The Solvency Test:
A New Era in Directorial Responsibility.

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I: INTRODUCTION

Nearly a decade ago the Law Commission released *Company Law: A Discussion Paper.*[1] The *Paper* expressed the view that the common law dividend rules were complicated and should be reduced to statutory form for the sake of clarity.[2] However, rather than merely codifying the dividend rules, the Law Commission favoured replacing them with a statutory solvency test. The test would apply to all transactions where wealth is transferred from the company to shareholders.

The Companies Act 1993 ("1993 Act") introduced a solvency test largely as proposed by the Law Commission. This provision has brought significant changes to New Zealand law in relation to distributions. This article will discuss the extent to which the solvency test, while being essentially a restrictive provision, has introduced an environment that is more permissive and allows companies to return capital to its shareholders. It will conclude that directors must be aware of the shift to greater personal liability introduced by the 1993 Act and that any breach of either component of the test may found a personal action against them.

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1 (1987) NZLC PP5.

2 For a discussion of the common law dividend rules see, for example, 1 *Hilton International Limited v Hilton* [1989] 1 NZLR 442.

II: THE SOLVENCY TEST

The solvency test is set out in s 4 of the 1993 Act and contains two separate components: liquidity, and balance sheet. The liquidity requirement demands that a company have the ability to pay its debts as they become due in the normal course of business.[3] The balance sheet requirement demands that the company's assets be of greater value than its liabilities, including contingent liabilities.[4]

Before authorising a distribution, directors must be satisfied on reasonable grounds that the company will meet both limbs of the solvency test immediately after the distribution.[5] Upon satisfaction, the directors may issue a distribution at any time, of any amount and to any shareholders they think fit, subject only to the requirements of s 53 of the 1993 Act and the company's constitution.[6] It is not necessary for the solvency test to be met at the time of authorisation.

During the interval between authorising and making a distribution, the board may cease to be satisfied on reasonable grounds that the company will satisfy the solvency test immediately after the distribution, whereupon the distribution is deemed unauthorised and will incur the same consequences as an unauthorised distribution.[7] Therefore, to avoid difficulties in the future, distribution should promptly follow the directors' authorisation.

The solvency test applies to distributions because they transfer wealth from the company to its shareholders and this may be detrimental to both creditors and non-participating shareholders:[8]

> The test is designed to be a substantial constraint in such circumstances because they are [circumstances] in which limited liability and management power are most open to abuse.

However, the solvency test does not deal with distributions exclusively and under the 1993 Act it must also be satisfied in the following situations: discounts provided to shareholders (s 55); unanimous assent (s108); minority buy-out rights (s 110); unfair prejudice remedy (ss 174-175); and amalgamations (ss 221-222).

Furthermore, satisfying the solvency test is not the sole requirement for authorising some distributions; directors must satisfy additional requirements before authorising the following distributions: dividends (s 53), discounts provided to shareholders (s 55), reduction of shareholder liability (s 57), share repurchases (s 58-67), share redemptions (s 68-75), and financial assistance by a company in the purchase of its own shares (s 76-81).

3 Section 4(1)(a).

4 Section 4(1)(b).

5 Section 52(1).

6 The board cannot issue a dividend to some, but not all, shares in a class nor can it issue dividends of greater value per share to some shares in a class.

7 Section 53(3) of the 1993 Act.

8 Law Commission, "*Company Law Reform and Restatement*", NLC R9 (1989) at para 330, p78.

The word "distribution" is broadly defined in the 1993 Act [9] and includes a direct or indirect transfer of money or property[10] to a shareholder or the incurring of a debt to, or for the benefit of, a shareholder.[11] Therefore, "distributions" include: dividends (s 53); reduction of shareholder liability (s 57); share repurchases (ss 58-67); share redemptions (ss 68-75); and financial assistance by a company in the purchase of its own shares (ss 76-81).

However, distributions, as defined by s 2 of the 1993 Act, must be received by shareholders "in relation to shares held". Literally, this means only benefits received in the capacity of shareholder are considered distributions. However, such an interpretation may prejudice creditors and non-participating shareholders. Small companies whose few shareholders are also company employees will commonly pay out all company profits as salaries, rather than dividends. This leaves the company with no taxable income. It is unclear whether the solvency test must be met before such salaries (in effect dividends) are paid. If a strict interpretation of the Act is adopted, the answer is clearly no because the salary is received in the context of employment and not in the context of shareholding. Yet it is anomalous to allow a controlling shareholder to receive as salary that which he or she could not receive as a dividend.

Thus, any portion of salary paid simply because an employee is also a shareholder should be regarded as a distribution and subject to the solvency test. Directors in this situation should ensure that both the solvency test and the requirements in s 52 are satisfied.[12]

It may be difficult to distinguish between the portion of salary earned through labour and the portion which is a dividend.[13] In this situation, directors should use the market salary as a useful guide and act reasonably in determining the respective portions.

Although the expressions "debts", "liabilities" and "assets" are used in the solvency test, they are not defined in the 1993 Act. However, the following sections of the 1993 Act indicate that in particular situations certain items are included within one of the expressions.

Under s 52(4) "debts" include fixed preferential returns on shares ranking ahead of shares in respect of which a distribution is made. In addition, s 52(4) defines "liabilities" to include any fixed preferential amounts payable to shareholders on the company's removal from the Register after a distribution, or if the shares were redeemed. However, "liabilities" does not include the total value of dividends payable on fixed preference shares in the future. Further, s 52(4) states that when determining the solvency test, directors may ignore fixed preferential amounts if:

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9 Section 2 of the 1993 Act.

10 This does not include the transfer of a company's own shares. The requirement of fair value in s 47 should ensure that a company is not prejudiced when capital is raised and raising capital when the company is in difficulty should not be discouraged.

11 Under s 2 of the 1993 Act, this may occur through the purchase of property, the redemption or other acquisition of shares, a distribution of indebtedness, or by some other means.

12 The requirements of s 52 of the 1993 Act are discussed above.

13 However in *Troon Place Investments Limited v CIR*, alt. cit. *GS Matthews (Chemist) Ltd v CIR* (1995) 17 NZTC 12,175, the IRD determined that part of a salary paid to a shareholder was assessable as dividends.

> [The] fixed preferential return is expressed in the [company's] constitution as being subject to the power of directors to make distribution.

Under s 77(6), a company that gives financial assistance in the purchase of its own shares cannot include the loan assistance as an "asset" for the purposes of the solvency test. However, the face value of all liabilities (contingent or otherwise) accrued through giving financial assistance must be included in the solvency test.[14]

However, the meaning of "face value" in s 77(6) is made somewhat unclear by s 4(4) and s 77(7). For s 4(4) allows directors determining the value of a contingent liability to consider both the likelihood of the contingency occurring and any claim to which the company is entitled and which can be reasonably expected to reduce or extinguish the liability. Further, s 77(7) states that the application of s 4(4) is not affected by s 77(6).

However, it is correct to read s 77(6) subject to the more specific wording of s 77(7). Further, if this were not correct, it is difficult to see why the *Companies Act 1993 Amendment Act 1994* inserted s 77(7). Thus, it is submitted that when s 77(6) and s 77(7) are read together, s 4(4) prevails and should be used to determine the value of contingent liabilities under s 76.

Nevertheless, under s 107(1)(e), at the agreement of all entitled persons financial assistance may be given otherwise than in accordance with s 76-80. In this situation, s 108(5) applies. This section mirrors s 77(6) but it includes no s 77(7) equivalent. Therefore it seems that in this context, s 4(4) will not apply and contingent liabilities will be accorded their face value. Thus, many companies will choose to use the s 76 procedure since the application of s 4(4) will make the solvency test easier to satisfy.

The classification of "asset" or "liability" adopted in the company's Balance Sheet will also be useful when determining an items nature for the purposes of the solvency test. It is appropriate to refer to accounting definitions since directors must have regard to the company's most recent financial statements prepared in compliance with s 10 of the Financial Reporting Act 1993 ("FRA") when they determine whether the solvency test is met.

1. The Liquidity Limb of the Solvency Test

The liquidity limb is similar to concepts contained in the unamended 1955 Act[15] in relation to voidable preferences (s 309) and reckless and fraudulent trading by company officers (s 320(1)). Thus, judicial consideration of those sections may provide a useful starting point when interpreting the liquidity test.

There are two primary difficulties with the liquidity test. First, is the meaning of the words "ability to pay debts as they become due" and second, is the meaning of the words "in the normal course of business".

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14 Section 77(6) of the 1993 Act.

15 The Companies Act 1955 prior to its amendment by the Companies Amendment Act 1993.

The meaning of the phrase "ability to pay debts as they become due" was discussed in *Re Northridge Properties (in liq)*[16] and the following principles were established for determining whether a company is able to pay its debts as they become due:

(i) What is relevant is whether a company is able to pay its debts at the present time. However, it is also relevant to consider the recent past and the company's position in recent weeks.

(ii) In determining the ability to meet debts as they become due, account must be taken of outstanding debts.

(iii) The phrase "as they become due" refers to the time when debts become legally due.

(iv) Non-cash assets may be taken into account if there is "a substantial element of immediacy" about the ability to obtain cash from non-cash assets.[17] And debts which mature while non-cash assets are converted must be considered.

(v) The test of solvency is an objective one.

In *Bank of Australasia v Hall*[18] the court held that a debtor had a reasonable period of time in which to convert non-cash assets into cash in order to pay debts as they became due and so satisfy the test. Furthermore, in *Sandell v Porter*[19] the court stated that:

> [T]he conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity. It is the debtor's inability, utilising such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency.

Section 4 does not expressly require a company to *use its own money* to pay debts as they become due.[20] This raises the issue of whether a director can consider support expected from another party, for example from a parent company. The issue is discussed in several Australian cases dealing with applications for winding up. In general the Australian courts are well disposed to the idea.[21]

Nevertheless, despite the line of Australian authority, it would be imprudent for directors to rely on third party financial assistance. This is because a court may not

16 Unreported, Richardson J, M46/75, 13 December 1977.

17 On the facts of *Re Northridge Properties (in liq)* the company was required to pay its debts as they became due "from its own money". Section 4 contains no such requirement and thus the element of immediacy is presumably not as strict.

18 (1907) 4 CLR 1514, at 1543 per Isaacs J.

19 (1966) 115 CLR 666, at 670 per Barwick CJ.

20 Cf voidable preference provisions, s 309 unamended 1955 Act. Note though that s 292 of the 1993 Act, the closest equivalent to s 309, does **not** require payment from the company's own money.

21 See: *Re Adnot Pty Limited* (1982) 7 ACLR 212 (SC of NSW) Cf *Re RHD Power Services Pty Limited* (1991) 9 ACLC 27. See also *Dunn v Shapowloff* [1978] 2 NSWLR 235, quoted with approval in *Southern Star Group Pty Limited v Taylor and others (No.2)* (1991) 9 ACLC 1,211 at 1,216. See also *Re Gold Resources Australia Limited* (1991) 9 ACLC 1,500 and *Argyll Park Thoroughbreds Pty Limited v Glen Pacific Pty Limited* (1993) 11 ACSR 1.

consider expected support from a third party "reasonable grounds for believing that the solvency test" would be satisfied. This is particularly so if the expected assistance has not eventuated by the time of trial.

The other ambiguous element of the liquidity limb is the meaning of the phrase "in the normal course of business". This phrase first appeared in the Law Commission's second draft Act and was borrowed from s 6.40(c)(1) of the American Model Business Corporations Act ("MBCA").[22] It was adopted to minimise fears of uncertainty which various parties had expressed.[23]

However, an element of uncertainty remains and it is unclear whether the words mean that:

(i) A company need only have the ability to pay debts which become due in the normal course of business (ie. not unusual or extraordinary debts); or

(ii) A company needs the ability to pay in the normal course of business all debts that become due, including any unusual or extraordinary debts.

It is submitted that the first meaning is preferable. Directors should be required to consider only debts with a realistic chance of falling due when determining the liquidity test. Directors cannot be realistically expected to include debts that they do not expect to fall due. Furthermore, contingent liabilities are considered in the balance sheet test.

Considerable New Zealand case law exists on the meaning of "in the *ordinary* course of business" and thus it is unusual that the Act's drafters chose the alternative wording of "in the *normal* course of business". However, while there may be subtle differences in the meanings of "ordinary" and "normal", in practice the words are identical.

In *Downs Distributing Company Pty Limited v Associated Blue Star Stores Pty Limited*,[24] Rich J stated that a transaction was in the ordinary course of business if:

> [T]he transaction [fell] into place as part of the undistinguished common flow of business done, that it [formed] part of the ordinary course of business as carried on, calling for no remark and arising out of no special or particular occasion.

This view was approved by the New Zealand Court of Appeal in *Julius Harper Limited v FW Hagedorn & Sons Limited*.[25]

22 See the Law Commission's report *Company Law Reform: Transition and Revision* NZLC R16 (1990) (LC16). In fact the MBCA uses the words "in the usual course of business".

23 LC16 at 3.

24 (1948) 76 CLR 463 (HC of Aust) per Rich J.

25 [1991] 1 NZLR 530, at 543 (CA).

2. The Balance Sheet Limb of the Solvency Test

The valuation of assets and liabilities for the purposes of the balance sheet limb can be difficult. Under s 4 of the 1993 Act directors "may rely on valuations of assets that are reasonable in the circumstances". Under s 138 of the 1993 Act, if a director acts in good faith, makes proper inquiry where the need for inquiry is indicated by the circumstances and has no knowledge that reliance on a third party is unwarranted, then when exercising powers or performing duties, that director may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by:

(i) An employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned; or

(ii) A professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence.

Compliance with s 138 may assist in establishing the reasonableness referred to in s 4.

Asset valuation is inherently subjective and the value of a particular asset may differ among valuers. If a valuation is incorrect, directors may invalidly certify that the solvency test is met. However, directors should escape liability if they engaged a reputable valuer and had no reason to suspect the valuation's inaccuracy.

If directors choose not to use valuation experts they must exercise reasonable skill in determining asset values. In some instances, directors may have more knowledge regarding a specific asset's value than an outside valuer. Thus, rather than simply accepting the value determined by an external valuer, directors may be required to use their own judgment. For example, industry knowledge may make directors better able to determine an asset's obsoleteness.

When determining the solvency test, directors must consider the company's most recent financial statements prepared in compliance with s 10 of the FRA. This requires that the company accounts be prepared on the assumption that the company is a going concern. Whether assets are valued as part of a business, as a going concern, or individually, at their winding up value, markedly affects their value.

The method selected to value a business will affect the balance sheet test. For example, an organisation rich in human resources may have a strong cash flow and satisfy the liquidity test. If a "going concern" assumption is adopted and goodwill is included, the business's value may be considerable because of the strength of the company's revenue flow. Thus, the balance sheet test will be met. However, if the company is valued by its assets on winding up, the company will fail the balance sheet test if its physical assets are outweighed by borrowings because its primary asset is people.

When an asset is useful to a company but of limited use to other entities, valuation is problematic. Since the asset has a specialised nature its market is

limited and thus the "break up" value (in this case the realisable value of the asset), is likely to be less than its book value or value as part of the going concern.

Meat processing companies provide a useful example because they often invest heavily in meat processing facilities which are of little use for anything else. Clearly there is a significant difference between the value of a processing facility sold as part of a business and the value of a facility sold individually when a company is broken up.

If a company's auditors are concerned about the company's status as a going concern, they will qualify their report. In this situation, directors should give very careful consideration to the appropriate value of assets and liabilities before making a distribution. It is likely that "break-up" asset values will be appropriate. In any case, it is unlikely that the company will be in a position to satisfy the solvency test.

Valuing intangible assets is also problematic. When a "going concern" assumption is valid, it is appropriate to include goodwill as an asset if the goodwill can be sold along with the company's other assets. However, goodwill should not be included when valuing a business if a "going concern" assumption is inappropriate, or the goodwill is generated by an owner's personal attributes and cannot be transferred along with the company's other assets.

Although the 1993 Act expressly refers to contingent liabilities, there is no reference to contingent assets in the balance sheet test. Thus, contingent assets should be ignored when determining the solvency test. This is consistent with the accounting doctrine of conservatism which does not allow contingent assets to be recorded until they eventuate. Directors are able to take into account rights of subrogation, indemnity and contribution when determining the value of contingent liabilities and thus contingent assets are recognised at least to this extent.

Valuing short term liabilities for the purpose of the balance sheet limb should not be difficult and directors will undoubtedly rely on accounting records. Long term liabilities are often more difficult to value and it may be necessary to use accounting experts when valuing these. For example, long term borrowing facilities are often at a floating rate of interest which makes it difficult to determine exactly the company's liability, particularly in the longer term.

If a company is tied into a long term lease, fixed outgoings under the lease should be treated as a liability. Reference to the accounting treatment of leases, detailed in Statement of Society Accounting Practises (SSAP) 18, would be consistent with the 1993 Act's requirements regarding the FRA.

SSAP 18 categorises leases as either finance or operating. A finance lease transfers to the lessee a substantial portion of all risks and rewards incidental to ownership of an asset. The lessee acquires the use of the asset for a substantial part of its useful life and in return must pay an amount approximating the fair value of the asset and the related finance charge. Such a lease is generally "non-cancellable"[26] and usually, either title is transferred to the lessee at the end of the lease or the lessee has an option to purchase the asset for a nominal amount.[27]

26 Defined at para 3.4 of SSAP 18. Includes a lease which is only cancellable on the occurrence of some remote contingency; or with the permission of the lessor; or if the lessee enters into a new lease with the lessor for the same or an equivalent asset; or upon payment by the lessee of an additional penalty amount (such that continuation of the lease is reasonably certain).

27 Para 3.2 of SSAP 18.

An operating lease is "a lease other than a finance lease" [28] and thus includes leases which do not transfer to the lessee a substantial portion of the risks and rewards incidental to ownership. Land and buildings are normally leased under an operating lease because they usually have either an indefinite useful life or a useful life that extends well beyond the lease term. Thus, unless the lease provides for title to pass to the lessee during or at the end of the lease, the lessee does not receive a substantial portion of the risks and rewards incident to ownership.[29]

Finance leases[30] should be recorded in the lessee's balance sheet as both an asset (the value of the property leased) and a liability (the obligation to pay future rentals). Initially, the asset and liability are recorded as identical amounts and this is the lesser of the fair value of the leased property and the present value of the lease payments.[31] The asset-value is depreciated in a manner similar to other depreciable assets owned by the company and in accordance with SSAP 3.[32] Similarly, the liability recorded in the balance sheet reduces as rent is paid. However, the liability does not reduce by the full amount paid because each payment is divided between the finance charge [33] and the reduction of the lease liability.

Thus, following SSAP 18 methodology, a finance lease has no initial effect on the balance sheet test. However, as the asset and liability amounts vary over time, the lease will have either a positive or negative net effect. Furthermore, rent payments are included when determining the liquidity test.

Under an operating lease, only rental expense appears in the lessee's financial statements. It is recognised on a systematic basis which represents the time pattern of the lessee's benefits, even if payments are not on this basis. Thus, following SSAP 18 methodology, an operating lease has no effect on the balance sheet test. However, the payments made, as opposed to the rental expense recognised on a systematic basis, will feature in the liquidity test.

Although directors must have regard to the company's most recent financial statements, these should be considered critically. SSAP 18 methodology is not always appropriate for the purposes of the solvency test. For example, leases of land and buildings are generally operating leases and therefore there is no record in the company's balance sheet of future rental liability. While this may be appropriate where a lease is readily assignable, where there are restrictions or a prohibition on assignment and sub-letting, it is prudent to include future rental payments as liabilities when determining the solvency test.

When liabilities are valued for the purposes of the balance sheet test, contingent liabilities create the most difficulty. A contingent creditor is a person

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28 SSAP 18, at para 3.3.

29 SSAP 18, at paras 4.28-4.29.

30 Hire purchase contracts of a financing nature (eg. conditional purchase agreements) should be accounted for on a similar basis to finance leases.

31 When calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease.

32 Accounting for depreciation.

33 The finance charge is the difference between the total minimum lease payments over the lease term and the initial recorded net liability. This charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability during each period.

towards whom, upon the happening of some future event, the company may become subject to a liability under an existing obligation.[34] Contingent liabilities include guarantees, uncalled share capital, letters of credit, bills of exchange, pending litigation, lease obligations, performance bonds, underwriting and hire purchase agreements. Under s 4(4) of the 1993 Act, directors may consider two factors when determining a contingent liability's value: the likelihood of the contingency occurring; and any claim to which the company is entitled and which can reasonably be expected to reduce or extinguish the contingent liability.

From an accounting perspective, "contingency" excludes general or unspecified business risks or conditions[35] and therefore these are not considered contingent liabilities. However, these factors may affect the assets' realisable values or indicate that a "going concern" assumption is inappropriate. Further, contingent liabilities are only included in the accounts if they are expected to be confirmed by future events and a reasonable estimate can be made of their value.[36] If the contingent liability cannot reasonably be estimated, it is not included in the accounts but disclosed in a note to the accounts. Contingent assets are not recorded in the accounts and are disclosed as a note.

For the purposes of the solvency test however, it is unsatisfactory to ignore a contingent liability simply because it cannot be accurately quantified. A value should be settled on which is as accurate as possible, given the circumstances. Directors should carefully consider the likelihood of a contingency occurring, its likely amount and any claims the company has which might reduce the amount of the contingency. Directors should take a conservative approach when determining the value of the contingency and the process should be carefully documented. Providing directors act reasonably and determine a realistic value they will satisfy the requirements of the 1993 Act. Where possible, directors should instruct the company's accountants to determine the value of contingent liabilities. Thus, if the value is later called into question, the directors will be protected since they may rely on liability estimates which are reasonable in the circumstances.[37]

Differentiating between assets and liabilities, or between liabilities and capital, should not normally be difficult. However, the distinction between capital and liabilities can become difficult with regard to subordinated debt.

Although subordinated debt is a loan, the lender (junior creditor) is only repaid once senior creditors are repaid in full. Thus, subordinated debt is used as quasi-equity and is commonly listed next to shareholders' funds in the company's Balance Sheet. There are several ways to structure a subordinated debt agreement. The structure chosen will dictate whether subordinated debt is included as a liability under the balance sheet test.

With "contractual subordination", sometimes called "contingent debt subordination", the junior creditor contracts not to be repaid until the senior debt is paid in full. This applies regardless of whether the debt matures or the company is wound up. On insolvency, the junior creditor may prove only for an amount which leaves sufficient value in the company to pay all senior creditors. Thus, junior debt

34 *Re William Hockley Limited* [1962] 1 WLR 555, at 558.

35 See SSAP 15.

36 See SSAP 15.

37 Section 4(2)(b).

is not really a debt until senior debt is paid. Clearly this form of debt subordination is a contingent liability for the debtor company. Therefore, when applying the solvency test, the company is entitled to consider both the likelihood of the contingency occurring and any claim which might reduce or extinguish the liability.

Alternatively, a "subordinated trust" structure could be adopted so that the junior creditor claims the junior debt on either maturity or liquidation, but holds the funds received on trust for the senior creditor. Under the solvency test, debt subordinated by this method is included at full value as a liability of the borrower.

With a "convertible subordinated" structure, subordinated debt is automatically converted into shares on maturity or winding up and the junior creditor is not entitled to be paid cash. Convertible subordinated debt is not a liability and can be treated as equity under the solvency test. Thus, borrowers prefer this method because the debt can be ignored in the balance sheet test. Lenders, however, may reject this method.

Where a number of forms of subordination are used in one agreement, the interpretation of the contract as a whole will determine whether the debt needs to be included in the balance sheet limb of the solvency test, and if so, at what amount.

3. The directors certificate

Under s 52(2), directors who vote in favour of a distribution must sign a certificate stating that in their opinion the company will, immediately after the distribution, satisfy the solvency test. The grounds for the directors' opinion should also be set out. Failure to comply with s 52(2) is an offence under s 52(5) and is subject, on conviction, to a fine not exceeding $5000.

The Act contains neither a model solvency certificate nor any detail on what a solvency certificate should include. However, the following preliminary points can be made. The liquidity and balance sheet tests should be referred to separately, as evidence that both tests were considered. Directors should also outline fully and clearly their "reasonable grounds" for believing that the solvency test will be satisfied after a distribution and reference to external valuations or to reports supporting the directors' statements should also be made. Should the directors' decision later be reviewed by a court, the certificate will provide prima facie evidence of their beliefs.

If a solvency certificate details very specific "reasonable grounds", it may be difficult to argue that a factor not referred to in the certificate was indeed considered. Stating brief and general grounds allows directors to argue that they considered factors which they did not. However, this may also wrongly suggest that some necessary factors were not considered or indeed, that due consideration was not given to the company's solvency position. Thus, it is recommended that directors state fully and clearly the "reasonable grounds" on which they base their beliefs.

A solvency certificate should be tailored to the particular situation and will differ between companies and for every distribution. Nonetheless, the certificate should at least deal with the following matters. It must state the amount by which the assets of the company exceed its liabilities. It should refer to the company's most recent financial statements prepared in accordance with s 10 of the FRA

since, under s 4(2)(a) of the 1993 Act, it is mandatory for directors to consider these.[38] In addition, to establish that no significant change in position has occurred since the financial statements were prepared, any recent accounts, such as half yearly accounts or accounts prepared for management purposes should also be referred to.

Directors must also determine whether the company's financial statements are based on realistic assumptions and are appropriate for assessing solvency.[39] For under s 4(2)(b), it is mandatory for directors to consider any circumstances which they know, or ought to know, affects or may affect, the value of the company's assets or liabilities. Similarly, any other information which could affect the values recorded in the financial statements, including any information which directors acquire after the statements are prepared, should also be included in the solvency certificate. In addition, any aspects of the financial statements which are unsatisfactory or unclear, the responses of company officers to enquires and any other reports or information directors obtain as a result of their enquires should be noted.

Directors should assess any risks or factors which might affect the company's ability to satisfy the solvency test. Any risks or factors identified should be included in the solvency certificate to demonstrate that these have been considered. To assist in establishing the "reasonable grounds" on which the directors' opinion are based, the certificate should refer to any management forecasts and budgets which indicate that the company will be able to pay its debts as they accrue following the proposed distribution. Similarly, if directors have relied on external valuations or reports, this should also be noted.

Where directors are not involved in the daily management of a company, they should seek written assurance from management regarding certain matters. In particular they should ask management to certify that the book value of fixed assets does not exceed their recoverable value. Further, management should assure that the stated value of receivables and inventories does not exceed their realisable value, that all liabilities (both actual and contingent) are recorded and that cashflow forecasts are reliable. Finally, directors should have management's assurance that the company will be able to pay its debts as they fall due in the normal course of business after the distribution is made and that all known claims or litigation have been discussed.

Directors should carefully consider the values given to the company's contingent liabilities and whether the accounting valuations contained in the financial statements are reasonable under the solvency test. Directors may prefer to instruct an auditor to determine the value of a company's contingent liabilities since directors may rely on valuations which are "reasonable in the circumstances".[40] Contingent liabilities which cannot be quantified for accounting purposes will be disclosed in the notes accompanying the financial statements and directors should determine an appropriate value for these. Furthermore, if, after the financial statements are prepared, a contingent liability

38 See s 4(2) of the 1993 Act.

39 See the section on Valuation Methods and the discussion regarding the "going concern" assumption.

40 Section 4(2)(b) of the 1993 Act.

becomes actual, its value alters, or a new contingent liability arises, directors should include this in the solvency certificate.

It is common for companies in a group to enter cross-guarantees and guarantee each other's debts. Thus, each subsidiary becomes contingently liable for the borrowings of the group. Since directors are entitled to consider the probability of a contingent liability causing the company an actual net loss,[41] directors will wish to consider all claims to which the subsidiary is entitled and which might reduce or extinguish its liability. Thus, directors in this situation may seek written assurance from the group's financial controller that the group's assets are greater than its liabilities (including contingent liabilities).

If directors receive an assurance then, in the absence of any special circumstances, it seems reasonable to assume that the guaranteeing subsidiary has no contingent liability under the cross-guarantee. For, although the subsidiary may have insufficient assets to pay the full amount guaranteed, it will have recourse to the assets of its guarantors. Thus, as long as the group's assets are greater than its liabilities, there should be sufficient funds to meet the amount guaranteed.

The solvency certificate should included a statement regarding the company's historical performance. For example, its recent ability to pay its debts as they accrued in the normal course of business. However, although this may reveal a problem-free trend, it is not a definitive satisfaction of the test which must be satisfied after a distribution.

4. The American Model Business Corporations Act (MBCA)

The following points are taken from the commentary to the MBCA. They provide a practical guide to the MBCA's "equity insolvency test" [42] which is similar to the 1993 Act's liquidity limb.

Where a company operates as a going concern, information generally available should indicate that no particular inquiry concerning the liquidity test is required. Thus, if the latest auditor's opinion does not qualify the company's status as a "going concern" and no adverse events occur after the opinion is given, satisfaction of the liquidity test should be unproblematic. Although neither a balance sheet nor an income statement can determine the liquidity test conclusively, significant shareholders' equity and normal operating conditions will also indicate that no difficulties should arise. In fact, the issue of liquidity need only be seriously addressed when circumstances indicate that the company is encountering difficulties or is in an uncertain position concerning liquidity and operations.

When determining the liquidity limb, certain judgments or assumptions are customarily justified in the absence of clear evidence to the contrary. For example, it is frequently assumed that, given the current and anticipated demand for a company's products or services, there will be sufficient funds to satisfy the company's existing and reasonably anticipated obligations on maturity. Further, it is assumed that indebtedness which matures in the short-term will be refinanced

41 Section 4(4) of the 1993 Act.

42 Section 6.40(c)(1) MBCA.

where the company's financial condition, future prospects and the general availability of credit to similar businesses indicate that such an assumption is valid. In addition, reasonable judgments are generally made regarding the likelihood, amount and timing of both asserted and unasserted contingent liabilities. Any insurance or other means of loss protection is also considered when establishing their value. Finally, it is usually assumed that a cash flow analysis based on business forecasts and budgets can be used to establish that a company can be reasonably expected to satisfy its known obligations as they mature.

5. Reasonable Grounds for Belief

Directors must be satisfied "on reasonable grounds" that the company will satisfy the solvency test after a distribution.[43] Although "reasonable" implies an objective standard, the balance sheet limb requires directors to have regard to all circumstances which they know, or ought to know, affects, or may affect, the value of a company's assets or liabilities. This introduces a subjective element and individual directors may avoid liability for circumstances of which they were not, and ought not to have been, aware.

Thus, "reasonable grounds" may contain both subjective and objective elements and may differ among directors. For example, executive and non-executive directors may know and be expected to know different things. However, prudent directors should assume that they must meet an objective test of "reasonable grounds". Therefore, they should seek all additional information necessary to be well informed on the company's solvency position.

The meaning given to "reasonable grounds" may be affected by several factors. For example, the courts may choose to construe the solvency test strictly since it replaces strict common law capital maintenance and dividend rules. Further, the meaning given to the phrase at common law in the context of director's actions when insolvency is imminent may be considered relevant. Similarly, the meaning given in reckless trading provisions and in cases which discuss how doubtful solvency affects the lawful declaration of dividends at common law may also be relevant. Finally, cases from overseas jurisdictions such as Canada and USA, where similar regimes exist to recover distributions, may be applicable.

Directors may seek to rely on two different types of "reasonable grounds"; those which they knew and relied upon when signing the solvency certificate and those which existed at the time the solvency certificate was signed but of which the directors were not aware until after the certificate was signed. To allow reliance upon both types of "reasonable grounds" is more objective and consistent with s 56(2)(b) which requires simply that reasonable grounds "exist". This view should not prevent a director from including in the solvency certificate the grounds on which their opinion was actually based at the time of signing.

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43 Section 52(1) of the 1993 Act.

6. Recovery of Distributions

If a company cannot pass the solvency test immediately after a distribution, the distribution is recoverable from shareholders even if the directors had reasonable grounds for believing that the solvency test would be met. Further, the distribution is recoverable regardless of whether the company later becomes solvent. However, shareholders are not required to repay a distribution made in breach of the solvency certificate if:

(a) It is received in good faith and without knowledge of the company's failure to satisfy the solvency test;
(b) The shareholder has altered its position in reliance on the distribution's validity; and
(c) It would be unfair to require repayment in full or at all.[44]

These exemption requirements will be difficult to satisfy. In particular, requirement (b) will only be met once a shareholder takes active steps [45] and spends the money in a manner which they would not have, had they not received the distribution.[46]

Under s 56(2), a director will be personally liable to the company for any distribution which cannot be recovered from a shareholder if:

(i) The director failed to take reasonable steps to ensure that correct procedure was followed under: s 52 (authorisation of a distribution); s 70 (redemption of shares); or s 77 (financial assistance for purchase of shares);[47] or
(ii) The director signed a solvency certificate without reasonable grounds for believing that the company would satisfy the solvency test;[48] or
(iii) The director failed to take reasonable steps to prevent a distribution after it was deemed not to have been authorised under s 56(3) of the 1993 Act; or
(iv) The director failed to take reasonable steps to prevent a discount after it was deemed not to have been authorised under s 55(5) of the 1993 Act.

In the above situations, the company may recover from its directors both amounts which are legally irrecoverable because a shareholder has satisfied the three exemption requirements detailed above and amounts which, although legally recoverable, cannot be recovered (eg because the shareholder cannot be located or is insolvent). An action to recover a distribution from the directors must be brought

44 Section 56(1) of the 1993 Act.

45 See *Westpac Banking Corporation v Nangeela Properties Limited* [1986] 2 NZLR 1, which construed the nearly identical wording in s 311A(7) of the unamended 1955 Act.

46 See Watts, P, "Judicature Amendment Act 1958 - Mistaken Payments" in Law Commission report, *Contract Statutes Review* at 191, NZLC R25, Wellington, May 1993.

47 Section 56(2)(a) and (c) of the 1993 Act.

48 Section 56(2)(b) and (d) of the 1993 Act.

within six years of the cause of action accruing.[49] However, the cause of action may not accrue until the distribution is unable to be recovered from shareholders.

If the company could have satisfied the solvency test with a smaller distribution, the court can allow the shareholder to retain an amount equal to the value of any distribution which could properly have been made. Similarly, the court can relieve the directors from liability in respect of a similar amount.[50]

Only directors who vote in favour of a distribution must sign the solvency certificate.[51] Thus, if a director was absent from the meeting which authorised the distribution or abstained from voting, he or she will avoid liability if the solvency certificate is inaccurate. However, directors who fail to attend or vote at meetings over a long period may be in breach of their more general duties to exercise care and diligence. If board meetings are governed by the 1993 Act's Third Schedule, or by similar provisions in the company's constitution, directors present at a board meeting are presumed to have voted in favour of a resolution, unless they expressly dissent or vote against it.

In addition to civil liability, directors can also face criminal liability in some circumstances. For example, a director who votes in favour of a distribution but fails to sign the solvency certificate commits an offence under s 52(5) and is liable, on conviction, to a fine not exceeding $5,000.00.[52] Similarly, a director who signs a certificate knowing that it is false or misleading with regard to a material particular commits an offence. On conviction the director is liable to a fine not exceeding $200,000.00 or to a maximum 5 years' imprisonment.[53] A director who signs a certificate knowing that it omits a material particular is also liable under this section.

Although directors charged with an offence in relation to a duty imposed on the board may have a defence under s 376, it is only available if a director has taken "all reasonable and proper steps" to ensure compliance with the Act. Thus the defence is unlikely to protect directors who fail to complete a solvency certificate.

The New Zealand Law Society have submitted that the solvency test attempts to make directors underwrite their company's solvency. The society submits that this is not a balanced or sensible commercial approach.[54] However, if directors have reasonable grounds for believing that the company will satisfy the solvency test they cannot be liable. Thus, it cannot be said that directors underwrite the company's solvency.

One submission to the Justice and Law Reform Commission suggested that courts should have a general power to relieve directors from personal liability if they acted honestly and reasonably, or ought fairly to be excused from liability.[55] This submission was not considered in the Justice Department reports. If directors

49 Section 4, Limitation Act 1950.

50 Section 56(5) of the 1993 Act.

51 Section 52 of the 1993 Act.

52 Section 373(1) of the 1993 Act.

53 Sections 377(1) and 373(4) of the 1993 Act.

54 Report of Department of Justice advisers to J&LRC, "Summary of Submissions" (DJ3), 9 May 1991, at 6.

55 Submission 21, a written submission by Fletcher Challenge Limited. See report of Department of Justice advisers to J&LRC, "Summary of Submissions" (DJ3), 9 May 1991, at 6.

act honestly and reasonably when deciding whether a company will pass the solvency test, they will almost certainly have reasonable grounds to believe that the solvency test will be met. Any general defence would weaken the requirements of the solvency test.

III: CONCLUSION

The solvency test has introduced a significant change to the making of distributions under New Zealand law. The capital maintenance regime which existed under the Companies Act 1955 is replaced by a more permissive regime that allows a company to return capital to its shareholders.

This article has discussed ambiguities in the solvency test and issues arising from its application only to companies reregistered under the 1993 Act. Given the lack of judicial consideration, even once companies are deemed to be reregistered on 1 July 1997 there is unlikely to be a flood of cases. Generally, cases will only be brought when a company goes into liquidation, since only then are directors' past decisions closely scrutinised. Where an arguable case exists under the 1993 Act plaintiffs will need to consider economic constraints and the commercial realities facing shareholders and directors before bringing an action.

Since courts prefer to decide company distribution cases on their individual merits, they are unlikely to formulate general guidelines relating to the test. Accordingly, directors and their advisers must approach the entire solvency test with caution since they may incur personal liability if they authorise an ultra vires distribution.

The 1993 Act has greatly liberalised company law in New Zealand. The solvency test is the essential check in this new and permissive regime. While directorial freedom is expanded under the regime, the solvency test operates as a significant restriction, enhancing scrutiny of directors' activities and providing greater transparency of company distributions.

NORTHERN REGION
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New Zealand Red Cross Provides:

* Emergency Relief and Response, in times of Disaster or Conflict in New Zealand and around the World.

* Education and Information for all New Zealanders on International Humanitarian Law.

* Emergency Preparedness and training including emergency aid to those in need of support in our communities.

The Northern Region fulfills the aforementioned through its 'on call' Emergency Relief Team and Response Units; the Meals on Wheels programme which delivers approximately 1500 meals daily throughout the Region; training courses which include First Aid, CPR, Humanitarian Law and caring for the elderly; and its Emergency Preparedness programme.

* * * *

An appropriate form of bequest would be:

'I give and bequeath the sum of $............................ to the Northern Region of New Zealand Red Cross to be paid for the general purposes of the Northern Region to the Regional Director for the time being of such Region, whose receipt shall be good and valid discharge for same.'

It is important to ensure that the words 'Northern Region' appear in the form of bequest if it is the testator's wish that the funds be used for the benefit of people in the North.