Humphries
ASSOCIATES

Company directors – solvency test

The solvency test plays an important role in the management of companies. While a company is not required to be solvent on every day it trades, the test must be met when certain transactions are proposed. In many cases, as a result of prudent management, companies will meet the test fairly easily. However, directors of companies that are marginally solvent will need to know with certainty whether the test has been satisfied, as this may be difficult to establish at a later date.

The test

To satisfy the solvency test:

- A company must be able to pay its debts as they become due in the normal course of business; and
- The value of its assets must be greater than the value of its liabilities (including contingent liabilities).

When to test?

The solvency test must be met on an amalgamation or if a company proposes to:

- Make a distribution;
- Repurchase or redeem shares;
- Provide discounts to shareholders;
- Reduce shareholder liability; or
- Provide financial assistance for acquiring the company's own shares.

Mandatory considerations

In considering whether a company meets the test, directors must have regard to:

- The company's most recent financial statements that comply with section 10 Financial Reporting Act 1993; and

- All other circumstances that they know, or ought to know, may affect the value of the company's assets and liabilities (including its contingent liabilities).

The test implies that directors will not be allowed to close their eyes to circumstances.

Relying on others

Directors are also permitted to rely on advice from professionals or employees provided that:

- The matter must be within the competence of the professional or employee;
- The director acts in good faith; and
- The director has no knowledge that reliance on the advice is unwarranted.

Directors' obligations

Directors are required to resolve that the company will be able to pass the solvency test immediately after the relevant transaction is implemented. The directors must also sign a certificate to that effect setting out in full the reasons for their opinion.

Directors should, for their own protection, set out in detail the grounds for their opinion that the company is solvent. References should be made to valuations, reports, and advice taken or received on which the opinion is based. Failure to provide adequate reasons in the directors' certificate may raise an inference, in hindsight, that the directors did not have any reasonable grounds for their belief.

Standard form certificates should be avoided. Each certificate should be specifically tailored to the relevant company and its particular character and circumstances.

Directors' liability

Directors can be held personally liable if:

- They fail to complete a solvency certificate;
- The procedure for authorising the relevant transaction has not been followed;
- Reasonable grounds for believing that the company would satisfy the solvency test did not exist at the time the solvency certificate was signed; or
- Between the date of approving the transaction and its date of execution, there has been a change in circumstances in relation to the company's ability to meet the solvency test.

Directors who vote in favour of a distribution, but who fail to sign a solvency certificate, commit an offence and are liable, on conviction, to a fine of up to $5,000. Signing a certificate knowing it to be false or misleading is an offence punishable by a fine of up to $200,000 or imprisonment for a term of up to 5 years.

Change in Circumstances

Where after a transaction has been authorised but before it has been implemented the board ceases to be satisfied on reasonable grounds that the solvency test will be met immediately after the transaction is implemented, the transaction is deemed not to be authorised.

Reasonable steps must be taken by a director to prevent a distribution being made if the director, having signed a solvency certificate, ceases to be satisfied that the company will satisfy the solvency test between the time of authorisation and the implementation of the distribution. Directors may be personally required to pay back unauthorised distributions to the extent they cannot be recovered from shareholders.

Creditors' rights

The purpose of the solvency test is to ensure that the rights of creditors are protected. However, the Companies Act 1993 does not provide creditors with any direct rights upon breach of the solvency test. However, creditors may be able to recover from directors personally in certain circumstances in the context of a liquidation.

Finally

The directors of a company doing anything affecting the structure of the company or in dealing with shareholders, must ask the question 'do we need to deal with solvency test issues?'. Given the potential personal liability for breach of the solvency test requirements, directors must be hard-headed and realistic when assessing solvency, giving consideration to many different matters and taking reasonable steps to obtain all information relevant to forming an opinion on the solvency statement.

How to get started

- Talk to us for further advice on the application of the solvency test to your business. We will be pleased to assist.
- Remember, you may suffer liability if you beach the solvency test requirements or fail to give all relevant matters due consideration. However, we will always be on hand to help when needed.

See Us First

- Before making any financial decisions.
- To assist you in meeting the necessary legal or financial requirements.
- If you consider that any of the issues contained in this fact sheet may affect you.

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