance

For many companies, demonstrating that the solvency test is met when making a distribution will be straightforward, as many investment companies have few major creditors and a liquid portfolio which can be readily turned to cash if required.

The solvency test is likely to be more complicated, and require greater attention, both in practical and legal terms, for companies

- which are making more frequent distributions
- where the valuation of assets or liabilities is more uncertain, either due to illiquidity in the underlying portfolio or due to high levels of volatility
- which have a higher level of creditors in relation to their assets
- which have less 'headroom' on the tests, or where going concern issues have been identified
- where there are other indications of problems regarding the company's solvency, for example if the company has, or is close to, breaching loan covenants
- which are heavily reliant on counterparties, in particular where the solvency of those counterparties may also be an issue

Distributions covered by the solvency test

The distributions covered by the solvency test include dividends, share buy-backs, tender offers and other share redemptions (though this is not an exhaustive list of all methods which a company may distribute assets to members). Although Guernsey company law sets out slightly different rules for dividends and other forms of distribution, in terms of the solvency test, the conditions are essentially identical.

Certificate of approval

Guernsey company law states that the Board of directors must approve a certificate stating:

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

The certificate must be signed on the Board's behalf by at least one director.

The statement of the Board's opinion that the test will be met after payment of the distribution is a matter of fact. However, setting out the grounds for that opinion is more subjective, and there is no guidance in the law as to what should be included in this statement. This statement is likely to be key evidence that the view taken by directors at the time was reasonable, even if subsequently creditors are left exposed.

It is unlikely that there is a 'one size fits all' template for this statement. It is, however, important that the statement does not simply set out the process which the Board went through to determine whether the solvency test is met, but also adequately sets out the grounds for believing that the test is met.

A company with a liquid portfolio and few major creditors, with a significant amount of 'headroom' on the net assets test and paying a dividend shortly after the balance sheet date, may be able simply to refer to the accounts as justification that the test has been met with little additional information or explanation. Other cases will be more complex, requiring more detailed explanation.

However, such a statement is likely to include:

- a statement of the most recent accounts which the directors have had regard to
- a statement of any other more recent information relied upon by the directors to demonstrate continuing compliance with the solvency test
- areas where the company has departed from an accounts based approach for the net assets test (e.g. share capital which is accounted for as a liability, but not treated as such for the purposes of the net assets test) and the reasons for doing so

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- confirmation that the directors are not aware of any events since the date of the most recent accounts relied upon that might affect compliance with the solvency test

Consideration of solvency test after authorisation of distribution

Guernsey company law states:

"If, after a distribution is authorised and before it is made, the board ceases to be satisfied on reasonable grounds that the company will, immediately after the distribution is made, satisfy the solvency test, any distribution made by the company is deemed not to have been authorised"

In addition, if a director ceases to be satisfied on reasonable grounds that the solvency test will be met, then the director must take reasonable steps to prevent the distribution being made to avoid personal liability.

If, for example, markets have fallen significantly since authorisation of a distribution, this may affect whether the net assets test is still met. Similarly, significant changes in the liquidity of the underlying portfolio, or solvency of major counterparties, might affect whether the cashflow test and/or the net assets test are still met.

In practical terms, this is not to suggest that a detailed 'real time' position needs to be calculated and assessed just prior to each distribution being made. If, based on the latest accounts, for example, the company has substantial 'headroom' on the net assets test, the market has risen since, and there are no other changes in the circumstances of the company, directors may be able to conclude very quickly that the solvency test is still met. Alternatively, Boards may instruct their advisers to report back to them, once authorisation has been given, on any changes in the circumstances of the company that might affect continuing compliance with the solvency test.

Consequences of breaching the solvency test

A distribution made to a shareholder at a time when the company did not satisfy the solvency test may be recovered by the company from shareholders subject to certain conditions. Where the distribution cannot be recovered from the shareholders, the directors can be held personally liable.

A director can be held personally liable if he/she:

- fails to take reasonable steps to ensure that the procedures required by Guernsey company law are followed
- authorises a distribution when reasonable grounds for believing the solvency test would be met do not exist
- fails to take reasonable steps to prevent a distribution being made if the director ceases to be satisfied on reasonable grounds that the solvency test is met

The cashflow test

The basics of the test

The cashflow test requires that a company must be able to pay its debts as they become due.

This part of the solvency test may be easier for some investment companies to demonstrate compliance with than, say, trading companies, as the cashflow position of the company may be more straightforward and predictable. In addition, many investment companies will have a pool of readily realisable assets which can be turned to cash at short notice if required.

However, current market conditions may require Boards to revisit presumptions that would have appeared reasonable only a few months ago.

Debts to be considered

The Board should consider all the company's debts for which a legal obligation exists, or which the company is committed to. Debts which may be incurred in the future, or which are not as yet envisaged, would not be relevant for the purposes of the cashflow test.

Boards should note that there is no time limit on how far forward they need to consider this test. This can be contrasted with Jersey company law, for example, where the equivalent legislation specifically refers to a period of 12 months.

Boards should therefore consider the repayment terms of all the debt obligations the companies are party to and assess whether they can be met as they become due. The fact that a loan may be repayable in 10 years' time (and therefore is not due now) does not mean that a Board can ignore the repayment terms of the debt when considering the cashflow test.

However, the length of time between the distribution and when a debt falls due might affect how reasonable it is for the Board to conclude that the company will be able to meet the debt as it becomes due.

If an investment company has a long-term loan which is due for repayment some years into the future, the company might not have sufficient cash today to pay both the distribution and the redemption value of the loan. However, if this was because of a lack of liquidity in the underlying portfolio (as opposed to a lack of resources), it may well be reasonable for the Board to conclude that it would be able to raise sufficient cash to meet the redemption value as it becomes due, given the length of time before repayment.

Boards should pay particular attention to any contingent liabilities that exist at the time of authorising a distribution, given the uncertainties over the amount and timing of when these potential debts may become due, if at all.

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Boards should note that, under IFRS / UK GAAP, contingent liabilities are only recognised on the balance sheet when it is probable that a liability will materialise. Boards may therefore need to take into account contingent liabilities which do not meet the criteria for balance sheet recognition in determining whether the cashflow test is met.

As a matter of prudence, Boards may wish to adopt a "worst case" approach to such contingent liabilities (i.e. reflecting any such liabilities, however remote, at their highest possible value repayable at the earliest juncture) to determine whether such liabilities represent a possible concern over whether the cashflow test is met.

Inclusion of fixed rate preference shares in cashflow test

Guernsey company law states that "debts" include *"fixed preferential returns on shares ranking ahead of those in respect of which a distribution is made"*.

The vast majority of Guernsey investment companies issue only ordinary shares. A few companies have issued zero dividend preference shares ('zeros'). As the redemption value of the zero is normally predetermined, Boards may need to take into account the redemption terms of the zero within the cashflow test.

However, the law provides that fixed preferential returns are included in the test *"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"*. Boards may wish to determine whether any such provisions exist which would mean that zeros could be ignored for the purposes of the cashflow test.

The net assets test

The net assets test requires that the value of the company's assets is greater than the value of its liabilities.

Guernsey company law states:

"in determining whether the value of a company's assets is greater than the value of its liabilities, the directors –

(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."

Accounts

There is no definition of accounts in Guernsey company law. For distributions such as dividends, published accounts will normally have been produced relatively recently prior to the authorisation of the dividend and are likely to form the starting point for consideration of the net assets test.

However, this will not always be the case, and other forms of distribution, such as share buy-backs, may take place some weeks or even months after the last set of published accounts were prepared.

Where more recent accounts, such as management accounts, are available which give a more up-to-date picture of the net assets test, Boards should have regard to these accounts rather than the earlier published accounts.

However, Boards may need to go further than considering the most recent accounts. As stated above, directors are also required to have regard to *"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"*.

Therefore, if there have been significant market falls since the last accounts were prepared, it may be necessary for further management accounts to be prepared before a distribution is authorised by the Board to confirm that the net assets test is still met. The need for further management accounts would depend, in part, on how much 'headroom' was available since the last accounts were prepared and whether any other changes have occurred since the preparation of the last accounts which might have a material impact on the valuation of assets and liabilities.

Assets

There is no definition of assets in Guernsey company law. Given the requirement to have regard to the latest accounts of the company, the starting point for directors would be items which are recognised as assets for accounts purposes.

It would appear technically possible for a contingent asset to be taken into account in considering whether the net assets test is met. However, in practical terms, given the uncertainty over whether this asset will ever be realised, it is debatable whether directors of an investment company which could meet the net assets test solely by virtue of a contingent asset should be prepared to make a distribution.

Under IFRS / UK GAAP, contingent assets are not recognised on the balance sheet until their receipt is virtually certain (at which point they are not considered to be contingent). Boards may therefore, as a matter of prudence, decide to ignore all contingent assets in determining whether the net assets test is met until they are recognised as assets for accounts purposes.

If, exceptionally, directors were intending to rely on a contingent asset to meet the solvency test, the reasons justifying this position should be carefully considered and documented separately in the certificate of approval (see below). Boards may also wish to take advice in such circumstances.

Liabilities which should be included

Guernsey company law states that liability *"includes duty, debt and obligation"*. Again, given the requirement in Guernsey company law to consider the most recent accounts of the company, the starting point for liabilities would be those items recognised as liabilities for accounts purposes.

The definition is also extended for the purposes of the net assets test to include *"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"*. Again, this condition is subject to the *"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"* exception.

As a result, Boards of Guernsey investment companies with zeros in issue may need to take these into account as liabilities for the purposes of the net assets test unless the memorandum or articles provide otherwise.

Under IFRS / UK GAAP there may be other forms of share capital which are accounted for as liabilities, but which are not fixed rate preference shares. For example, the AIC is aware of split capital investment companies which have had to account for their entire share capital as liabilities (though amendments to IFRS / UK GAAP has changed this position). In such cases, the accounts of the company would show the company's liabilities equal to its assets.

Clearly, if the net assets test were applied on the basis of the accounts classification of assets/liabilities, then such companies would never be able to meet the net assets test, and therefore prevented from

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making any distributions. This is clearly not the intention of the law and there is therefore an argument that share capital (other than fixed rate preference share capital) which is required to be accounted for as a liability under IFRS / UK GAAP can be excluded as a liability for the purposes of the net assets test.

As stated above, with changes to IFRS / UK GAAP, and the fact that most Guernsey investment companies issue only ordinary share capital, the AIC expects that this is unlikely to be an issue for many, if any, current Members. The AIC intends to lobby for a clarification to the law to make it clear that share capital (other than fixed rate preference share capital) which is required to be accounted for as a liability under IFRS / UK GAAP can be excluded as a liability for the purposes of the net assets test.

However, in the interim, Boards of Guernsey investment companies thinking of issuing new shares other than those classes already in issue should confirm the accounting treatment of such shares with their advisers and, if liability classification is required, take further advice as to the implications this might have on the net assets test.

As with the cashflow test, Boards may need to take contingent liabilities into account for the net assets test even if they have yet to be recognised as liabilities for balance sheet purposes. Again, Boards may wish to take a "worst case scenario" approach (i.e. including all contingent liabilities at their highest value) to determine whether there are any concerns over the net assets test being met. Indeed, Boards may wish to take a similar approach to the assets side of the balance sheet.

Valuation

The starting point for the valuation of assets and liabilities should be the accounts valuation. However, there may be circumstances where Boards need to depart from this basis.

For example, if the investment company is likely to breach its loan covenants (where clearly the risk to creditors is higher) directors might need to consider the repayment value of the debt and the possible impairment of the value of illiquid assets if the company were forced to sell assets at short notice to repay debt. The same type of consideration might apply if the investment company was experiencing going concern problems, or was considering a liquidation (voluntary or not).



Association of Investment Companies

24 Chiswell Street
London EC1Y 4YY

Telephone 020 7282 5555

Fax 020 7282 5556

enquiries@theaic.co.uk

www.theaic.co.uk

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