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GUIDE

The Solvency Test

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Introduction

This Guide sets out the background of the 'solvency test' and its relevance and applicability in Guernsey.

The Solvency Test

Background

When the solvency test was introduced in July 2008 as part of the Companies (Guernsey) Law, 2008 (the **Law**), it represented a fundamental change to Guernsey's company law in relation to the maintenance of capital and solvency.

Historically, the preservation of a company's capital was achieved by restricting its ability to:

- pay dividends, other than out of profits available for distribution, and
- distributing out of its share capital unless sanctioned by the court.

The Law follows models used in other jurisdictions by abandoning the concept of capital maintenance and, instead, imposing a solvency test on any transfer of value from a company to its members. This approach, allows directors to make a distribution to shareholders out of the share capital account (or from any other source available to the company) provided they certify that the company will satisfy a statutory solvency test after payment is made. This gives directors of a Guernsey company both more responsibility and control when considering the impact of a transaction on the company than in many other jurisdictions.

Statutory definition

The definition of the solvency test is set out at section 527 of the Law.

In order to satisfy the solvency test, a company must:

a) Be able to pay its debts as they become due (i.e. the 'cash flow test')

b) Have an asset value greater than its liabilities (i.e. the 'balance sheet test'), and

c) If it is a company supervised by the Guernsey Financial Services Commission, satisfy any other requirements as to solvency imposed in relation to it by or under any other relevant legislation (i.e. the 'regulatory test').

The cash flow test

The cash flow test requires a company to demonstrate that it is able to pay its debts 'as they become due', providing a 'test within a test', namely that the company should be able to pay its debts both presently and in the future. The ability of a company to pay its future debts speaks to the commercial reality that it must be viable and able to continue to meet its liabilities to function. How far must a company look in the future? Persuasive guidance can be found in the Supreme Court case of *BNY Ltd v Eurosail* (**BNY**), in which Lord Walker considered that the 'reasonably near future' will depend on 'all the circumstances [of each case], but especially on the nature of a particular company's business.'[1]

The balance sheet test

The 'balance sheet test' requires that a company must show that the value of its assets are greater than the value of its liabilities. In BNY, Lord Walker confirmed that, when the court considers whether the balance sheet test has been met, it will look at the company's assets and make a proper allowance for its prospective and contingent liabilities. If the court considers that the company cannot reasonably be expected to be able to meet those liabilities, it will be deemed insolvent even if it is able to pay its current debts as they fall due.

Factors to consider

When considering whether a company will pass the solvency test, the directors must have regard to the company's most recent accounts and all other circumstances that they know or ought to know will or may affect the value of the company's assets and liabilities. In determining the value of assets and liabilities, directors may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

[1] [2013] 1 WLR 1408 at paragraph 37

There is no express requirement in the Law for directors to account for contingent liabilities when considering the solvency test (particularly in relation to the balance sheet test), however, as a matter of good corporate governance, contingent liabilities ought to be accounted for.

When is the solvency test considered important?

The solvency test is important in a number of situations, including:

- when a company wishes to make distributions or pay dividends to its members;
- when directors must decide whether their fiduciary duty to take into account the interests of the company's creditors has been engaged
- when determining whether a liquidator or administrator can set aside a transaction
- when considering whether a company has met the test for administration or liquidation
- if the members of the company wish to voluntarily wind it up
- in circumstances where a company is to be restored, and
- when considering whether the company has taken part in wrongful trading.

Distributions and dividends

When a company decides to distribute a dividend or make other distributions, the directors must ensure that the solvency test will be met immediately after the distribution is made and sign a certificate to that effect. Directors can be held personally liable for distributions that are made when the solvency test is not met.

Section 309 of the Law provides that a distribution 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. There are a number of exceptions, covering situations in which (i) the shareholder received the payment in good faith and without knowledge of the company's failure to satisfy the solvency test, (ii) the shareholder has altered their position in reliance on the validity of the receipt of the distribution and (iii) it would be unfair to require repayment in full or at all.

Directors' fiduciary duties and the company's creditors

Directors of companies in Guernsey owe a common law duty to act in good faith, and in the best interests of the company. In considering the best interests of the company, they are generally required to have regard to what is in the interests of those with a financial stake in the company – normally its shareholders. Where a company is insolvent, it is recognised that directors must have regard to the interests of creditors when deciding what steps are in the best interests of the company. The requirement to consider the interests of creditors may also arise in circumstances short of actual insolvency.

The debate on the issue tends to centre around two main points. First, when does the duty arise? Second, is the obligation to consider creditors 'paramount' or merely another factor that directors must take into account? These issues were considered in the Guernsey case of *Carlyle Capital Corporation Limited v Conway & Ors*[2] (Carlyle), in which the Royal Court confirmed that directors have a fiduciary duty to take proper regard of the interests of creditors when a company is on the 'brink of insolvency' and that this duty will require giving 'precedence' to creditors' interests where necessary in particular situations.

More recently, in *BTI 2014 LLC v Sequana SA*[3] the English Supreme Court confirmed that the so-called 'creditor duty' is engaged when the directors know, or ought to know, that the company is insolvent or bordering on insolvency, or that an insolvent liquidation or administration is probable. Lord Briggs approved the judgment in *Carlyle* that the duty operates on a sliding scale and whether it requires giving precedence to creditors' interests depends on the circumstances. The judgment will be highly persuasive in Guernsey.

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[2] Guernsey Royal Court, judgment no. 38 of 2017. Mourant Ozannes (Guernsey) LLP acted for Carlyle Capital Corporation Limited and its joint liquidators.

[3] [2022] UKSC 2

Company conversions, transfers and registrations

In order to convert a company a declaration of compliance must be completed and delivered to the Registrar, per sections 46, 48, 55 and 57 of the Law. This declaration must confirm that the company satisfies the solvency test.

For the approval of an amalgamation proposal under section 64 of the Law, resolutions are required from the directors of each amalgamating body corporate that they are satisfied on reasonable grounds that the amalgamated body corporate will, immediately after the amalgamation becomes effective, satisfy the solvency test. Similarly, section 78 of the Law prohibits the registration of an overseas company as a Guernsey company unless it would, immediately after registration, satisfy the solvency test.

Section 90 of the Law prohibits the removal of a company from the Register of Companies unless it would immediately before removal satisfy the solvency test.

Administration orders and voluntary or compulsory liquidation

Under section 374 of the Law, the court may make an administration order if it is satisfied that a company (or a cell of a protected cell company) does not satisfy or is likely to become unable to satisfy the solvency test. The court must also be satisfied that the making of such an order would satisfy one of the statutory purposes (e.g. the survival of the company as a going concern or that a more advantageous realisation of the company's assets would be made on a winding up).

Section 406(a) of the Law states that the court may order the winding up of a company if the company has passed a special resolution for it to be wound up. If the debtor is solvent, it may make a declaration of solvency in form prescribed by Insolvency Rules contained in the Companies (Guernsey) (Insolvency Rules) Regulations, 2022 which states that, in the opinion of the board, the company satisfies the solvency test. If the debtor is insolvent, the winding up resolution may still be passed by members but there are certain consequences including that the liquidator appointed must be independent. As such, a director or former director, company secretary or administrator of the company would be ineligible to be the liquidator.

Section 406(e) of the Law states that a company may be wound up by the court if it is 'unable to pay its debts' within the meaning given in section 407 of the Law. Section 407 sets out that the court may find that a company is 'unable to pay its debts' if the court determines that 'the company fails to satisfy the solvency test.'

Office holders setting aside transactions

Section 424 of the Law enables liquidators to seek relief in relation to preferences given by the company to creditors, sureties or guarantors prior to a winding up. The liquidator must demonstrate that the company gave effect to the transaction with a desire to improve the person position in the company's liquidation, in circumstances where the company was insolvent or became insolvent as a result of the transaction.

Section 426D of the Law enables liquidators and administrators to apply to the court to set aside transactions at an undervalue. The transaction must have occurred within six months of the company entering insolvency, or two years if a third party is connected to the company. If these timescales have lapsed, liquidators and administrators will still be able to rely on their current customary law powers to set aside those transactions.

Liquidators and administrators also have the power to set aside extortionate credit transactions entered into in the last three years before the liquidation/administration.

Company restoration

When considering whether to restore a company to the Register of Companies pursuant to section 371 of the Law, the court 'shall have regard to', amongst other things, whether or not the company would satisfy the solvency test on restoration.

Wrongful trading

When assessing whether a director has any liability for wrongful trading pursuant to section 434 of the Law, the solvency test will be relevant in considering whether a director knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation.

Liabilities for failing solvency test

If the correct procedure for making a distribution or dividend is not followed or there are no reasonable grounds for certifying that the solvency test is met, the directors of a company may be found personally liable to reimburse the relevant dividend or distribution if it cannot be recovered from members. Directors would not, however, be liable to repay a distribution where the company satisfied the solvency test immediately after the distribution was made.

If a company distribution is authorised and a director later ceases to be satisfied that the company will pass the solvency test once the distribution has been paid, the director must take reasonable steps to prevent the distribution being made. Failure to do so could render the director personally liable to repay so much of the distribution as is not able to be recovered from the company's members.

In order to avoid liabilities, directors must carefully consider whether a company meets the solvency test when making decisions that could impact on the company's financial position. If in doubt, directors should seek advice to minimise the risk of personal liability.

Contacts

A full list of contacts specialising in insolvency law can be found here.