



**FROM THE CAPITAL MAINTENANCE RULE TO THE SOLVENCY TEST: SOME
THOUGHTS ON THE NEW APPROACH TO CREDITOR PROTECTION IN
MALAWIAN COMPANY LAW**

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DECLARATION

I hereby declare that I have read and understood the regulations governing the submission of a Master of Laws dissertation, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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8 March, 2017

DEDICATION

To my parents, Andrew Kumwenda and Beatrice Phiri.

ABSTRACT

In July, 2013 Malawi enacted a new Companies Act [Act No. 15 of 2013] replacing the old Companies Act 19 of 1984. The Companies Act, 1984 was basically an adoption of the English Companies Act, 1948 and in line with the English law, it regulated distributions through the classical capital maintenance rule. In contrast, the new Companies Act, 2013 which came into force in May, 2016 has jettisoned the capital maintenance rule. As an alternative to that rule, the Act has introduced for the first time in Malawian company law edifice, the concept of the solvency test.

Jurisdictions that have adopted the solvency test in their company law essentially have done so on the basis that company law should focus on the core risk at stake – company insolvency, and that it is meaningless to state that creditors look to the company’s capital as a trust fund out which their debts would be settled. Despite having the same theoretical basis for adopting the solvency test, the manner in which the solvency test is defined and applied in a particular statute has significant effects on whether in its operation, the test affords adequate protection to the interests of creditors.

This research examines the definition and application of the solvency test under the Companies Act, 2013 so as to determine whether in its operation as a financial restriction for distributions and other company transactions, it will afford adequate protection to creditors. It follows the approach used by Professor Kathleen Van der Linde in her analysis of the solvency and liquidity approach in the Companies Act, 2008. Thus, it analyses the Malawian law by focusing on the two separate elements of the test (equity solvency and balance sheet solvency) as well as other aspects of the test which are likely to raise legal interpretation issues.

The twin solvency test adopted in different jurisdictions ordinarily varies in its balance sheet solvency element. Some jurisdictions such as South Africa and New Zealand utilise the net assets approach in their balance sheet test. Others such as New York and Delaware still emphasise on the trust fund doctrine and thus utilise stated capital in their balance sheet test.

Malawi is a stated capital/surplus jurisdiction. Its new solvency based regime still focuses on the meaningless trust fund doctrine. The new solvency test approach in Malawi is incomplete and inadequate to fully protect creditors against opportunistic shareholder behaviour. A number of recommendations are made for an effective solvency test approach that will afford adequate protection to creditors against opportunistic shareholder behaviour.

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LIST OF ACRONYMS

CBCA – Canada Business Corporations Act

IFRS – International Financial Reporting Standards

GAAP – Generally Accepted Accounting Principles

MTI – Ministry of Trade and Industry (Malawi)

OBCA – Ontario Business Corporations Act

CHAPTER ONE: INTRODUCTION AND STATEMENT OF THE PROBLEM

Every statute that regulates the incorporation and operation of companies includes some provisions protecting the interests of creditors against unsafe distributions of company assets to shareholders¹. These provisions ordinarily contain the following rules: (a) mandatory disclosure rules, especially in relation to financial performance of the company; (b) detailed legal capital rules that throughout the life of the company govern the maintenance of its share capital and other quasi-capital reserves; and (c) broad solvency based standards underpinned by personal liability attaching to directors or controllers². The third rule, the incorporation of solvency based standards in company law, as a strategy for protecting the interests of creditors is a feature of recent company law reforms that have resulted in the discarding of long outmoded legal capital rules in some common law jurisdictions³.

Jurisdictions that have adopted the solvency standards (solvency test) have essentially done so on the same theoretical justifications. The argument is that, unlike traditional legal capital rules, the solvency test gives advance recognition to the ultimate priority that creditors enjoy over shareholders upon dissolution of the company by preventing the company from favouring its shareholders through partial liquidation and it also addresses the fundamental expectation of creditors to be paid on time⁴. The Republic of Malawi on 20th May, 2016 became the latest jurisdiction to adopt the solvency test when its new Companies Act 15 of 2013 ('Companies Act, 2013') came into force. Without contesting the theoretical basis upon which the solvency test is adopted, this paper seeks to examine the solvency test approach as enacted in the new Malawian Companies Act so as to assess whether, in its operation as a financial restriction to distributions, it will provide adequate protection to creditors.

This chapter gives a background to the study. It gives a brief synopsis of the literature review on the traditional legal capital rules and the company law reforms that have seen the adoption of the solvency test as an alternative to the legal capital rules. In this regard, it discusses briefly the position in the United States of America ('US') as a leading jurisdiction on

¹ See generally R Kraakman et al *The Anatomy of Corporate Law: A Comparative and Functional Approach* 2ed (2009) chapter 5.

² E Ferran and L Chan Ho *Principles of Corporate Finance Law* 2ed (2014) 71.

³ For example the United States of America effected amendments in 1980 to its Model Business Corporation Act which resulted in the jettisoning of traditional legal capital concepts. See generally Manning and Hanks *Legal Capital Being a Concise Practical Exposition with Illustrative Examples* 3ed (1990).

⁴ K Van Der Linde 'The solvency and liquidity approach in the Companies Act 2008' (2009) 2 *TSAR* 224 at 226.

the reforms to the legal capital rules in company law. It also discusses briefly the unique position of the United Kingdom ('UK') which to a large extent still maintains the obsolete legal capital rules. It then discusses the introduction of the solvency test in Malawi and why there is need to undertake a study on the operation of the solvency test in Malawi. Finally, it gives a layout of the chapters in this paper.

1.1 BACKGROUND

1.1.1 The concept of legal capital

Legal capital can best be described as a broad concept that embraces the rules relating to the raising of capital through share issuance, the maintenance of share capital, and the returning of value to shareholders in circumstances that do not infringe the maintenance of capital requirements⁵. The development of the legal capital concept in traditional company law can be traced from the conflict that has always existed between two stakeholders in a company (creditors and shareholders). The interests of creditors and shareholders are likely to conflict whenever assets of shareholders are to be committed to the company's treasury and whenever assets are to be distributed to shareholders from the corporate treasury⁶. Thus, the legal apparatus built by the common law and statute around the concept of legal capital was fundamentally aimed at striking a partial accommodation of that conflict of interests⁷.

A discussion of the legal capital rules logically begins by looking at the rules on raising of capital through share issuance (pay in rules)⁸. The common law as developed in the UK, established a rule that every share in a limited company having share capital must have a fixed nominal or par value⁹. Shareholders could not be allotted shares at an amount less than the par value¹⁰. This rule was thought to be important because it allowed creditors to ascertain the fixed and certain amount of capital that they were entitled to regard as their security¹¹. This requirement for shares to have a par or nominal value was the rule in most common law

⁵ E Ferran and L Chan op cit (n2) 71.

⁶ Shareholders like to minimize the amount of assets they must contribute into the company in exchange for shares while maximizing the distribution of company assets to them. Creditors on the other hand like to do the opposite. See, B Manning *Legal Capital* 2ed (1981) 1.

⁷ Ibid.

⁸ The discussion in this background only focuses on the concept of par value shares. It is duly appreciated that the pay in requirements for shareholders are many and a discussion of such nature may be a thesis on its own.

⁹ *Ooregum Gold Mining Co. of India -v- Roper* 1892 AC 125. See also the UK Companies Act, 2006, section 542.

¹⁰ E Ferran and L Chan Ho op cit (n2) 72.

¹¹ Ibid.

countries including the US¹². However, around 1912 legal capital rules in the US eventually authorized the company constitution to have provisions providing for shares with no par value¹³. Shareholders subscribing for shares in a company whose constitution allowed for authorized capital to have no par value shares would simply be required to pay the consideration as declared by the board of the company¹⁴. In this regard, traditional US legal capital rules permitted companies to decide whether the authorized share capital would be divided into par value shares or not¹⁵. Notably, despite the eventual philosophical divide between the UK and the US, the discussion in the literature on the legal capital rules relating to the raising of capital through share issuance converged on this important critic of par value shares:

‘The concept of par value of share capital might have significance if it gave some indication of the market value of a company’s assets. However, it usually does not and instead may be a source of confusion...

As time goes on, the overall net worth of the company and the value of individual shares in the company depend on the success of the company’s business ventures and also on the general economic factors. In practice, the par value of a share commonly bears little relation to the price at which it trades in the market.’¹⁶ [Sic]

In addition to the rules on raising capital through share issuance, the legal capital concept provided rules on the maintenance of share capital. The capital maintenance doctrine developed from the common law cases of *Trevor –v- Whitworth*¹⁷ and *Re Exchange Banking Company, Flitcroft’s Case*¹⁸. It essentially states that the issued share capital of a company, whatever the amount, is a guarantee fund intended for the protection of creditors which must be maintained in the sense that the company is not allowed to return its issued share capital to its shareholders unless authorized by statute¹⁹. The settled view is that the capital maintenance rule which the Lords recognized in *Trevor –v- Whitworth* was borne out of concern for the position of creditors in the wake of the development of the concept of limited liability of shareholders²⁰. The concept of limited liability of shareholders developed as one of the legal consequences of the principle of separate legal personality enunciated in the leading English case of *Salomon –v- Salomon & Co*

¹² Other countries such as New Zealand and South Africa also followed the UK position.

¹³ Manning and Hanks op cit (n3) 29.

¹⁴ Ibid.

¹⁵ Ibid 26-30.

¹⁶ E Ferran and L Chan Ho op cit (n2) 72. See also B Manning op cit (n6) 23 and HS Cilliers et al *Cilliers & Benade: Corporate Law* 3ed (2000) 222 - 224.

¹⁷ 1887 (12) App Cas 409 (HL).

¹⁸ 1882 (21) Ch D 518, 533–534.

¹⁹ FHI Cassim ‘The Reform of Company Law and the Capital Maintenance Concept’ (2005) *SALJ* 285.

²⁰ B McCabe ‘The Desirability of a Share Buy-Back Power’ (1991) 3 Issue 1 *Bond Law Review* 117. See also FHI Cassim op cit (n19) 284.

*Ltd*²¹. Shareholders are in principle not liable for the debts and liabilities of the company²². This entails that the claims of creditors are confined to the assets of the company, thus, they cannot obtain satisfaction of their debts from the personal assets of the shareholders of the company²³.

Consequently, a number of rules were developed at common law. Cilliers and Benade state that important rules of the common law were that a company may not buy back its own shares; may only pay dividends out of profits and may not issue shares at a discount²⁴. Apart from the common law rules, jurisdictions enacted statutory provisions that further entrenched the capital maintenance doctrine²⁵.

However, stemming from the criticism of par value shares highlighted earlier²⁶, the relevance of the capital maintenance rules was questioned. The argument was that it was a fiction to state that creditors dealt with a company on the basis of its issued share capital as the capital maintenance rules had nothing to do with ensuring that a company had adequate capital to meet the claims of creditors²⁷.

1.1.2 Legal capital in Malawian company law

Company law in Malawi traces its origins from English company law. Before 1986, the English companies' statutes of 1908 and 1913 regulated companies in Malawi²⁸. As a result of company law reform²⁹, Malawi enacted a new Companies Act in 1984 ('Companies Act, 1984') which came into force on 1st April, 1986. This Act was basically an adoption of the English Companies Act, 1948. Through this adoption of the English Companies Act, 1948 in the Malawian Companies Act, 1984 company law in Malawi was essentially constructed on the foundations which were put in place by the Victorians in the middle of the last century³⁰. The Companies

²¹ 1897 AC 22 (HL).

²² FHI Cassim et al *Contemporary Company Law* 2ed (2012) 33.

²³ Ibid 35.

²⁴ HS Cilliers et al op cit (n16) 322.

²⁵ For example, in the UK, section 16 of the Companies Act 1928 first made it a statutory offence for a company to give financial assistance for the acquisition of its own shares. In South Africa, the Companies Act, 1973 prohibited the payment of interest on share capital (section 79); issuing of shares at a discount (sections 81, 82).

²⁶ See n16.

²⁷ FHI Cassim op cit (n19) 285.

²⁸ M Nzunda 'New Company Law for Malawi' (1989) 33 No.1 *Journal of African Law* 1.

²⁹ Ibid.

³⁰ Company Law Review Strategy – A Working Paper (Unreported). Paper was accessed by contacting the Department of Private Sector Development – Doing Business Reforms Unit, Ministry of Industry and Trade, Malawi (email of contact person: kasinje@gmail.com).

Act, 1984 required the memorandum of association of a company limited by shares to state the amount of authorized share capital of the company which was divided into par value shares³¹. It also maintained several provisions that entrenched the capital maintenance doctrine. For instance, Section 74 of the Companies Act, 1984 restricted dividends payment. These could only be made out of profits. Further, the Act prohibited a company from acquiring its own shares in Section 73. In its Section 60, the Act prohibited a company from paying a commission, discount or other allowance to a person as a consideration for subscription of the company's shares unless as permitted by the Act. Although not directly a rule of capital maintenance, in its Section 72, it contained a prohibition against a company providing financial assistance for the acquisition of its own shares.

1.1.3 Company law reform and the protection of creditors

The development of the legal capital concept discussed above meant that inevitably or not, the courts and the statutes did combine the capital maintenance rules and the par value concept to produce two concerning propositions: (a) the measuring rod for judging the propriety or impropriety of distributions to equity holders was the company's 'capital'; and (b) 'capital', in line with the criticism of the concept of par value shares noted earlier, referred not to the assets held by the company but to the abstract number that was obtained by multiplying the number of shares issued by the par value assigned to each share³². For jurisdictions that eventually followed the US approach of introducing no par value shares, similarly capital did not refer to the assets held by the company but simply meant stated capital³³. In effect creditors whose real interest is that distributions should only be made if there are sufficient assets to meet their claims as they become due or on winding up, were left exposed as the measuring rod for distributions was capital which in essence did not mean assets³⁴.

Just as it did in 1912 to introduce the concept of no par value shares in its traditional company law edifice, the US led the way in reforming the legal capital concept. It all began in 1975 when the state of California adopted a new General Corporations Law. Manning writing in 1981 wrote that the draftsmen of the new law in California and the accompanying legislative

³¹ Table B of the First Schedule to the Act.

³² Manning and Hanks op cit (n3) 34.

³³ Ibid.

³⁴ See generally the discussion by Manning and Hanks on Legal Capital – Development of the Key Concept. Manning and Hanks op cit (n3) 20 – 43.

report concurred with the general thesis that the traditional doctrinal edifice of par and legal capital was ineffective³⁵. The California Corporations Code, 1975 provided that a company's articles of incorporation needed to only state the total number of authorized shares and the number of shares divided into classes³⁶. This meant that the statute omitted the further provision found in all other US state statutes that the articles needed to also state whether the share was par or no par³⁷. Further, section 500 of the 1975 California Corporation Code completely reformed the proposition highlighted earlier that the measuring rod for judging the propriety or impropriety of distributions to shareholders was the availability of the company's capital³⁸. The new statute (its s500) permitted a shareholder distribution: (a) to the extent of the company's retained earnings; or (b) if, after the distribution, 'assets' (as statutorily defined) were 125% of liabilities (as defined) and if other detailed criteria was met regarding the ratio of current assets and current liabilities.

In the US, state legislatures have plenary powers to create corporations³⁹. In an attempt to provide a drafting guide for the states, the Committee on Business Corporations of the American Bar Association drafted the Model Business Corporation Act, 1950 ('Model Act')⁴⁰. Influenced by the changes that took place in California, in 1980 the financial provisions of the Model Act were revamped in their entirety⁴¹. To appreciate the nature of changes that occurred, the Report of the Committee on Corporate Laws which accompanied the 1980 amendments is useful:

'The amendments to the financial provisions of the Model Business Corporation Act (the "Model Act") reflect a complete modernization of all the provisions of the Model Act concerning financial matters, including -

(a) the elimination of the outmoded concepts of stated capital and par value, (b) the definition of "distribution" as a broad term governing dividends, share repurchases and similar actions that should be governed by the same standard, (c) the reformulation of the statutory standards governing the making of distributions....'⁴² [Sic]

³⁵ B Manning op cit (n6) 164.

³⁶ See section 202 of the California Corporations Code, 1975 produced in DF Zickerman et al *California Corporations Code and Corporate Securities Rules* (1990) 23.

³⁷ B Manning op cit (n6) 164.

³⁸ See n32.

³⁹ Cox and Hazen *Corporations* 2ed (2003) 31.

⁴⁰ See R Garrett 'History, Purpose and Summary of the Model Business Corporation Act' (1950) Vol 6 Issue 1 *BUS.LAW*. 1-7.

⁴¹ Manning and Hanks op cit (n3) 176.

⁴² Report of the Committee on Corporate Laws: American Bar Association (1979) 34 *The Business Lawyer* 1867 – 1889.

Consequent to the reforms that commenced in 1980, 1984 saw the appearance of the first complete revision of the Model Act, Revised Model Business Corporation Act, 1984 ('Revised Model Act')⁴³. Upon further amendments to it in the 1980's, the Revised Model Act finally incorporated a refined set of integral provisions on shareholder pay in and shareholder pay out obligations reflecting modern thought and practice in corporation law, finance and accounting⁴⁴. The said refined set of integral provisions on shareholder pay in and shareholder pay out rules included the following provisions:

(i) Section 6.01 (a) on authorized shares which eliminated the mandatory legal capital requirement to specify par or no par value shares⁴⁵.

(ii) Section 1.40 (6) which broadly defined a distribution as any asset flow from the company's coffers to shareholders that was not matched by an equivalent asset inflow⁴⁶.

(iii) Section 6.40 (c) which provided a test for regulating distributions to shareholders. It reads as follows:

'No distribution may be made if, after giving it effect - (1) the corporation would not be able to pay its debts as they become due in the usual course of business; or (2) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution. ...'

Section 6.40(c) above demonstrates the incorporation of solvency based standards as a strategy for protecting the interests of creditors in a modern company law statute. The first restriction in s6.40 (c) (1), whether the corporation would not be able to pay its debts as they become due in the usual course of business, is what is referred to as the equity insolvency test⁴⁷. The second restriction in s6.40 (c) (2), whether the corporation's total assets would be less than the sum of its total liabilities is referred to as the balance sheet solvency test⁴⁸. The equity insolvency test has generally been part of US corporation law since the early 1800s and the

⁴³ DM Branson 'Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law' (1993) Vol 72 Art 7 Issue 1 *Nebraska Law Review* 259 at 260n4.

⁴⁴ Manning and Hanks op cit (n3) 177.

⁴⁵ S6.01 (a) provides that the articles of incorporation must set forth any classes of shares and series of shares within a class, and the number of shares of each class and series, that the corporation is authorized to issue.

⁴⁶ See Manning and Hanks op cit (n3) 182. See also S1.40 (6) which defines a distribution as a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise.

⁴⁷ Ibid 63.

⁴⁸ Ibid 182.

states incorporated it in their statutes⁴⁹. However, the incorporation of the twin solvency test (combination of equity insolvency and balance sheet solvency test) in the Revised Model Act was certainly a new feature. Apart from gaining acceptance in a majority of states in the US, the section 6.40 combination of equity insolvency and balance sheet solvency coupled with a deletion of mandatory outdated legal capital concepts has also been adopted internationally by jurisdictions seeking to modernize their company law provisions with respect to affording better protection to creditors when the company effects certain transactions⁵⁰. The twin solvency test depending on jurisdiction is referred to simply as ‘solvency test’ or ‘solvency and liquidity test’⁵¹. This paper adopts the simple terminology of solvency test to mean the twin solvency test. Further, this paper uses the words ‘equity solvency’ or ‘equity insolvency’, ‘balance sheet solvency’ or ‘balance sheet insolvency’ to mean the two separate tests.

By contrast, in the UK traditional legal capital rules still remain. Section 542 of the UK Companies Act, 2006 states that every share in a limited company having a share capital must have a fixed nominal or par value such that an allotment of a share that does not have a fixed nominal value is void. The provisions on distributions and reduction of capital in the Companies Act, 2006 reinforce the common law prohibition on return of capital to shareholders⁵². In terms of regulating distributions, UK company law has not adopted a solvency based regime. The Companies Act, 2006 defines a distribution as every description of distribution of a company’s assets to its shareholders whether in cash or otherwise⁵³. It then incorporates mandatory capital maintenance rules such as; a company may only make a distribution out of profits available for such purpose⁵⁴ and a limited company is prohibited from acquiring its own shares whether by purchase, subscription or otherwise⁵⁵.

⁴⁹ The 1950 Model Act employed equity insolvency test in several provisions (ss 5(a), 40, 41(a), 60). Following the Chancery courts in England (equity courts), an 1824 opinion by Justice Story in the American case *Wood –v– Dummer* pronounced the equity insolvency test in American corporation law. 30 F.Cas. 435 (no. 17, 944) (C.C.D.Me.1824)

⁵⁰ South Africa began its reforms to the traditional legal capital rules in 1999 which eventually led to the adoption of the Companies Act, 2008. The said 2008 Companies Act replaced the Companies Act 1973 and essentially it has jettisoned all the obsolete legal capital rules and adopted the twin solvency test for assessing the legality of distributions and other company transactions. Similarly, New Zealand also jettisoned the obsolete legal capital rules and adopted a twin solvency test for assessing the legality of distributions.

⁵¹ South Africa refers to it as the solvency and liquidity test whilst New Zealand refers to it as the solvency test.

⁵² Part 23 of the Companies Act, 2006 deals with distributions whilst Part 17 deals with reductions of capital.

⁵³ Section 829 of the Companies Act, 2006. Reduction of capital is not a distribution.

⁵⁴ Section 830 of the Companies Act, 2006.

⁵⁵ Section 658 (1) of the Companies Act, 2006.

However, policymakers at the European level appear to be edging towards moving away from the mandatory legal capital rules and in line with that approach, the possibility of shifting to a solvency based pay-out regime for dividends by private companies was considered in the UK in the reform exercise that preceded the Companies Act 2006⁵⁶. In fact, in terms of reduction of capital by private companies, the Companies Act, 2006 in section 641 adopted a solvency based regime by providing that a private company limited by shares may reduce its share capital by special resolution supported by a solvency statement⁵⁷. The willingness to adopt a solvency based regime for reductions of capital when it can be argued that in economic terms, dividends, reductions of capital and share buy backs have much in common and can be regarded simply as alternative methods of returning value to shareholders is quiet odd⁵⁸. However, looked at from the angle of company law reform, it demonstrates how far UK company law has come from the mandatory legal capital rules to the point of embracing solvency standards.

1.1.4 The shift to the solvency test in Malawi

Malawi has also reformed its company law by enacting a new Companies Act 15 of 2013⁵⁹ ('Companies Act, 2013') which has replaced the Companies Act, 1984. The new Companies Act, 2013 in complete contrast to the Companies Act, 1984 states that shares created after commencement of the Act must not have a nominal value⁶⁰. It also permits a number of transactions that were prohibited outright in the Companies Act 1984 as a result of its capital

⁵⁶ E Ferran and L Chan Ho op cit (n2) 155-156.

⁵⁷ Section 643(1) of the Companies Act, 2006 defines solvency statement: A solvency statement is a statement that each of the directors— (a) has formed the opinion, as regards the company's situation at the date of the statement, that there is no ground on which the company could then be found to be unable to pay (or otherwise discharge) its debts; and (b) has also formed the opinion— (i) if it is intended to commence the winding up of the company within twelve months of that date, that the company will be able to pay (or otherwise discharge) its debts in full within twelve months of the commencement of the winding up; or (ii) in any other case, that the company will be able to pay (or otherwise discharge) its debts as they fall due during the year immediately following that date. (2) In forming those opinions, the directors must take into account all of the company's liabilities (including any contingent or prospective liabilities).

Similarly, section 714 of the Act continues the theme from the Companies Act 1985 where a private company is allowed to make a redemption or purchase of its own shares out of capital as long as the directors make a solvency statement.

⁵⁸ E Ferran and L. Chan Ho op cit (n2) 159.

⁵⁹ Malawi Gazette Supplement of 26th July, 2013. The Act only came into force on 20th May, 2016.

⁶⁰ Section 87 of the Malawi Companies Act, 2013.

maintenance regime. The new Act permits the previously prohibited transactions subject to among other conditions, the company satisfying the solvency test⁶¹.

The requirement to consider and satisfy the solvency test in certain company transactions is an entirely new concept in Malawian company law⁶². The Company Law Review Strategy developed by the Ministry of Trade and Industry in Malawi ('MTI') which was a working paper for the review of the Companies Act, 1984 in the year 2012, did not contain any detailed discussion of the policy that led to the adoption of this entirely new concept in Malawian company law⁶³. However, the MTI in the introduction to its Company Law Review Strategy did give an indication of the thought process that occurred in the revision of company law in Malawi:

'...The Draft Report on Prioritisation of Economic Laws for Revision (December 2008) recommended that Malawi emulates the recent company law reforms in the United Kingdom (UK), South Africa and the ongoing company law reforms in Kenya.

South Africa has also just completed a review of its companies law. Furthermore, commonwealth countries that led the reforms being undertaken in the above mentioned countries would also be useful. These are New Zealand in 1993 and Canada in 1985...'⁶⁴

In effect, Malawi reformed its company law by emulating the company law reforms that occurred in South Africa, Canada, New Zealand and even the UK.

1.2 PROBLEM STATEMENT

From the discussion so far, two facts become evident. Firstly, the argument for eliminating the obsolete legal capital rules and adopting the twin solvency tests in modern company law has received backing in many common law jurisdictions. The argument states that the balance sheet

⁶¹ To illustrate this point, for example, **section 110 of Malawi's Companies Act, 2013** provides on share repurchases by the company and is couched as follows:

'(1) A company may, subject to – (a) the approval of the Board; and (b) its constitution authorizing it to do so, purchase or otherwise acquire its own shares. (2) A company shall not offer or agree to purchase or otherwise acquire its own shares unless – (a) the Board is satisfied that – (v) the company shall immediately after the acquisition *satisfy the solvency test...*' (My emphasis)

⁶² It should be noted that this reference to "a new concept in Malawian company law" is in respect of the Companies Act and not the financial services laws as are administered by the financial services regulator in Malawi. Companies that are licensed or registered as financial institutions have always been required to meet the solvency test per the financial services laws.

⁶³ Company Law Review Strategy – A Working Paper (Unreported). See n30.

⁶⁴ Ibid.

solvency element gives advance recognition to the ultimate priority that creditors enjoy over shareholders upon dissolution of the company by preventing the company from favouring its shareholders through partial liquidation and the equity insolvency element addresses the fundamental expectation of creditors to be paid on time⁶⁵. Secondly, the commonwealth countries that have followed the lead of the US in reforming their company law, somehow maintain different looking provisions on the definition of the solvency test and the related regulation of distributions. Consequently, since the introduction of the modern solvency test approach in company law, scholarly reviews on the operation of the solvency test and the protection of creditors from unsafe company distribution of assets to shareholders have generally proceeded by looking at the unique provisions as enacted in each jurisdiction. Bayless Manning certainly led the way in reviewing legal capital reforms in the Model Act and the Revised Model Act across the Atlantic⁶⁶. Closer to Malawi, Kathleen Van der Linde also examined the solvency and liquidity approach in the South African Companies Act, 2008⁶⁷. Therefore, as Malawi has only had the solvency test in its company law since the 20th of May, 2016 the author suggests a valid argument can be made that an examination of the operation of the solvency test as enacted in the Malawian Companies Act, 2013 is warranted.

To elaborate the point being made above, an example can be given of a recent scholarly work reviewing the operation of section 6.40 of the Revised Model Act. According to James J. Hanks, in its nearly thirty years as part of the Revised Model Act, section 6.40 has worked remarkably well⁶⁸. However there have been questions centering on the interpretation and application of the two solvency tests that are the heart of the statute⁶⁹. In terms of the application of the equity insolvency test in the US, a difficulty arises in determining the corporation's ability to pay debts in the usual course of business at some unspecified time 'in the future'. The further in the future is the time when the determination must be made, the more difficult it is for the board to make the requisite determinations at the time of its authorization⁷⁰. However, in the US the argument is that directors should find solace from the business judgment rule and as long as their determination of equity solvency was based on a rational basis they should not be liable if it

⁶⁵ K Van Der Linde op cit (n4) 226.

⁶⁶ B Manning 'Legal Capital'. See n6 and n3.

⁶⁷ See n4.

⁶⁸ JJ Hanks 'Legal Capital and the Model Business Corporation Act: An Essay for Bayless Manning' (2011) *Law and Contemporary Problems* 211 - 230.

⁶⁹ Ibid.

⁷⁰ Ibid.

turns out to have been the wrong decision⁷¹. For jurisdictions that may have transplanted the US legislation into their company law without having the corresponding business judgment rule in their statutes the situation would obviously be difficult for directors.

In 2009, Van der Linde examined the operation of the solvency and liquidity approach in the South African Companies Act, 2008. According to Professor Van der Linde the balance sheet solvency test in the 2008 Act is out of step with international trends as it is only satisfied whenever the assets equal the liabilities following a permitted transaction and no provision is made for a solvency margin except in limited circumstances⁷². She further highlights the importance of the question as to what is the proper determination and valuation of assets and liabilities to be taken into account when assessing the solvency of a company. The argument is that a determination of assets and liabilities based on compliant financial statements is a fairly narrow concept and that the application of the solvency and liquidity test involves more than looking at statements and records⁷³.

Additionally, the requirements of when the solvency test must be considered and satisfied as well as the manner of application of the test have significant ramifications on the protection of creditors⁷⁴. To illustrate, an example can be given of the provision regulating distributions in the South African Companies Act, 2008⁷⁵. Whilst the general principle under the South African Act is that a distribution must not be made if the board does not reasonably believe the company will satisfy the solvency and liquidity requirements immediately after the distribution, the wording of the relevant provision makes it possible for one to interpret it as meaning that once the board has by resolution acknowledged that it has applied the test and reasonably concluded that the company will satisfy the test immediately after completing the proposed transaction, then it will not matter that at the actual point of effecting the transaction the company does not satisfy the test⁷⁶.

Therefore, the foregoing discussion demonstrates the need to examine the definition of the solvency test as enacted in the new Malawian Companies Act, 2013 as well as any other matters that may need to be considered in the application of the solvency test as a financial

⁷¹ Ibid.

⁷² K Van der Linde op cit (n4) 228.

⁷³ Ibid 231.

⁷⁴ Ibid 233 – 239.

⁷⁵ Section 46 of the Companies Act, 2008.

⁷⁶ K Van Der Linde Op Cit (n4) 239.

restriction on distributions and other company transactions in the Act so as to assess whether the new solvency test approach in Malawi will afford adequate protection to creditors.

1.2.1 Research Question

The underlying question this paper seeks to answer is whether the solvency test as enacted in the new Malawian Companies Act, 2013 will in its application or operation afford adequate protection to the interests of creditors in various company transactions. In order to answer this question, the paper will be directed by the following specific questions:

(i) What are the substantive requirements of the balance sheet and equity solvency tests in the new Malawian Companies Act?

(ii) What guidance does the Act provide on other matters for possible consideration in the application of the solvency test such as the determination and valuation of assets and liabilities as well as the manner of application of the test?

1.3 RESEARCH OUTLINE

Chapter one outlines the background to the study, the statement of the problem, justification of the study and the research questions directing the study. As can be seen from this chapter, the central thesis for this research paper is that modern company law statutes have moved away from the traditional concepts of legal capital and have incorporated the solvency test as a more adequate restriction when it comes to protecting the interests of creditors during distributions to shareholders.

Against this backdrop, chapter two sets in context the conceptual and theoretical framework underpinning the solvency test approach. Because the solvency test is an alternative to the traditional legal capital rules, an examination of the critical arguments for and against legal capital will be laid out in this chapter.

Chapter three then looks at the design of the solvency test in the new Malawian Companies Act. It examines the elements of the definition of solvency test in the Act and assesses whether there is any drawback in the way the solvency test is enacted in the Act. The chapter, which follows the approach used by Professor Van der Linde in her discussion of the solvency and

liquidity approach in the South African Companies Act, 2008, mainly proceeds by examining the interpretational issues of the equity insolvency and balance sheet solvency elements of the solvency test as enacted in the Malawian Act.

Chapter four follows the discussion in the preceding chapter and mainly looks at other issues for possible consideration in the definition of the solvency test under the Companies Act, 2013. Still influenced by the approach of Professor Van der Linde in her discussion of the solvency and liquidity approach in South Africa, the chapter discusses the following issues: the assets and liabilities that should be included and their valuation; the time when the test should be considered and satisfied; and the manner in which the test should be applied.

The thesis concludes in chapter five by drawing lessons from the preceding chapters and making recommendations on the design of the solvency test in the new Companies Act, 2013.

CHAPTER TWO: SOLVENCY BASED REGIME – THEORETICAL ISSUES

2.0 INTRODUCTION

Chapter one has described the overall topic of this study: to examine the solvency test approach in the new Malawian Companies Act so as to assess whether, in its operation as a financial restriction to distributions and other company transactions, it will provide adequate protection to creditors. This chapter expounds the theoretical basis for adopting a solvency based regime as a modern method for protecting creditors. It begins by examining the theory of creditor protection in company law and asks the question do creditors require the protection afforded by the solvency test? The discussion then looks at the concept of the solvency test and identifies as well as evaluates the issues surrounding both the equity insolvency and the balance sheet solvency tests.

Noting that the new solvency based regime developed out of questioning the value of the legal capital doctrine in creditor protection, the discussion generally proceeds by evaluating the arguments and counter-arguments put forward by both the critics and defenders of the traditional legal capital doctrine.

2.1. CREDITOR PROTECTION IN COMPANY LAW

The term ‘creditor’ expresses a single basic proposition⁷⁷. A creditor has, subject to the special terms of credit, a higher and prior claim to the assets of his debtor than the debtor has himself⁷⁸. Thus, when a creditor’s claim becomes due and payable, the creditor may, in normal course, enlist the engines of the law to compel his debtor to pay the debt, regardless of the consequent diminution of the assets that ‘belong’ to the debtor⁷⁹. According to Manning, a creditor of a company seeks four objectives:

‘(1) The creditor will be happier if the company holds substantial assets at the time he extends credit and thereafter;

(2) The creditor will want to restrict the company from incurring debts to other general creditors with whom he might have to share the company’s limited assets;

⁷⁷ Manning and Hanks op cit (n3) 5.

⁷⁸ Ibid.

⁷⁹ Ibid.

(3) The creditor will want the company assets to be free and unencumbered of any lien interests of a prior (secured) creditor; and

(4) The creditor will want to preserve a cushion of protective assets, and will want to see to it that no shareholder makes off with assets of the company while the creditor's claim is still outstanding and unpaid.⁸⁰ [Sic]

These four objectives provide the essence of creditor protection in company law. As to what is meant by 'creditor protection' in company law, the literature mainly offers a historical explanation. William W Bratton describes creditor protection in US corporate law in this manner:

'Creditor protection came into corporate law in the United States with the enactment of the first general corporation laws in the mid-nineteenth century. These extended limited liability to the shareholders as a usual consequence of incorporation, simultaneously imposing creditor protective provisions now known as legal capital rules.

The original legal capital rules mandated minimum capital, requiring that shareholders pay in full for stock issued and constraining their receipt of dividends and other distributions of capital. The rules made creditor protection as intrinsic an aspect of incorporation as limited liability...⁸¹ [Sic]

In England, creditor protection in company law perhaps was brought to the fold by Lord Jessel M.R. in *Flitcrofts' Case* when he stated that 'a creditor gives credit to a company on the faith of the representation of that company that its capital will only be applied for purposes of the business and that the creditor therefore has a right to say that the company must keep its capital and not return it to the shareholders' [Sic]⁸². This statement by Lord Jessel envisages protecting creditors from the risk that shareholders would subsequently withdraw their capital investment⁸³.

Therefore, creditor protection rules in company law developed out of the recognition that shareholders of companies with debt have strong incentives to act opportunistically at the expense of existing creditors⁸⁴.

⁸⁰ Ibid 11.

⁸¹ WW Bratton 'Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process' (2006) 7 *Eur. Bus. Org. L. Rev.* 39-87.

⁸² *In Re Exchange Banking Company (Flitcrofts' Case)* supra (n18) 519.

⁸³ J Armour 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (1999) 63 *MLR* 367. ('J Armour Share Capital and Creditor Protection').

⁸⁴ JR Macey and L Enriques 'Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules' (2001) *Paper 1413 Faculty Scholarship Series: Yale Law School Faculty Scholarship* 1168.

2.1.1 Creditor Protection and the Case for Solvency-Based Distribution Regulation

One way shareholders act opportunistically at the expense of creditors is to engage in asset diversion by means of company distributions⁸⁵. To restrict such corporate behaviour and thus protect the interests of creditors, company law built a legal apparatus around the concept of legal capital⁸⁶. Legal capital rules have subsequently been jettisoned in common law jurisdictions in favour of solvency standards⁸⁷ and whilst they continue to be in use in Europe, the emerging European consensus is that rules that regulate distributions are in need of reform⁸⁸. However, the principle of creditor protection per se does not tell us whether creditors require the protection afforded by solvency standards.

According to Jonathan Rickford the basic interest of creditors, in contexts where assets are to be returned to shareholders, is a fair and proportionate protection against threats to insolvency⁸⁹. Company law should focus on the core risk at stake – insolvency⁹⁰. Although this is the basis upon which solvency standards have generally been adopted in most common law jurisdictions, to understand the way in which the solvency standards operate, it is helpful, analytically, to distinguish between those creditors who are able to change the terms on which they lend to reflect the associated risks of default, and those who are not so able—sometimes termed ‘adjusting’ and ‘non-adjusting’ creditors respectively⁹¹.

Adjusting creditors are those creditors who voluntarily enter into debt contracts with companies and are free to negotiate the terms of the contractual relationship⁹². They are willing to incur the transaction costs such as gathering information, negotiation and the like, necessary to adjust the terms upon which credit is extended so as to compensate them appropriately for the

⁸⁵ Ibid.

⁸⁶ WW Bratton op cit (n81).

⁸⁷ Manning and Hanks op cit (n3).

⁸⁸ See generally, D Kershaw ‘Involuntary Creditors and the Case for Accounting-Based Distribution Regulation’ (2007) *LSE Law, Society and Economy Working Papers No. 16*. Accessed from <https://www.lse.ac.uk/collections/law/wps/WPS16-2007Kershaw.pdf>. Available on 20 December, 2016.

⁸⁹ J Rickford ‘REFORMING CAPITAL: Report of the Interdisciplinary Group on Capital Maintenance’ (2004) *EBLR* 971.

⁹⁰ Ibid 967.

⁹¹ To formulate the foundational theory upon which this thesis proceeds on, the analysis by J Armour provides helpful insight. See, J Armour ‘Legal Capital: An Outdated Concept?’ (2006) *Centre for Business Research, University of Cambridge Working Paper No. 320* p4. Accessed from http://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp320.pdf. Available on 30 November, 2016. (‘J Armour Legal Capital’).

⁹² Ibid.

risk they are bearing⁹³. Economic theorists argue that these creditors can self-protect against the risk of non-payment by the company⁹⁴. This can be done in a number of ways including through the terms of the contracts that they negotiate⁹⁵. They argue further that the ability to self-protect indicates that rules developed by the common law or statute aimed at protecting creditors, are unnecessary⁹⁶. On this argument alone, one may be tempted to state that *adjusting creditors do not require the protection of the statutory solvency standards* (my emphasis). However, the only world where creditors need no protection from the common law or statute is a fictional world of perfect capital markets, in which parties have perfect information and financial contracting is costless⁹⁷. Helen Anderson explains this notion in this manner:

‘...the self-protection argument is based on the “efficient markets” hypothesis. This holds that “all relevant information will be available to the market and that the market will rapidly, if not instantaneous, digest all information as it becomes available”.

But even the proponents of this theoretical outlook are prepared to admit that markets do not always work efficiently, because it does not take into account situations where there is not full information about the investment or the borrowing company’s financial position’⁹⁸ [Sic]

If markets are imperfect and are characterized by information asymmetries such that it can now be argued that statutory rules are needed to protect adjusting creditors, what makes the legal capital rules inefficient so as to be jettisoned in favour of solvency standards?

One argument in favour of employing legal capital rules as a means of protecting adjusting creditors relates to the capital maintenance rule as a conditional restriction for distributions. For Professor Armour, the capital maintenance rule can be understood as a means of reducing the costs of post-contractual opportunism by shareholders⁹⁹. According to this understanding, at the time of contracting, adjusting creditors incorporate the legal capital of the company into their assessment of the risk of default by the company¹⁰⁰. If, following the consummation of the contract, the company is able to return legal capital or an amount representing legal capital in the accounts to the shareholders then the terms of the agreement are

⁹³ Ibid.

⁹⁴ H Anderson ‘Directors’ Liability to Creditors – What are the Alternatives?’ (2006) 18.2 *BLR* 3.

⁹⁵ Ibid.

⁹⁶ Ibid 4.

⁹⁷ J Armour Share Capital and Creditor Protection op cit (n83) 357.

⁹⁸ H Anderson op cit (n94) 4.

⁹⁹ J Armour Share Capital and Creditor Protection op cit (n83) 367.

¹⁰⁰ D Kershaw op cit (n88) 5.

unilaterally altered by the company to the detriment of the adjusting creditor¹⁰¹. The capital maintenance doctrine is therefore a conditional financial restriction whereby, provided the company is able to meet a certain minimum financial condition (e.g. the availability of profits – ‘net profits test’), shareholders are free to participate in company distributions¹⁰².

Consequently, rather than having each adjusting creditor contract separately with the company for a restriction on distributions, the capital maintenance statutory framework can be understood as writing a collective ‘creditor term’ into the corporate constitution¹⁰³. In this vein, those who argue for legal capital rules state that statutory capital maintenance rules reduce the costs for contracting for adjusting creditors as they are provided with ‘default contract terms’.

The counter-argument to the theory that statutory legal capital rules might assist adjusting creditors in reducing their costs of contractual specification is that the statutory legal capital rules should generally be defaults, ie only applicable unless parties specify otherwise – rather than mandatory, so that parties to whom they are not suited do not find themselves saddled with inferior terms¹⁰⁴. To this extent, Armour notes that if one considers the mandatory capital maintenance doctrine, several commentators argue that the relevant statutory provisions are unlikely to be terms which any creditor would choose for themselves¹⁰⁵. This is because share capital is based on historic valuations ascribed to assets transferred to the company and as time goes on the utility of capital as a minimum financial condition for distributions will diminish, as the value of the company’s assets bears less and less resemblance to the amount of the shareholders’ capital claims¹⁰⁶.

The conclusion drawn out of the foregoing economic theory against mandatory legal capital rules is that whilst legal capital rules were rationalized as an attempt to protect corporate creditors from expropriation by shareholders, and whilst in theory, rules which prevent such wealth transfers (eg capital maintenance rules) can enhance efficiency (by reducing the costs of contracting for adjusting creditors), the mandatory legal capital rules impose restrictions on

¹⁰¹ Ibid.

¹⁰² J Armour Share Capital and Creditor Protection op cit (n83) 367 - 368.

¹⁰³ Ibid 368.

¹⁰⁴ See, I Ayres and R Gertner ‘Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules’ (1989) 99 *Yale LJ* 87 at 87–89 cited in J. Armour Share Capital and Creditor Protection op cit (n83) 362.

¹⁰⁵ J Armour Share Capital and Creditor Protection op cit (n83) 373.

¹⁰⁶ J Armour Legal Capital op cit (n91) 8.

companies which are ill-tuned to the needs of contracting parties¹⁰⁷. On the whole, the costs of such restrictions are likely to outweigh any benefits they bring¹⁰⁸.

As for non-adjusting creditors (creditors who do not contract with companies), a restriction on the return of capital to shareholders is by itself of little assistance¹⁰⁹. It cannot be said that non-adjusting creditors rely on the capital maintenance regime. Non-adjusting creditors such as employees, tort claimants, tax regulators etc cannot be said to be the creditors that were envisaged by Lord Jessel M.R. in *Flitcrofts case*. Rickford states that by definition involuntary or non-adjusting creditors do not rely on the levels of capital maintained by the companies concerned¹¹⁰.

In view of the literature questioning the value of the legal capital doctrine, the case for solvency based distribution regulation is made. Armour after utilizing economic analysis to examine the capital maintenance regime, suggests that ‘instead, tests which restrict shareholder asset transfers on the basis of gearing (ratio of debt to equity) or liquidity (ability to realize cash for assets) would be more appropriate¹¹¹. Ferran also notes the case for solvency standards in regulating distributions¹¹². She begins by highlighting the legal capital doctrine expounded in Article 17(1) of the EC Second Company Law Directive which reads as follows:

‘Except for cases of reductions of subscribed capital, no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company’s annual accounts are, or following a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes.’ [Sic]

She states that the effect of this provision is that only that portion of the net assets that exceeds the capital and undistributable reserves can be paid out to shareholders, *notwithstanding that from a solvency perspective, which tests the ability to pay debts as they fall due and/or by reference to the overall net asset position (total assets less total liabilities, not treating share capital as a liability), the company might well have capacity to make larger pay-outs without threatening creditors’ expectations of repayment* (my emphasis)¹¹³. In this regard, solvency based distribution regulation would afford better protection to both adjusting and non-adjusting

¹⁰⁷ J Armour Share Capital and Creditor Protection op cit (n83) 377.

¹⁰⁸ Ibid.

¹⁰⁹ J Armour Legal Capital op cit (91) 5.

¹¹⁰ J Rickford op cit (n89) 932.

¹¹¹ J Armour Share Capital and Creditor Protection op cit (n83) 373.

¹¹² E Ferran and L Chan Ho op cit (n2) 156.

¹¹³ Ibid 156-157.

creditors. This is certainly the case as economic theory demonstrates that rigid legal capital rules that seek to protect creditors *ex ante* are inefficient¹¹⁴. Flexible *ex post* solvency standards are inherently preferable¹¹⁵.

2.2 THE CONCEPT OF THE SOLVENCY TEST

The foregoing discussion elucidates the fact that the development of the solvency test as a minimum financial condition for distributions is a result of reforms to the legal capital doctrine. As highlighted in the previous chapter, company law reforms that have come to the field of legal capital began in 1975 when the state of California in the USA amended its General Corporation Law¹¹⁶. Prior to the amendment, the law in California permitted corporations to pay dividends only from the corporation's 'earned surplus,' which was an antiquated legal accounting concept based on the idea that shares had a 'par value' representing the amount of capital contributed to the corporation¹¹⁷. The amended California Corporations Code which was adopted in 1977 discarded long out-modelled legal capital concepts and adopted GAAP as a step towards improving the law's regulation of dividend distributions¹¹⁸. However, the solvency test approach adopted in many common law jurisdictions today bears much similarity to the one enacted in the Revised Model Act¹¹⁹. Cox and Hazen make the following comments on the Model Act:

'The current version of the Model Act follows California's lead in jettisoning most of the traditional legal capital concepts ... It also retains the equity insolvency test as a basic restriction. The Model Act diverges significantly from California in rejecting a restriction based on earnings.

In lieu of retained earnings or earned surplus, the Model Act uses a simpler and more flexible balance-sheet test. The new provision prohibits distributions if, after the distribution, a corporation's total assets are less than its total liabilities plus liquidation preferences, if any. The Model Act further declines dependency on GAAP by placing the method for valuation of assets and liabilities within the directors' discretion, subject to a standard of reasonableness under the circumstances.'¹²⁰ [Sic]

¹¹⁴ J Armour Share Capital and Creditor Protection op cit (n83) 367. He used economic analysis to demonstrate that legal capital rules impose costs that are not outweighed by their benefits and creditors can protect themselves without the need for mandatory rules of company law to perform that function.

¹¹⁵ E Ferran and L Chan Ho op cit (n2) 157.

¹¹⁶ See paragraph 1.1.3 of Chapter 1 above on company law reforms and the protection of creditors.

¹¹⁷ The State Bar of California, Business Law Section, Corporations Committee *REVISIONS TO STREAMLINE AND UPDATE CORPORATION CODE PROVISIONS RELATING TO DISTRIBUTIONS AND REPURCHASES OF SHARES*. Accessed from <http://www.calbar.org/buslaw/> on 29 November 2016.

¹¹⁸ Cox and Hazen op cit (n39) 565.

¹¹⁹ For example the solvency test adopted in New Zealand.

¹²⁰ Ibid.

The equity insolvency and the balance sheet solvency tests form the basis of the solvency test regime under investigation in this thesis.

2.2.1 Function and operation of the solvency test

Professors Pellens and Sellhorn state that a solvency test's primary function is to prevent distributions by companies that are already insolvent, as well as distributions that are likely to result in the company becoming insolvent¹²¹. The solvency test protects creditors by ascertaining that distributions to shareholders are only made when the corporation documents before a proposed distribution that payments due to creditors are not jeopardized¹²². Solvency-based standards operate by requiring the directors of a company to take a view on the company's solvency and to assume personal liability for that view¹²³. Thus, solvency tests can be drafted in different ways but typically would require directors to certify that the company is solvent at the time of the pay-out and for some time thereafter¹²⁴.

In terms of the equity insolvency test, Manning states that this test was developed by the English Chancery Courts – equity courts¹²⁵. In the equity courts, the test of a debtor's insolvency was whether he was unable to meet his obligations as they became due¹²⁶. The significance of the equity insolvency test is that it is a restraint on distributions to shareholders within the context of the on-going corporation¹²⁷. As to its meaning, Professor Jooste, noting that in Australia the test for insolvency of a company has for a long time been whether the company is unable to pay its debts as they become due and payable, utilises what the Australian courts have held in that regard to determine the meaning of equity insolvency test. He states as follows:

‘The Australian Courts have held that whether a company is unable to pay its debts as they fall due is always a question of fact to be decided as a matter of commercial reality in the light of all the circumstances of the case, and not merely by looking at the accounts and making a mechanical comparison of assets and liabilities.

¹²¹ See B Pellens and T Sellhorn ‘Improving creditor protection through IFRS reporting and solvency tests’ in M Lutter ‘Legal Capital in Europe’ (2006) Special Vol. 1 *ECFR* at 380.

¹²² *Ibid.*

¹²³ E Ferran and L Chan Ho *op cit* (n2) 158.

¹²⁴ *Ibid.*

¹²⁵ Manning and Hanks *op cit* (n3) 63.

¹²⁶ *Ibid.*

¹²⁷ DT Murphy ‘Equity Insolvency and new Model Business Corporation Act’ (1981) *University of Richmond L R* 839 at 844.

The position must be viewed as it would be by someone operating in a practical business environment. This requires a consideration of the company's financial condition in its entirety, including the nature and circumstances of its activities, its assets and liabilities and their nature, cash on hand, moneys procurable within a relatively short time by the sale of assets, by way of a loan and mortgage or pledge of assets, or by raising capital.

The size of any deficiency between assets and liabilities of the company is a factor that can be taken into account, for it may be indicative of a company that, on relevant dates, could not reasonably be expected to be able to pay its debts as and when they become due.¹²⁸ [Sic]

Despite this elaborate expression of the meaning of equity insolvency test, equity insolvency has been said to be an elusive concept. In 1981, Daniel Murphy in his analysis of the revisions to the financial provisions of the Model Act said that 'one consequence of the recent and far-reaching revisions to the financial provisions of the Model Act is to re-focus attention on the significance of the *elusive concept of equity insolvency* as it affects corporate distributions'¹²⁹ (my emphasis). Recently, Hanks has analysed the application and interpretation of the current equity insolvency test in section 6.40(c) (1) of the Revised Model Act. He states that there is ordinarily little difficulty in determining whether a corporation, even one in financial difficulty, is currently able to pay its debts in 'the usual course of business'¹³⁰. The difficulties arise in determining the corporation's ability to pay its debts in the usual course at some unspecified time in the future¹³¹. The further in the future is the time when the determination must be made, the more difficult it is for the board to make the requisite determination at the time of its authorization¹³².

The official comment to section 6.40 notes as follows on the determinations that must be made by the board with regards to the equity insolvency test:

'In determining whether the equity insolvency test has been met, certain judgments or assumptions as to the future course of the corporation's business are customarily justified, absent clear evidence to the contrary.

These include the likelihood that (a) based on existing and contemplated demand for the corporation's products or services, it will be able to generate funds over a period of time sufficient to satisfy its existing and reasonably anticipated obligations as they mature, and (b) indebtedness which matures in the near-term will be refinanced where, on the basis of the corporation's financial condition and future prospects and the

¹²⁸ R Jooste 'Corporate Finance' in FHI Cassim et al op cit (n22) 278.

¹²⁹ DT Murphy op cit (n127) 839.

¹³⁰ Generally, it either is or is not paying its debts on time. JJ Hanks 'Legal Capital and the Model Business Corporation Act: An Essay for Bayless Manning' (2011) 74 *Law and Contemporary Problems* 211 at 219.

¹³¹ Ibid.

¹³² Ibid.

general availability of credit to businesses similarly situated, it is reasonable to assume that such refinancing may be accomplished...”¹³³ [Sic]

Noting the above comment, Manning asks the following questions: Can a board of directors with any confidence make such futuristic analyses and judgments? Over how many months, years or decades ahead are they called upon to do so¹³⁴? Pellens and Sellhorn perhaps provide the answer to these questions as they state that neither the Model Act itself nor the explanatory literature contains concrete guidance on how to conduct equity insolvency tests¹³⁵.

The foregoing discussion on the Model Act’s equity insolvency test paints the picture of the issue that surrounds the operation of the equity insolvency test and its ability to provide adequate protection for creditors. According to Ferran, since it is not feasible to expect directors to assume personal liability for the performance of the company long into the future (when they may no longer be in charge of directing its affairs), a limited time horizon, such as twelve months, is appropriate for the equity insolvency test¹³⁶. She however goes on to state that the discussion in the literature on how best to factor long term liabilities into the assessment of equity insolvency is a complex and controversial issue¹³⁷. Van der Linde also notes the same issue in her analysis of the solvency and liquidity approach in the South African Companies Act, 2008¹³⁸. Section 4(1) (b) of the 2008 Act states that the liquidity element will be satisfied if, considering all reasonably foreseeable financial circumstances of the company at the time, it appears that the company will be able to pay its debts as they become due in the course of business for a period of twelve months¹³⁹. Van der Linde submits that the imposition of a time limit is undesirable and that the ‘ordinary course of business’ of each company should be the decisive factor in judging its liquidity¹⁴⁰. This is because, whilst the specification of a time period will provide more certainty for directors when they authorize a distribution, it may disadvantage creditors of companies that have clearly foreseeable longer-term commitments that are not payable within twelve months¹⁴¹. In the UK, concerns about longer term solvency issues were an inhibiting factor when the possibility of shifting to a solvency based pay-out regime for

¹³³ See Model Business Corporation Act: Official Text with Official Comments published by the American Bar Association. This comment is also quoted by JJ Hanks op cit (n130) 220.

¹³⁴ Manning and Hanks op cit (n3) 185.

¹³⁵ B Pellens and T Sellhorn in M Lutter op cit (n121) 382.

¹³⁶ E Ferran and L Chan Ho op cit (n2) 158.

¹³⁷ Ibid.

¹³⁸ K Van der Linde op cit (n4) 229.

¹³⁹ Ibid.

¹⁴⁰ Ibid.

¹⁴¹ Ibid.

dividends by private companies was considered in the reform exercise that preceded the Companies Act, 2006¹⁴². The worry was that the proposed equity solvency test which would only require the directors to consider debts falling due in the next year, thus allowing the company to pay a dividend even though it had long term liabilities exceeding its assets, provided only an assurance of short-term solvency and this was not a sufficient guarantee of the company's ability to meet its long term debts, and therefore did not provide adequate protection for creditors¹⁴³.

In view of the foregoing, Ferran states that where a specification of a time period for assessing equity insolvency is in place, one approach would be to require directors simply to take account of long term liabilities in determining their company's solvency thereby leaving considerable discretion with the directors as to the weight to be attached to long-term liabilities¹⁴⁴. This ordinarily would mean the relevant Companies Act accepts by way of codification of the business judgment rule, that these are matters of judgment for the directors¹⁴⁵. She further states that another approach would be to require directors to determine solvency specifically by reference to an accounts-based balance sheet test of an excess of assets over liabilities¹⁴⁶.

The balance sheet test was developed as a concept of insolvency for use in bankruptcy proceedings in the English common law courts¹⁴⁷. The test for bankruptcy was whether the aggregate amount of the debtor's assets was less than the total amount of his liabilities¹⁴⁸. Thus balance sheet tests start by comparing the company's assets shown on its balance sheet with the liabilities shown there¹⁴⁹. Cox and Hazen state that in accounting, the balance sheet sets forth a company's cumulative financial position as of a specific date¹⁵⁰. The balance sheet reports on the composition of the company's assets, liabilities, and owners' equity at a fixed point in time¹⁵¹. This elaboration of a balance sheet means that an accounts-based balance sheet test is static; it

¹⁴² E Ferran and L Chan Ho op cit (n2) 158.

¹⁴³ Ibid.

¹⁴⁴ Ibid.

¹⁴⁵ This is largely the approach under the Model Act. See JJ Hanks op cit (n130) 211.

¹⁴⁶ E Ferran and L Chan Ho op cit (n2) 158.

¹⁴⁷ Manning and Hanks op cit (n3) 64.

¹⁴⁸ Ibid.

¹⁴⁹ Ibid 65.

¹⁵⁰ Cox and Hazen op cit (n39) 538.

¹⁵¹ Ibid 538-539.

speaks of a particular point in time¹⁵². In this regard, a balance sheet solvency test can be differentiated from an equity insolvency test whose assessment is inherently forward looking¹⁵³.

The literature in the US, itself being a leading jurisdiction on the reforms to legal capital, categorizes balance sheet tests into two groups. These are balance sheet tests that employ stated capital and those tests not employing stated capital¹⁵⁴. For balance sheet tests that employ stated capital these are mainly sub-categorized into stated capital/surplus test and stated capital/earned surplus test¹⁵⁵. Manning states that the central idea of the stated capital/surplus test is that a distribution is forbidden if after giving effect to it the total of assets would be less than the sum of liabilities plus stated capital; or (put affirmatively) a distribution is permitted to the extent there is a 'surplus', with 'surplus' defined as the amount by which assets are greater than the sum of liabilities plus stated capital¹⁵⁶. The stated capital/earned surplus test works just as the stated capital/surplus test except that the earned surplus test looks to realized gains and accumulated but undistributed profits as the normal basis of distributions¹⁵⁷. Thus earned surplus is a far more stringent limitation on distributions than mere surplus test because it links such distributions directly to the financial performance of the company¹⁵⁸.

On the other hand, balance sheet tests that do not employ stated capital are sub-categorized into net worth and adjusted net worth tests¹⁵⁹. Net worth balance sheet test prohibits distributions if after giving effect to it, a company's assets as shown on the balance sheet would be less than its liabilities¹⁶⁰. Adjusted net worth balance sheet test works in the same manner as the net worth test except that it adjusts the standard net worth calculation by including or excluding certain assets or liabilities in a manner different from that employed by GAAP to arrive at net worth¹⁶¹.

Jurisdictions that have followed the US' lead in adopting twin solvency tests, mainly adopt the net worth test¹⁶² or the adjusted net worth test as their balance sheet test¹⁶³. The Official

¹⁵² See JJ Hanks op cit (n130) 226.

¹⁵³ Ibid. See also K Van Der Linde op cit (n4) 227.

¹⁵⁴ Manning and Hanks op cit (n3) 68.

¹⁵⁵ Ibid. Other states in the US employed stated capital/surplus or net profits test and stated capital/nimble dividends test although these balance sheet tests are not as common as the capital surplus and earned surplus tests.

¹⁵⁶ Ibid.

¹⁵⁷ Cox and Hazen op cit (n39) 560.

¹⁵⁸ Ibid.

¹⁵⁹ Manning and Hanks op cit (n3) 68-69. Can also be termed as net assets and adjusted net assets test.

¹⁶⁰ Ibid.

¹⁶¹ Ibid. Section 6.40 of the Revised Model Act adopts the Adjusted Net Worth test. The new provision prohibits distributions if, after the distribution, a corporation's total assets are less than its total liabilities plus liquidation preferences, if any.

¹⁶² For example South Africa, see section 4(1) (a) of the Companies Act, 2008.

Comment to section 6.40 of the Revised Model Act highlights the inadequacy of balance sheet tests that utilize ‘stated capital’, ‘capital surplus’ and ‘earned surplus’ (as well as other types of surplus). It states that the net effect of most statutes in the US that employed stated capital and the surplus tests was to permit the distribution to shareholders of most or all of the corporation’s net assets (its capital along with its earnings) if the shareholders wished this to be done¹⁶⁴.

However, any form of balance sheet test - be it capital surplus test, earned surplus test, net worth test or adjusted net worth test - by its very nature is inherently dependent upon the accounting principles followed in constructing the numbers on both the assets and the liabilities sides of the balance sheet¹⁶⁵. Manning states that the interplay of law and accounting that determine these numbers is exceedingly complex, subtle and difficult¹⁶⁶. In the same vein, Ferran states that a reference to an accounts based balance sheet test of an excess of assets over liabilities leads to the problem that financial statements drawn up under accounting rules that were not designed with creditors’ interests primarily in mind are not necessarily a reliable yardstick¹⁶⁷. Consequently, a fundamental question posed in the assessment of the modern twin solvency tests is whether there is a case for adopting the additional balance sheet test or indeed the equity insolvency test on its own is adequate?

Hanks argues that it is not necessary to have both solvency tests and that the equity insolvency test is all that is needed¹⁶⁸. Hanks’ view is perhaps given force by an economic argument which states as follows:

‘There is no difference between an assessment of the net asset position of a company (balance sheet test) and an assessment of solvency (equity insolvency), once the accounting figures are subjected to proper business appraisal.

This is because the value of an asset is the discounted value of the cash which the asset is expected to realize and the value of a liability is the discounted value of the prospect of having to lay out cash to satisfy it. If so, the addition of a net assets test adds nothing, particularly if there is a requirement to take account of the accounting information in reaching the conclusion on solvency...’¹⁶⁹ [Sic]

¹⁶³ This is certainly the case in New Zealand.

¹⁶⁴ See full text of section 6.40 plus Official Comment reprinted in the *Business Lawyer*, (1986) 42 *Bus. Law.* 259.

¹⁶⁵ Manning and Hanks op cit (n3) 65.

¹⁶⁶ *Ibid.*

¹⁶⁷ E Ferran and L Chan Ho op cit (n2) 158.

¹⁶⁸ See JJ Hanks ‘The New Legal Capital Regime in South Africa’ (2010) *Acta Juridica* 131 at 147-148.

¹⁶⁹ J Rickford op cit (n89) 977.

Rickford argues that the main advantage for adopting the additional simple balance sheet test as was adopted under the Revised Model Act is that it provides a further discipline which will in practice assist company directors in considering the basis on which they may legitimately decide to make a distribution¹⁷⁰. However he goes on to state that because of the linkage to historical balance sheet information, the test is inflexible and not properly linked to solvency¹⁷¹.

Despite the argument against the adoption of a balance sheet test in addition to the equity insolvency test, it ought to be borne in mind that balance sheet and equity insolvency tests have different theoretical justifications. Van der Linde states that balance sheet test gives advance recognition to the ultimate priority that creditors enjoy over shareholders upon dissolution of the company by preventing the company from favouring its shareholders through a partial liquidation and the justification for equity insolvency test is that it addresses the fundamental expectation of creditors to be paid on time and also fits in well with the representation a company is said to make when it incurs debt, namely that it reasonably expects to be able to pay as and when the debt becomes due¹⁷². This is the thesis upon which jurisdictions have followed the US' lead in adopting the twin solvency tests.

2.3 CONCLUSION

Shareholders of companies with debt have strong incentives to act to the detriment of creditors by, among other ways, asset diversion through distributions. Traditionally, the legal capital doctrine has been the legal apparatus for regulating distributions. However, modern company law has jettisoned the legal capital doctrine and adopted the solvency test as a financial restriction on distributions.

Having seen the adoption of the solvency test as a financial restriction on distributions, it is important to examine whether creditors require the protection afforded by the solvency test. One way to do this is to distinguish between adjusting creditors and non-adjusting creditors and how they relate to the traditional legal capital doctrine.

Arguments borne out of economic theory conclude that legal capital rules are inefficient and the costs they impose on adjusting creditors outweighs their benefits. As for non-adjusting

¹⁷⁰ Ibid 975.

¹⁷¹ Ibid.

¹⁷² K Van der Linde op cit (n4) 226.

creditors, legal capital rules simply do not afford them any assistance. Further, flexible solvency standards are deemed to be better alternatives to the legal capital rules. In this regard, whilst the theory of creditor protection *per se* may not explain why creditors require the protection afforded by the solvency test, the criticism levelled against legal capital rules in a sense makes out the case for the solvency test.

Modern company law statutes that follow the US' Model Act enact the twin solvency test (equity solvency test and balance sheet solvency test). The equity solvency test looks at whether a company is able to pay its debts as they become due in the normal course of business. It is forward looking and generally involves a question of fact. Generally, the equity solvency test does not present a lot of issues for discussion although there is an issue in the literature relating to how best to factor long term liabilities into the assessment of equity insolvency.

The balance sheet solvency test on the other hand reports on a company's financial position at a particular point in time. Any form of balance sheet test utilizes accounting principles to determine the assets and liabilities on a company's balance sheet. The dependence on accounting principles by the balance sheet test is its main criticism. Consequently, it has been argued that the equity insolvency test is all that is needed and that the further adoption of the balance sheet test is a redundancy.

Whilst the arguments against the adoption of the balance sheet solvency test as an additional obligation in assessing company distributions have some force, the case for the twin solvency tests is made on the foundation that equity insolvency and balance sheet solvency tests have different theoretical justifications.

CHAPTER THREE: THE SOLVENCY TEST UNDER THE NEW MALAWIAN COMPANIES ACT, 2013.

3.0 INTRODUCTION

This chapter analyses the interpretation and application of the solvency test as defined in the new Malawian Companies Act, 2013. The chapter (as well as the next chapter) is primarily modelled on the review of the solvency and liquidity approach in the South African Companies Act, 2008 by Professor Van der Linde¹⁷³. Whilst, in her analysis of the solvency test under the 2008 Act, Van der Linde looks at the two separate elements of the solvency test (equity solvency test and balance sheet solvency test) as well as the following other matters: the assets and liabilities that should be included and their valuation; the circumstances where a qualification applies in favour of preferential shareholders; the time when the test should be considered and satisfied; and the manner in which the test should be applied, this chapter only considers the two separate elements of the test. The other matters for possible consideration are examined in chapter four.

The argument in this chapter is that whilst the solvency test which has been enacted in the new Malawian Companies Act represents welcome reforms to the inefficient regime of regulating distributions via the traditional English capital maintenance rule as was the case under the old Malawian Companies Act, 1984¹⁷⁴, the design or drafting of the said test is out of step with international trends. In its current state, the test will not afford adequate protection to creditors against opportunistic shareholder behaviour.

3.1 INTERPRETATION OF THE SOLVENCY TEST UNDER THE COMPANIES ACT, 2013

Section 2(5) of the Companies Act, 2013 provides as follows:

‘For the purposes of this Act – “solvency test” means –

- (a) the company is able to pay its debts as they become due in the normal course of business; and
- (b) the value of the company’s assets is greater than the sum of –

¹⁷³ See, K Van der Linde op cit (n4).

¹⁷⁴ The old Malawian Companies 1984 was basically an adoption of the English Companies Act, 1948. See the discussion in para 1.1.2 in chapter one of this paper.

- (i) the value of its liabilities; and
 - (ii) the company's stated capital.
- (c) other than in relation to compromises, reconstructions and takeovers in determining whether the value of a company's assets is greater than the value of its liabilities, the board may take into account –
- (i) in the case of a public company or a private company, the most recent financial statements of the company prepared in accordance with IFRS; and
 - (ii) a valuation of assets and estimates of liabilities that are reasonable in the circumstances.
- (d) for the purposes of determining whether the value of the compromise, reconstruction or take-over company's assets is greater than the value of its liabilities and its stated capital, the directors of each compromise, reconstruction or take over company –
- (i) shall have regard to –
 - (aa) financial statements that are prepared in accordance with IFRS and that are prepared as if the compromise, reconstruction or take over had become effective; and
 - (bb) all other circumstances that the directors know or ought to know would affect, or may affect, the value of the compromise, reconstruction or take over company's assets and the value of its liabilities;
 - (ii) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.'

At the outset, an assumption can be made that the introductory sentence to the above quoted section 2(5) as well as its paragraphs (a) and (b) intended to provide that *for the purposes of this Act - a company satisfies the solvency test if: (a) the company is able to pay its debts as they become due in the normal course of business; and (b) the value of the company's assets is greater than the sum of the value of its liabilities and the company's stated capital* (my emphasis). This would seem to be a more appropriate reading of the provision and the remaining paragraphs in the provision qualify this meaning of solvency test.

In section 2(5) (a) and (b) above, the Companies Act, 2013 has enacted the equity insolvency test (whether a company is able to pay its debts as they become due in the normal course of business) and the balance sheet solvency test (whether the value of the company's assets is greater than the sum of the value of its liabilities and stated capital)¹⁷⁵. For distributions to be legal under the new Act, both the equity insolvency test and the balance sheet test must be met¹⁷⁶. Notably, under the Malawian Act the twin solvency tests are only referred to as the

¹⁷⁵ See, Manning and Hanks op cit (n3).

¹⁷⁶ Section 98 of the Companies Act, 2013.

solvency test¹⁷⁷. Further, the solvency test is not only a prerequisite for all distributions, but must also be satisfied when effecting other transactions that may prejudice creditors¹⁷⁸. This is in line with international trends¹⁷⁹.

3.1.1 The equity insolvency element

Equity insolvency test is generally referred to as the liquidity test in other jurisdictions¹⁸⁰. There are two main approaches to liquidity or the ability to service debt¹⁸¹. Van der Linde explains these two main approaches as follows:

‘The first entails a balance sheet test based on current assets and current liabilities, while the second involves a cash flow analysis. A reference to debts “as they become due” or “as they become payable in the ordinary course of business” indicates that a cash flow prediction should be used.

This takes into account not only current assets but also future income of and credit given to the company. On the liabilities side not only existing current liabilities but also prospective liabilities are included... The cash flow prediction approach is more commonly used, and is also followed in the ... Companies Act 2008.’¹⁸² [Sic]

The Malawian Act defines the equity solvency element to mean that a company is able to pay its debts ‘as they become due in the normal course of business’. The phrase ‘in the normal course of business’ has the same meaning as the South African Companies Act phrase ‘in the ordinary course of business’ or the American Revised Model Act phrase ‘in the usual course of business’¹⁸³. In effect, a similar cash flow prediction approach should be used in Malawi.

The equity insolvency limitation adopted in the Companies Act, 2013 is not new in Malawi. Under the old Companies Act, 1984 it formed an integral part of the law relating to liquidation of companies¹⁸⁴. Section 213 (1) (d) of the 1984 Act provided that a court may order the winding up of a company if the company was unable to pay its debts. A company was deemed to be unable to pay its debts if a creditor to whom the company was indebted in a sum

¹⁷⁷ The terminology can be distinguished from the South African Companies Act, which refers to the twin solvency tests as the solvency and liquidity test. See, section 4 of the Companies Act 2008.

¹⁷⁸ For example, if a company gives financial assistance in connection with the acquisition of its shares. See section 124 of the Companies Act, 2013.

¹⁷⁹ See sections 44, 45 of the South African Companies Act, 2008.

¹⁸⁰ For example in South Africa.

¹⁸¹ K Van der Linde op cit (n4) 226.

¹⁸² Ibid.

¹⁸³ The words ‘normal’, ‘ordinary’, ‘usual’ have the same meaning: regular; common. See, <http://www.dictionary.com/browse/normal>. Accessed on 4 January 2017.

¹⁸⁴ See, Section 213 of the Companies Act, 1984.

exceeding K100 then due had served on the company a written demand under his hand requiring the company to pay the sum so due, and the company had for 21 days thereafter neglected to pay the sum or to secure or compound it to the reasonable satisfaction of the creditor¹⁸⁵. Further, a company was also deemed to be unable to pay its debts if it was proved to the satisfaction of the court that the company simply was unable to pay its debts¹⁸⁶.

What the Malawian courts have held with regard to company insolvency under the Companies Act, 1984 would therefore be useful in determining the meaning of equity insolvency under the new Companies Act, 2013. Unfortunately, there is exasperatingly little discussion in the cases of an approach or methodology to be employed in making this determination of insolvency¹⁸⁷.

However, as noted in the previous chapter, Professor Jooste has highlighted what the Australian courts have held in relation to the meaning of equity insolvency. Whether a company is unable to pay its debts as they fall due is always a question of fact to be decided as a matter of commercial reality in the light of all the circumstances of the case, and not merely by looking at the accounts and making a mechanical comparison of assets and liabilities¹⁸⁸. A similar determination can be found in an American case, *Hoagland v. United States Trust Co*¹⁸⁹ where a prominent construction company with assets significantly in excess of liabilities, was in a typically tight cash position but was able to meet all of its obligations until the filing of the petition in bankruptcy¹⁹⁰. The court after meticulously reciting the financial chronology of the company during the relevant months, concluded based on the factual evidence of the company's relationships with its lenders and the value of its collateral that the company was solvent when the payments in question - repayment of certain loan obligations were made¹⁹¹. Therefore the court examined the financial condition of the company in great detail and reached the conclusion that the company was solvent based on a factual assessment of the company's viability at the

¹⁸⁵ See, Section 213(3) (a) of the Companies Act, 1984.

¹⁸⁶ See Section 213(3) (c) of the Act.

¹⁸⁷ See, *In the Matter of Katundu Haulage Ltd and in the Matter of Cane Products Ltd*, Miscellaneous Civil Cause Number 62, 63, 114 and 134 of 2004, High Court of Malawi, Principal Registry. The Court merely restated the common principle elucidated in the jurisprudence: 'the fact that a creditor has made repeated application for payment, and that the company has neglected to pay, affords cogent evidence that it is unable to pay its debts.' Case accessed from www.malawilii.org/mw/.../18_0.rtf on 4 January, 2017.

¹⁸⁸ R Jooste 'Corporate Finance' in FHI Cassim et al op cit (n22).

¹⁸⁹ 110 N.J.Eq.489, 160 A.662 (N.J.Ch.1932)

¹⁹⁰ DT Murphy op cit (n127) 848.

¹⁹¹ Ibid.

time of the transfers¹⁹². In a sense therefore, the methodology to be employed in determining the equity insolvency test under the Malawian Companies Act, 2013 should involve a factual assessment of the financial condition of the company taking into account all the circumstances of the case.

As highlighted in the preceding chapter, there is ordinarily little difficulty in determining whether a company, even one in financial difficulty is currently able to pay its debts as they become due in the normal course of business¹⁹³. The difficulty arises when directors have to consider how best to factor long term liabilities in the equity insolvency test¹⁹⁴. Consequently, one of the approaches taken in the statutes has been to prescribe a specific time period such as 12 months for the determination of equity solvency¹⁹⁵. This approach has been criticized on the basis that whilst the specification of a time period will provide more certainty for directors when they authorize a distribution, it may disadvantage creditors of companies that have clearly foreseeable longer-term commitments that are not payable within twelve months¹⁹⁶.

The submission is that the imposition of a time limit is undesirable and that the ‘ordinary course of business’ of each company should be the decisive factor in judging its liquidity¹⁹⁷. This is certainly the case under the new Malawian Companies Act, 2013 which does not impose a time limit and merely uses ‘normal course of business’ as the decisive factor. The Companies Act, 2013, on this aspect, is therefore in line with good international practice¹⁹⁸.

3.1.2 The balance sheet solvency element

Under section 2 (5) of the Companies Act, 2013 a company will satisfy the balance sheet solvency element if the value of its assets is greater than the sum of the value of its liabilities and its stated capital. This definition of the balance sheet solvency test means that Malawi is a stated capital/surplus jurisdiction¹⁹⁹.

¹⁹² Ibid.

¹⁹³ JJ Hanks op cit (n68).

¹⁹⁴ E Ferran and L Chan Ho op cit (n2). See the discussion in para 2.2.1 in chapter two of this paper.

¹⁹⁵ This is the case in the South African Companies Act, 2008.

¹⁹⁶ K Van der Linde op cit (n4) 229.

¹⁹⁷ Ibid. See also E Ferran and L Chan Ho op cit (n3) 158.

¹⁹⁸ The Revised Model Act, New Zealand Companies Act, California Corporation Code do not prescribe a time period.

¹⁹⁹ See the discussion in para 2.2.1 in chapter two of this paper. Pages 25 to 28.

The central idea of stated capital/surplus balance sheet solvency tests is that a distribution is forbidden if after giving effect to it, the company's assets would be less than the sum of its liabilities plus stated capital or (put affirmatively) a distribution is permitted to the extent there is a 'surplus', with 'surplus' defined as the amount by which assets are greater than the sum of liabilities plus stated capital²⁰⁰. Practically, if the figures on the assets side of a company's balance sheet actually reflect their sell-off value, and if all the assets are sold for cash, and if all the creditors are paid off, and if the money that is left over for the shareholders is less than the 'capital' they put into the company in the first place, the stated capital/surplus statutory scheme forbids the ongoing company from distributing assets to shareholders²⁰¹. Manning presents a balance sheet example of this practical interpretation as follows:

²⁰⁰ Ibid. The discussion was largely taken from Manning and Hanks Op Cit (n3) 68.

²⁰¹ Ibid 34-35.

'Balance Sheet of Laminated Thumbscrew, Inc., Immediately Following Organization and Funding

<u>ASSETS</u>		<u>LIABILITIES</u>	
Cash	\$50,000		-0-
		<u>SHAREHOLDERS' EQUITY</u>	
		Capital: 500 ordinary shares	\$50,000
		Surplus	-0-
	<u>\$50,000</u>		<u>\$50,000</u>

In the circumstances of this balance sheet, there is no "surplus" and a distribution of any assets to shareholders would be 'illegal'.

Balance Sheet of Laminated Thumbscrew, Inc., Year End After Two Years of Operations

<u>ASSETS</u>		<u>LIABILITIES</u>	
Cash	\$16,000	Accounts payable	<u>\$3,000</u>
Accounts receivable	8,000	Liabilities	\$3,000
Securities	54,000	<u>SHAREHOLDERS' EQUITY</u>	
Inventory	15,000	Capital: 500 ordinary shares	50,000
Land	5,000	Surplus	<u>46,001</u>
Patents	<u>1,001</u>	Shareholders' equity	<u>96,001</u>
	<u>\$99,001</u>		<u>\$99,001</u>

As a result of the second year's operations, according to this accounting record, the company has acquired additional assets, has paid off the bank debt, overcome the deficit it had at the end of the preceding year and generated a balance sheet surplus of \$46,001 above its 'capital' and debt. The company may now legally distribute to shareholders assets having a 'book value' of \$46,001 or less.²⁰² [Sic]

²⁰² Ibid 35-36.

In company law, ‘capital’ refers to proceeds from the sale of shares and represents money or other consideration that shareholders pay for an interest in the company or a right to participate in profits and growth through dividends and other distributions of company assets²⁰³. In effect, a company’s capital is the company’s issued capital²⁰⁴.

The significance of this definition of ‘capital’ becomes apparent when one considers the definition of stated capital included in the Malawian Companies Act, 2013. Stated capital is defined in the Act as follows:

‘(a) ... in relation to a class or classes of shares issued by a company including such no par value or nominal shares as may have been issued by the company before the commencement of this Act, means the total of all amounts received by the company or due and payable to the company in respect of –

- (i) the issue of the shares; and
- (ii) calls on the shares;

(b) ... in relation to a class or classes of shares issued by a company including such par value or nominal shares as may have been issued by the company before the commencement of this Act, means the total value of all amounts received by the company or due and payable to the company in respect of –

- (i) the nominal paid-up value of the shares where applicable; and
- (ii) the share premiums paid to the company in relation to those shares and required to be transferred to the share premium account’ [Sic]

The above definition of stated capital which incorporates the total amounts received by the company in respect of par value shares (albeit par value shares issued before the commencement of the Act) as well as the consideration received for shares without par value is not unusual in company law²⁰⁵. From the above definition, stated capital under the Companies Act, 2013 is a corresponding analogue to the issued capital of a company. Interestingly, the issued capital of a company bears no necessary relationship to the market value of the shares of the company: the market value of shares in a company may exceed or be less than the issue price for those shares²⁰⁶. The issued capital of a particular share is the amount that was paid to the company at the time of its issue²⁰⁷ and the value of shares will constantly fluctuate²⁰⁸. Therefore usage of

²⁰³ V Krishna ‘Equity Financing: Corporate Aspects’ (2008) 19.3 Canadian Current Tax. See also Cox and Hazen op cit (n39) 484.

²⁰⁴ KP McGuinness *The Law and Practice of Canadian Business Corporations* 6ed (1999) 299.

²⁰⁵ See R Garrett ‘Capital and Surplus under the New Corporation Statutes’ (1958) Vol 23 Issue 2 *Law and Contemporary Problems* 245 - 246.

²⁰⁶ Ibid.

²⁰⁷ Ibid.

stated capital in the balance sheet solvency element of the definition of solvency test under the Companies Act, 2013 seems odd considering that stated capital in this case bears little or no relationship to the word ‘capital’ in the economic sense of the word²⁰⁹. As was highlighted in the previous chapter, creditors are interested in ‘capital’ in the economic sense of the word²¹⁰.

Jurisdictions like Malawi, which by virtue of their balance sheet solvency tests require distributions to be made out of surplus, are founded on the ‘trust fund doctrine’²¹¹. Cox and Hazen explain the inefficiency of the trust fund doctrine:

‘The “trust fund doctrine” that is at the core of the corporate statutes’ embrace of the concept of legal capital is primarily a rule against the wrongful withdrawal of assets that should be retained by the corporation for the protection of creditors.

There is in fact no true trust fund at all, but only a legal prohibition against withdrawals of corporate assets that reduce the margin of safety for creditors. The margin so identified, however, has no intrinsic relationship to the variables that subject creditors to improper risks or prejudice some of the shareholders themselves...²¹² [Sic]

Also noting the reliance on the meaningless trust fund legal doctrine by statutes that restrict dividend payments to surplus, Gibson states that for creditors the governing standard in the determination of surplus, should be ‘value of assets’²¹³. However, there is an anomaly in that the amount of net assets and hence the amount of surplus and hence the permissible source of dividends does not rest on the realizable values, as the trust fund doctrine presupposes, but on an accumulation of liabilities²¹⁴. Further, there is also an inefficiency with balance sheet solvency tests that employ stated capital/surplus benchmarks which stems from the fact that distributions are never and can never be paid out of surplus, they are paid out of assets; surplus cannot be

²⁰⁸ Cox and Hazen op cit (n39) 487.

²⁰⁹ Economists define ‘capital’ as assets of the business used to acquire additional worth. This can be contrasted to ‘capital’ in the legal sense which is the amount the business’ proprietors agree to invest in the business. See generally Maurer School of Law: Indiana University ‘The Corporate Creditor and Legislative Restrictions on the Distribution of Capital’ (1955) Vol 30 Issue 2 Art 6 *Indiana Law Journal* 239. See also, Cox and Hazen op cit (n39) 501.

²¹⁰ J Armour Legal Capital op cit (n91) 8.

²¹¹ See, GD Gibson ‘Surplus, So What? The Model Act Modernized’ (1962) 17.3 *The Business Lawyer* 476 to 499 at 486.

²¹² Ibid 503.

²¹³ GD Gibson op cit (n211) 487.

²¹⁴ Ibid 488 – 489.

distributed, assets are distributed²¹⁵. In the words of Manning, ‘no one ever received a package of surplus for Christmas’²¹⁶.

In view of the foregoing, an examination of the approach of three jurisdictions (New York, Delaware and Canada) that employ stated or legal capital in their balance sheet tests would not go amiss in an attempt to appreciate the efficacy of such an approach.

3.1.2.1 New York Business Corporation Law

Section 510(b) of the New York Business Corporation Law regulates distributions. It reads as follows:

‘Dividends may be declared or paid and other distributions may be made either (1) out of surplus, so that the net assets of the corporation remaining after such declaration, payment or distribution shall at least equal the amount of its stated capital, or (2) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year...’²¹⁷

The New York statute provides a definition of stated capital²¹⁸. The interpretation of the definition is that stated capital in New York’s case fixes the margin of net assets or value that must be retained in the business and restricts the distribution of assets to the shareholders²¹⁹.

Statutes that employ stated capital in the determination of balance sheet solvency prescribe stated capital as the margin of safety for the benefit of the company’s creditors²²⁰. In effect, New York is still founded on the ‘trust fund doctrine’²²¹. New York Business Corporation Law continues to use the inefficient legal capital mechanism by incorporating stated capital in the determination of balance sheet solvency as a restriction for dividend and other distributions.

²¹⁵ See Manning and Hanks op cit (n3) 37.

²¹⁶ Ibid 38.

²¹⁷ Ibid.

²¹⁸ See s102 (a) (12) of the New York Business Corporation Law.

²¹⁹ Cox and Hazen state that a corporation’s legal capital is the same as the corporation’s stated capital. According to a New York case *Randall –v- Bailey*, 23 N.Y.S.2d 173, legal capital is an amount that measures the margin of net assets or value that is to be retained in the business as against withdraws in favour of the shareholders. See Cox and Hazen op cit (n39) 502.

²²⁰ Ibid.

²²¹ See GD Gibson (n211).

With respect to the protection of creditors, there are no particular advantages set out in the literature to justify the New York stated capital/surplus approach²²².

3.1.2.2 Delaware General Corporation Law

Under section 170(a) of the Delaware General Corporation Law dividends may be declared out of: (1) surplus, or (2) in case there is no surplus, net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. Surplus is defined as the excess of the net assets of the corporation over the amount so determined to be capital²²³. Net assets means the amount by which total assets exceed total liabilities²²⁴. Statutory ‘capital’ is determined as follows: (1) for par value stock, the par value of the consideration received for the issuance of such stock constitutes capital unless the board determines that a greater amount of the consideration received for such stock shall constitute capital; and (2) for stock with no par value, the entire consideration received for the issuance of such stock constitutes capital unless the directors, at the time of issuing shares for cash, or within 60 days after issuing shares for consideration other than cash, allocate a smaller portion of the total consideration to capital²²⁵.

The law of stated capital and pay-out restrictions in Delaware is the product of a continuing conflict between an urge to protect creditors by a simplistic mechanical rule, on the one hand, and on the other, the pressures of business reality²²⁶. In terms of a simplistic mechanical rule, Delaware is a balance sheet surplus jurisdiction like New York²²⁷. The funds available for a lawful dividend under the ‘surplus test’ are calculated by subtracting the current value of total liabilities and the corporation’s capital from the current value of the corporation’s total assets²²⁸. The limitation is that the distribution must not impair the corporation’s capital²²⁹. This means Delaware being the most important source of corporations law in the US continues

²²² See generally RA Booth ‘Capital Requirements in United States Corporation Law’ (2005) *Working Paper Series Paper 102*. Accessed from [digitalcommons.law.umaryland.edu/...](http://digitalcommons.law.umaryland.edu/) on 17th January, 2017. See also RS Stevens ‘New York Business Corporation Law of 1961’ (1962) 47 *Cornell L. Rev.* 141. See also CA Peterson and NW Hawker ‘Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions’ (1998) 31 *Akron Law Review* 1.

²²³ Section 154 of the Delaware General Corporations Law.

²²⁴ *Ibid.*

²²⁵ See Robinson & Cole LLP ‘Issuing Dividends under Delaware Corporate Law’. Accessed from www.mnat.com/files/1-519-2507.pdf. Accessed on 17th January 2017.

²²⁶ Manning and Hanks *op cit* (n3) 82.

²²⁷ Business reality is covered by the concept of nimble dividends in Delaware which is not the subject of this thesis. Manning and Hanks explore the concept in their book. *Ibid* 83.

²²⁸ *Ibid.*

²²⁹ Cox and Hazen *op cit* (n39) 556.

to follow traditional legal capital rules, albeit with some important twists²³⁰. However, as was the case with the New York, there are no particular advantages for creditors that are set out in the literature to justify the balance sheet surplus approach adopted by the state of Delaware²³¹.

3.1.2.3 The Canadian solvency and liquidity test

In terms of statutory language, section 42 of the Canada Business Corporations Act ('CBCA')²³² which regulates dividends is quiet similar to the Malawian solvency test provision. It reads as follows:

“A corporation shall not declare or pay a dividend if there are reasonable grounds for believing that

(a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or

(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes.”

In Canada, stated capital represents the equity investment made by the shareholders in the corporation²³³. Canadian literature notes that stated capital has two distinct purposes – (a) protection of creditors; and (b) protection of shareholders²³⁴. In terms of protection of creditors, the idea is that creditors look to the corporation's stated capital as the measure of its security – the pool from which the corporation will pay its debts²³⁵.

The solvency test is not only applicable to the declaration and payment of dividends under the Canadian law. The test is also available when a company wants to redeem its previously issued shares; purchase its own shares and reduce its share capital. Notably, the same equity solvency test applies to all company transactions but in terms of balance sheet solvency test, it varies depending on the nature of the transaction²³⁶. In a redemption, the balance sheet test is met if after the payment, the realizable value of the corporation's assets exceeds the sum of the company's liabilities and the amount required to pay for all shares ranking in priority to or equally with the shares being redeemed or purchased²³⁷. In a company transaction to acquire its

²³⁰ RA Booth op cit (n222) 18 – 21.

²³¹ See RF Balotti and JA Finkelstein 'The Delaware Law of Corporations & Business Organizations' (2009) Statutory Deskbook Edition 165 – 167.

²³² R.S.C., 1985, c. C-44. See also section 38(3) of the Ontario Business Corporations Act ('OBCA').

²³³ KP McGuinness op cit (n204) 386.

²³⁴ V Krishna op cit (n203) 21.

²³⁵ Ibid.

²³⁶ See, www.commonlaw.uottawa.ca/.../index. Accessed on 12 January 2017.

²³⁷ Section 32 (2) OBCA and section 36(2) CBCA.

shares, the balance sheet test requires that after payment, the realizable value of the corporation's assets must not be less than the sum of its liabilities and stated capital²³⁸.

This balance sheet stated capital/surplus test for share repurchases has been said to be of particularly wide import in Canadian law because it prohibits the purchase of shares even where the shares that are being purchased are payable in priority to other shares of the corporation²³⁹. The usage of stated capital in the determination of balance sheet solvency is seen as a stricter restriction to corporate distributions²⁴⁰.

3.1.2.4 What would be a better approach for Malawi?

Seemingly, the stated capital/surplus balance sheet test in Canada is used because it is viewed as a stricter test than the loose net assets test (whether the realizable value of the corporation's assets would be less than the aggregate of its liabilities)²⁴¹ or the test that makes reference to the availability of assets to settle the liabilities of preferential shareholders²⁴².

If the usage of stated capital/surplus restrictions stems out of the need to provide a more stringent test to corporate distributions than the modern net assets test exemplified by the Revised Model Act, then, on the one hand, it is understandable. In South Africa, where the solvency element is satisfied whenever the assets equal the liabilities following a distribution and no provision is made for a solvency margin except in limited circumstances where the liquidation preferences of preference shareholders must be taken into account²⁴³, it has been said that a comparison with the solvency requirements applicable in other jurisdictions shows that the current South African test is relatively lenient and out of step with international trends²⁴⁴.

On the other hand, instead of utilizing the system of stated capital/surplus which is criticized as archaic²⁴⁵, the state of California whose Corporations Code eliminated the concepts of surplus and stated capital as the basis for permitting distributions offers a modern approach

²³⁸ Section 30(2) OBCA and section 34(2) CBCA.

²³⁹ KP McGuinness op cit (n204) 393.

²⁴⁰ Section 35 CBCA for example is said to contain a loose restriction. The section provides for alternative acquisition of shares by a corporation. The transaction is prohibited where the assets of the company would be less than the sum of its liabilities and the amounts required to repay the holders of shares who rank in priority to the holders of the shares to be repurchased. See KP McGuinness Ibid.

²⁴¹ The net assets test is a loose restriction. Ibid 394.

²⁴² See sections 35(3) and 36(2) CBCA.

²⁴³ Section 4 of the Companies Act, 2008.

²⁴⁴ K Van der Linde op cit (n4) 228.

²⁴⁵ GD Gibson op cit (n211).

for providing somewhat greater protection to creditors than the bare net assets test. Section 500 of the California Corporations Code (as amended in 2011) applies two alternative balance-sheet restrictions ie retained earnings test and adjusted net worth test. Each of these alternatives requires a margin of assets over liabilities subsequent to the distribution:

‘a corporation may make a distribution if the board of directors determines either;

- (1) the amount of retained earnings of the corporation immediately prior to the distribution equals or exceeds the sum of (A) the amount of the proposed distribution plus (B) the preferential dividends arrears amount; or
- (2) immediately after the distribution, the sum of the corporation’s assets would equal or exceed the sum of its liabilities plus preferential rights amount²⁴⁶.

Interestingly, even before the 2011 amendments in California, their Corporations Code which provided somewhat two rigid alternative balance sheet restrictions, thus, retained earnings test and the asset-liabilities ratio test, was seen by prominent company law academics as a better, less lenient approach than the flexible net assets test²⁴⁷.

Therefore, the current solvency test as defined in the new Companies Act, 2013, because of the balance sheet solvency element which utilizes the stated capital/surplus approach, is inadequate as a mechanism for protecting creditors and is out of step with international standards as it is founded on the meaningless trust fund doctrine. A better approach would be to follow the approach taken in the amended California Corporations Code, 2011 which is stricter than the net assets test as California provides for a solvency margin for the benefit of creditors.

3.2 CONCLUSION

The definition of the solvency test in section 2 (5) of the Companies Act, 2013 includes the equity solvency test as well as the balance sheet solvency test. For distributions and other company transactions to be legal under the Act, both tests must be met.

The equity insolvency element as defined in the Act involves a cash flow prediction. Notably, an examination of the literature from other jurisdictions on the meaning of the equity insolvency test leads to a conclusion that the equity insolvency test as enacted in the new Companies Act, 2013 is in line with good international standards.

²⁴⁶ See a publication by Bulchater from <http://www.bulchater.com/publication/amendment-to-the-california-corporations-code-governing-corporate-distributions-and-dividends-to-shareholders/>. Accessed on 20th January 2017.

²⁴⁷ See Cox and Hazen op cit (n39) 504 and K Van der Linde op cit (n4) 228.

The balance sheet solvency test, on the other hand, permits distributions only to the extent there is a surplus (surplus refers to the amount by which assets of a company exceed its liabilities and stated capital). The usage of stated capital in the determination of balance sheet solvency in the Companies Act, 2013 is odd considering that stated capital bears no necessary relationship to capital in the economic sense of the word. Further, jurisdictions like Malawi which provide for distributions to be made out of surplus only are founded on the trust fund doctrine which doctrine is criticised for being insufficient and meaningless when it comes to protecting creditors. All in all, there is no justification in the literature for employing stated capital/surplus limitations when measuring the legality of distributions.

However, in other jurisdictions, it has been stated that stated capital/surplus restrictions are stricter than the net assets balance sheet tests. In that case, if the intention in Malawi is to provide for a stricter solvency test regime, the way to do so should not be to use the stated capital/surplus restriction. Indeed, the state of California (its law as amended in 2011) which provides for an alternative retained earnings/adjusted net worth balance sheet test would be a better example for Malawi to follow.

In view of the foregoing, it is submitted that the current solvency test as defined in the Malawian Companies Act, 2013, because of the balance sheet solvency element which utilises the stated capital/surplus approach founded on the meaningless trust fund doctrine, will not afford adequate protection to creditors during distributions and is out of step with international trends.

CHAPTER FOUR: OTHER MATTERS TO CONSIDER IN THE APPLICATION OF THE SOLVENCY TEST IN THE COMPANIES ACT, 2013.

4.0 INTRODUCTION

Chapter three has mainly looked at the interpretation of the equity insolvency and balance sheet solvency tests provided in paragraphs (a) and (b) of section 2(5) of the Companies Act, 2013. This chapter looks at the following other aspects of the solvency test that may raise legal interpretation issues in the operation of the test under the Companies Act, 2013: (i) the assets and liabilities that should be included and their valuation; (ii) the time when the test should be considered and satisfied; and (iii) the manner in which the test should be applied.

Other jurisdictions, in their definition of the solvency test, provide for the circumstances where a qualification applies in favour of preferential shareholders²⁴⁸. The Companies Act, 2013 does not provide for preferential rights in its definition of the solvency test. This chapter therefore does not discuss that aspect.

4.1 ASSETS AND LIABILITIES AND THEIR VALUATION

The Companies Act, 2013 provides some guidance on how to make asset and liability determinations for purposes of assessing a company's equity or balance sheet solvency. The Act in its section 2(5) (c) states that other than in relation to compromises, reconstructions and takeovers in determining whether the value of a company's assets is greater than the value of its liabilities, the board may take into account: (i) in the case of a public or a private company, the most recent financial statements of the company prepared in accordance with IFRS; and (ii) a valuation of assets and estimates of liabilities that are reasonable in the circumstances²⁴⁹. A number of issues come up when one attempts to analyse this provision.

First and foremost, the size of any deficiency between assets and liabilities of a company is a factor that can be taken into account when ascertaining the liquidity of a company and information on this deficiency will ordinarily be recorded in the financial statements²⁵⁰. To that

²⁴⁸ See for example, section 4(2)(c) of the South African Companies Act, 2008; section 52(4) of the New Zealand Companies Act, 1993; section 6.40(c)(2) of the American Revised Model Act; section 500(2) of the California Corporations Code.

²⁴⁹ See s2 (5) (c) of the Companies Act, 2013 reproduced in para 3.1 of this paper.

²⁵⁰ See *Credit Corporation Australia Pty Ltd –v- Atkins* (1999) 30 ACSR 727 at 758 cited by R Jooste 'Corporate Finance' in FHI Cassim et al op cit (n22).

extent, section 2(5) (c) of the Companies Act, 2013 applies both to equity solvency and balance sheet solvency tests²⁵¹. Section 2(5) (c) of the Act, by merely providing that the board may take into account financial statements prepared in accordance with IFRS in determining whether the value of the company's assets is greater than the value of its liabilities, is not very helpful as a matter of guidance for the board especially when assessing a company's equity solvency.

Financial statements are a collection of reports about a company's financial results, financial condition and cash flows²⁵². However, the application of the equity insolvency test essentially amounts to a prediction of the company's cash flow over a period of time²⁵³. Further, whether a company is unable to pay its debts as they fall due is always a question of fact to be decided as a matter of commercial reality in the light of all the circumstances of the case, and not merely by looking at the accounts and making mechanical comparison of assets and liabilities²⁵⁴. Considering the foregoing characteristics of equity solvency, it is quiet odd that the way section 2(5) (c) has been drafted, it gives leeway for one to read the provision as giving power or discretion to directors to merely rely on information recorded in financial statements when applying the equity insolvency test²⁵⁵. If that indeed is the case then the provision is limited and out of step with international trends. The liquidity test should be based on not only financial information contained in the company's records and statements, but also on *reasonably foreseeable financial circumstances* (my emphasis) that may affect the company's ability to pay its debts²⁵⁶.

It is easy to submit that Malawi should clarify its law and perhaps follow the South African approach (with the suggested amendments by Van der Linde)²⁵⁷. However, there is a marked difference in the way the Malawian section 2(5) (c) and section 4(2) (a) of the South

²⁵¹ This point is made by keeping in mind that the balance sheet test under the Companies Act, 2013 is satisfied whenever the value of the assets of the company exceed the value of its liabilities and stated capital.

²⁵² Financial statements normally include: balance sheet – which shows the company's assets, liabilities and shareholder's equity as of the report date; income statement – which shows the results of the company's operations and financial activities for the reporting period; and statement of cash flows – which shows changes in the company's cash flows during the reporting period. See generally the definition of financial statements from www.accountingtools.com/definition-financial-statements. Accessed on 31 January, 2017.

²⁵³ In South Africa one predicts the company's cash flow situation over the ensuing 12 months. See s 4(1) (b) of the Companies Act, 2008. See also the Official Comment to s6.40 of the Revised Model Act.

²⁵⁴ See R Jooste 'Corporate Finance' in FHI Cassim et al op cit (n22) 278.

²⁵⁵ The provision states that the board *may*... 'may' denotes power or discretion.

²⁵⁶ K Van der Linde op cit (n4) 230.

²⁵⁷ For example Van der Linde suggests that the phrase 'considering all reasonably foreseeable financial circumstances of the company should only appear in the liquidity aspect of the test.' Ibid.

African Companies Act, 2008 are drafted²⁵⁸. The South African law is mandatory in its wording whilst the Malawian law gives directors power or discretion²⁵⁹. If the idea in the Malawian Act was to give directors discretion in determining whether the value of the company's assets exceeds the value of its liabilities, then section 6.40 (d) of the Revised Model Act would be a better example for Malawi. The said section 6.40 (d) reads as follows:

‘the board of directors may base a determination that a distribution is not prohibited under subsection (c) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.’

The Official Comment to section 6.40 notes that under this provision the determination of a corporation's assets and liabilities and the choice of the permissible basis on which to do so are left to the judgment of its board of directors²⁶⁰. Hanks highlights that the solvency test in section 6.40 (c) of the Revised Model Act would be improved if the Act afforded an opportunity for the board to consider ‘*all reasonably foreseeable financial circumstances of the company*’ (my emphasis) in the same manner as the South African Companies Act, 2008²⁶¹. In this regard, if Malawi were to largely adopt the Revised Model Act's section 6.40 (d) with a bit of modification, it could mean that directors in Malawi have discretion to base the determination of assets and liabilities on financial statements prepared on the basis of accounting practices (IFRS) and principles that are reasonable in the circumstances (this last part could be amended by replacing it with ‘all reasonably foreseeable financial circumstances of the company’).

The Official Comment goes further to highlight that when making a judgment under section 6.40 (d), the board may rely upon opinions, reports, or statements, including financial statements and other financial data prepared or presented by public accountants or others²⁶². Similarly, when making a solvency and liquidity enquiry in South Africa, the board is at liberty to rely on others, unless the board has actual knowledge, or ought in the circumstances to have had grounds for the suspicion, that such reliance is unwarranted²⁶³. This will certainly be the case in Malawi. Directors will be at liberty to rely on the opinions of other people such as

²⁵⁸ Section 4(2) (a) of the Companies Act, 2008 must be read together with the introductory text to section 4(1) which states that: “For any purposes of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company -...”

²⁵⁹ Section 4(2) (a) of the 2008 Act states that for the purposes contemplated in subsection (1) – (a) any financial information to be considered *must* be based on - ...

²⁶⁰ See Manning and Hanks op cit (n3) 202.

²⁶¹ J.J Hanks op cit (n168) 144.

²⁶² Manning and Hanks (n260).

²⁶³ R Jooste ‘Corporate Finance’ in FHI Cassim et al op cit (n22) 278.

officers or employees of the company, legal counsel, public accountants or any other person whom the directors believe is competent enough to handle the matters under enquiry²⁶⁴.

Secondly, section 2(5) (c) of the Companies Act, 2013 goes further to state that when determining whether the value of the company's assets is greater than the value of its liabilities the board may take into account a valuation of assets and estimates of liabilities that are reasonable in the circumstances. The language of this provision is somehow similar to the language used in section 4(2) (b) of the New Zealand Companies Act, 1993. The said provision reads as follows:

'(2) Without limiting sections 52 and 55 (3), in determining for the purposes of this Act whether the value of a company's assets is greater than the value of a company's liabilities, including contingent liabilities, the directors –

... **(b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.**' (My emphasis) [Sic]

New Zealand literature highlights that when it comes to the valuation of assets the main issue that arises concerns the meaning of 'value' of the company's assets. The company's assets should be valued on the basis of their market value, rather than the historical cost that might be recorded in the company's financial accounts²⁶⁵. Further, market value should be assessed on a going concern basis, rather than on a liquidation basis²⁶⁶. This is because a liquidation basis of valuation would assume the very thing that the solvency test is intended to assess²⁶⁷. The meaning of 'value' as determined in New Zealand is similar to the meaning determined in the US. The Official Comment to the Revised Model Act notes that the statute authorizes departures from historical cost accounting and sanctions the use of appraisal and current value methods to

²⁶⁴ The Companies Act, 2013 has actually codified the business judgment rule. Section 220 (4) of the Act reads: '(4) A director or officer of a company who makes a business judgment shall be taken to meet the requirements of subsection (1) ... in respect of the judgment where the director or officer –

- (a) makes the judgment in good faith and for a proper purpose;
- (b) does not have a material personal interest in the subject matter of the judgment;
- (c) Informs the company of the subject matter of the judgment to the extent he reasonably believes to be appropriate; and
- (d) reasonably believes the judgment is in the best interests of the company.' [Sic]

Subsection (1) provides that every director and officer of the company shall exercise – (a) the powers and discharge the duties of his office honestly, in good faith and in the best interests of the company; and (b) the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

²⁶⁵ *Cudden –v- Rodley* CA67/99, per Richardson P, Gault and Henry JJ. This case is cited in Watts, Campbell & Hare 'Company Law in New Zealand' 1ed (2011) 222.

²⁶⁶ Watts, Campbell and Hare Ibid.

²⁶⁷ Ibid.

determine the amount available for distributions²⁶⁸. Thus, the ordinary meaning of ‘value’ seems to be settled and any person making a valuation of assets and liabilities for purposes of solvency in Malawi should be properly guided.

Notably, the Malawian Companies Act, 2013 does not make any reference to contingent liabilities as liabilities that must be included in the determination of the value of liabilities. The Companies Act, 2013 would do well to further guide directors on the issue of contingent liabilities in the same vein as South Africa and New Zealand have. In New Zealand, the Companies Act, 1993 makes explicit reference to contingent liabilities and goes further to prescribe the method for valuation of contingent liabilities for directors²⁶⁹. The South African Companies Act, 2008 actually goes further to provide for contingent assets. Its section 4(2)(b)(i) states that the board or any other person applying the solvency and liquidity test to a company must consider a fair valuation of the company’s assets and liabilities, including any reasonably foreseeable contingent assets and liabilities. Van der Linde perhaps crucially gives the reason why statutes such as the New Zealand and South African Companies Acts explicitly mention or include contingent liabilities (in the South African case, contingent assets as well). She comments as follows:

‘In accounting terms, contingent liabilities are possible liabilities and must be distinguished from “provisions”, which are existing liabilities of uncertain timing or amount. Similarly, contingent assets are assets that the company may acquire in the future.

It is important to note that contingent assets and contingent liabilities are not required to be reflected in financial statements in terms of international accounting standards and international financial reporting standards, and will also not appear in accounting records...²⁷⁰ (my emphasis)
[Sic]

Considering that section 2(5) (c) of the Companies Act, 2013 merely refers directors to financial statements prepared in accordance with IFRS when making asset and liability determinations and considering that contingent assets and contingent liabilities are not required to be reflected in financial statements in terms of international accounting standards and IFRS, and will also not appear in accounting records, a refinement of the new Malawian Act to provide for contingent liabilities and contingent assets in the determination of assets and liabilities as

²⁶⁸ See Manning and Hanks op cit (n3) 204.

²⁶⁹ See the introductory text to section 4(2) and section 4(4) of the Companies Act, 1993.

²⁷⁰ K Van der Linde op cit (n4) 231.

well as possibly providing for the method of valuation of such contingent assets and contingent liabilities would be most appropriate for Malawi.

4.2 TIME AT WHICH THE SOLVENCY TEST IS APPLIED

When examining the application of the solvency test it is necessary to consider the time at which the board must apply the solvency test²⁷¹. Importantly, one must distinguish between the time when the test should be considered and the time when the test should be satisfied²⁷².

4.2.1 When should the test be considered?

Section 98(2) of the Companies Act, 2013 provides on board authorization of distributions. It states that a board may authorize a distribution at such time and of such amount as it thinks fit, provided it is of the opinion that the company shall, upon the distribution being made, satisfy the solvency test. In most jurisdictions, authorization of distributions is usually the first step that a company will go through in making a distribution²⁷³. This is the case in New Zealand where section 52(1) of the Companies Act, 1993 reads as follows:

‘The board of a company that is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the solvency test may ... authorize a distribution by the company at a time, and of an amount, and to any shareholders it thinks fit.’ [Sic]

It is interesting to note the similarity between section 52(1) of the New Zealand Companies Act, 1993 and section 98(2) of the Companies Act, 2013. It is further interesting to note how the said section 52(1) has been interpreted. Van der Linde highlights that under this provision the board has to consider the financial restrictions at the time of authorization and be satisfied that the company will be solvent and liquid immediately after the distribution²⁷⁴.

Therefore, *it is not the financial position at the time of authorization that is considered, but the prospective position at the time of payment* (my emphasis)²⁷⁵.

Considering the similarity between the Malawian and the New Zealand law, directors in Malawi must consider the test at the time of authorization of a distribution but in doing so they

²⁷¹ Watts, Campbell and Hare op cit (n265) 223.

²⁷² K Van der Linde op cit (n4) 233.

²⁷³ See Watts, Campbell and Hare op cit (n265) 223. See also s6.40 (a) of the Revised Model Act.

²⁷⁴ K Van der Linde op cit (n4) 234.

²⁷⁵ Ibid.

must look at the prospective financial position at the time of payment as the determining factor on whether to effect a distribution.

4.2.2 When should the test be satisfied?

In a sense, the preceding discussion already answers this question. The general requirement under the Companies Act, 2013 is that the solvency test must be satisfied upon completing the distribution. Almost all of the different transactions that involve pay-outs to shareholders under the Act contain this general requirement. A company's financial assistance in connection with the acquisition of its own shares is permitted if the board has previously resolved that 'immediately after giving the assistance, the company will satisfy the solvency test'²⁷⁶; a contract with a company for the acquisition by the company of its own shares is enforceable against it 'except to the extent that the company would after performance of the contract fail to satisfy the solvency test'²⁷⁷; company purchase of its own shares is permitted to the extent that 'immediately after the purchase, it will satisfy the solvency test'²⁷⁸; shareholder discount schemes are only permitted 'where the company satisfies the solvency test'²⁷⁹; and a company is prohibited from extinguishing or reducing a liability in respect of an amount unpaid on a share or reducing its stated capital unless 'immediately after taking such action, the company will satisfy the solvency test'²⁸⁰. The approach taken under the Act as regards the determination of when should the test be satisfied with respect to the various company transactions seems to avoid the complex timing rules that proceed by distinguishing the various company transactions²⁸¹. This approach is commendable.

4.3 MANNER OF APPLICATION OF THE SOLVENCY TEST

To analyse the manner of application of the solvency test under the Companies Act, 2013 the chapter specifically looks at two aspects of the test: (i) whether the test imposes an objective or

²⁷⁶ s124 (2) (c) Companies Act, 2013.

²⁷⁷ Ibid s123 (1).

²⁷⁸ Ibid ss109 (4) and 110(2) (a) (iv).

²⁷⁹ Ibid s106 (3).

²⁸⁰ Ibid s100 (5).

²⁸¹ See the approach taken by California in s166 of the California Corporations Code, New Zealand in ss52 and 56 of the Companies Act, 1993; and the US in s6.40 (e) and (g) of the Revised Model Act.

subjective standard on the board of directors? And (ii) whether the test involves a formal or an informal procedure?

4.3.1 Does the test impose an objective or subjective standard?

Under section 98(2) of the Companies Act, 2013 board authorization for a distribution may be given only if the board is *of the opinion that the company will satisfy the solvency test* upon making the distribution (my emphasis). The Act imposes a subjective standard for directors²⁸². However, directors ought to base their subjective beliefs or opinions on reasonable grounds. This is the language that is used in the provisions that detail out the specific company transactions effecting distributions²⁸³.

The fact that the determination of the solvency test incorporates a subjective standard which directors must meet is further highlighted by section 107(2) of the Act which provides on the recovery of unlawful distributions from shareholders and liability of directors. The said provision states that where, in relation to a distribution made to a shareholder, the procedure for payment of dividends has not been followed or *reasonable grounds for believing that the company would satisfy the solvency test* (in relation to share repurchases or financial assistance) did not exist at the time the certificate was signed, directors who signed the certificate are personally liable for the distribution which cannot be recovered from shareholders (my emphasis). The Companies Act, 2013 has therefore prescribed a lower standard for directors which should be easier to meet.

4.3.2 Is it a formal or informal procedure?

Section 98(3) of the Companies Act, 2013 provides that directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, upon the distribution being made, satisfy the solvency test. This requirement for a formal solvency

²⁸² ‘Subjective’ means related to or based on beliefs, attitudes and opinions instead of verifiable evidence. See, Black’s Law Online Dictionary, 2ed. Accessed from <http://thelawdictionary.org/subjective/> on 8 February, 2017.

²⁸³ For example, s100 (5) prohibits a company from reducing its stated capital **unless there are reasonable grounds on which the directors may determine that**, immediately after taking such action, the company will satisfy the solvency test; s109 (4) prohibits a company from making any payment for the acquisition of its own shares where **there are reasonable grounds for believing that the company** would after making the payment fail to satisfy the solvency test. See also s106 (3) of the Act.

certificate is in line with international standards²⁸⁴. The law in New Zealand for example is almost the same as the law in Malawi. Section 52(2) of the Companies Act, 1993 reads as follows:

‘The 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 **and the grounds for that opinion.**’ (My emphasis).

The only difference between section 98(3) of the Companies Act, 2013 and section 52(2) of the Companies Act, 1993, is that the New Zealand 1993 Act adds the words ‘and the grounds for that opinion’. Directors in New Zealand are advised to not only take considerable care in determining the solvency position of the company before authorizing the distribution, but they should also ensure that they have systems in place to record the reasons for their decision, and the information and advice on which it is based²⁸⁵. The reason for such advice stems from a recognition of the fact that challenges to decisions to authorize distributions usually occur at a time when the company is in insolvent liquidation and a great deal of hindsight will be brought to bear in examining the director’s decision in those circumstances²⁸⁶. This advice can similarly be given to directors who sign solvency certificates under the Malawian 2013 Act despite the said Act not specifically requiring them to state the grounds for their opinion. It may be prudent for directors to follow such advice because signing the solvency certificate without reasonable grounds may expose them to personal liability under section 107(2) of the Companies Act, 2013 (already highlighted in para 4.3.1 above). In any event, as highlighted earlier, directors’ opinion on solvency must be based on reasonable grounds.

Further, in support of the requirement for a formal declaration, it has been stated that the declaration places a positive duty on directors and thus appears more likely to prevent unlawful distributions which may compromise the position of creditors and shareholders²⁸⁷. This statement cannot be contested. Conversely, the disadvantage with the formal solvency declaration requirement is that compliance with this formality introduces a specific date for application of the financial restrictions and thus impairs flexibility²⁸⁸. Fortunately, the new Malawian Companies Act addresses this flexibility concern. Section 98(4) of the Act provides

²⁸⁴ South Africa, New Zealand, England all require a formal solvency declaration.

²⁸⁵ Watts, Campbell and Hare op cit (n265) 228.

²⁸⁶ Ibid.

²⁸⁷ K Van der Linde op cit (n4) 238.

²⁸⁸ Ibid.

that where after a distribution is authorized and before it is made, the board ceases to be satisfied that the company will satisfy the solvency test after making the distribution, any distribution made will be deemed not to have been authorized. This provision offers a solution to dealing with a change in the financial situation of a company between the date of authorization by the directors and the date of implementation of a distribution²⁸⁹. The inclusion of section 98(4) discussed herein, is commendable.

4.4 CONCLUSION

Apart from the two separate elements of the solvency test, ie equity solvency and balance sheet solvency elements, legal interpretation issues may arise from the following other aspects of the test: (i) the assets and liabilities and their valuation; (ii) time when the test should be considered and satisfied; and (iii) manner of application of the test.

The determination of assets and liabilities is an exercise which is relevant for both equity and balance sheet solvency tests. For purposes of the equity solvency test, the difference between assets and liabilities of a company is a factor that may be considered. To that extent, when making a determination of which assets and liabilities of the company to consider so as to examine the difference between them for purposes of the equity solvency test, directors should not only look at financial statements but should also consider all reasonably foreseeable financial circumstances of the company. The Companies Act, 2013 merely refers directors to financial statements prepared in accordance with IFRS. The Act is limited in this respect.

Further, the Companies Act, 2013 does not provide for contingent assets or contingent liabilities to be taken into account when making asset and liability determinations. This is so despite the fact that in terms of accounting standards and IFRS, financial statements and other accounting records are not required to reflect contingent assets and contingent liabilities. The Act is out of step with international trends.

As for valuation of assets and liabilities, issues revolve around the meaning of 'value' of the company's assets. Value of the company's assets means the current market value of the assets determined on a going concern basis.

²⁸⁹ See also Van der Linde's discussion on New Zealand's approach which is quiet similar to s98 (4) discussed herein. Ibid 238 – 239.

A proper reading of the Act demonstrates that directors must consider the test at the time of authorisation but in doing so must keep in mind that it is not the financial position at the time of authorisation that is considered but the prospective position at the time of payment. Generally, the Act provides that the test should be satisfied upon completing the distribution.

Finally, the Act imposes a lower subjective standard for directors when determining whether the company will satisfy the solvency test upon completing a distribution. However, directors ought to be aware that the subjective standard must stem from reasonable grounds. Commendably, the Act prescribes a formal solvency procedure when making distributions. It may be prudent for directors to document, whenever they sign a solvency certificate, the grounds upon which they opine the company will satisfy the solvency test. Signing the solvency certificate without reasonable grounds may expose them to the risk of incurring a personal liability in the event it is later found the distribution made to shareholders was illegal.

CHAPTER FIVE: CONCLUSION

5.0 INTRODUCTION

This chapter provides a summary of the different aspects of the operation of the solvency test as a financial restriction for distributions and other company transactions, followed by a conclusion and recommendations on the drafting of section 2 (5) of the Companies Act, 2013 which defines the solvency test. The recommendations are made by drawing lessons from the discussion in the preceding chapters and in doing so the paper addresses the concern(s) that precipitated the study.

The chapter also suggests further areas of research that can be undertaken in order to further strengthen the solvency test regime in Malawi vis-à-vis creditor protection.

5.1 SUMMARY OF THE DIFFERENT ASPECTS OF THE OPERATION OF THE SOLVENCY TEST AND RECOMMENDATIONS OF THE STUDY

5.1.1 Design of the solvency test and creditor protection

The manner in which the solvency test is defined in a particular statute has significant effects on whether in its operation the test affords adequate protection to the interests of creditors²⁹⁰.

The solvency test as defined in section 2 (5) of the Companies Act, 2013 comprises of an equity solvency element as well as a balance sheet solvency element. Looking at the definition of the two separate elements of the test, it is notable that there are no fundamental issues which stem from a reading of the definition of the equity solvency test to suggest that in its operation it will not afford adequate protection to creditors²⁹¹. The balance sheet solvency element on the other hand should have creditors concerned.

Section 2 (5) of the Act provides for a stated capital/surplus balance sheet test²⁹². Stated capital/surplus balance sheet tests utilise the arbitrary legal (stated) capital concept and are founded on the meaningless trust fund doctrine²⁹³. As a result of the enactment of the stated capital/surplus balance sheet test, this paper notes that the twin solvency test as currently enacted

²⁹⁰ See chapter 1 para 1.2.

²⁹¹ See chapter 3 para 3.1.1.

²⁹² See the definition of stated capital/surplus balance sheet test in Manning and Hanks op cit (n3) 68.

²⁹³ Ibid.

in the Companies Act, 2013 will not afford adequate protection to creditors in its operation as a measuring rod for the legality of distributions under the Act²⁹⁴.

5.1.2 Why twin solvency test?

A fundamental question posed in the assessment of the twin solvency test is whether there a case for adopting the additional balance sheet test or indeed the equity insolvency test on its own is an adequate restriction²⁹⁵? The basic answer to this question is that the balance sheet and equity solvency tests have different theoretical justifications²⁹⁶. The balance sheet test gives advance recognition to the ultimate priority that creditors enjoy over shareholders upon dissolution of the company by preventing the company from favouring its shareholders through a partial liquidation and the equity insolvency test addresses the fundamental expectation of creditors to be paid on time and also fits in well with the representation a company is said to make when it incurs debt, namely that it reasonably expects to be able to pay as and when the debt becomes due²⁹⁷.

The suggestion in this paper is that for jurisdictions like Malawi which have followed the US' lead in adopting the twin solvency test, the different theoretical justifications alluded to herein provide an appropriate thesis for enacting the twin solvency test.

5.1.3 The case for the solvency test in company law

Looking at the theory of creditor protection in company law and the development of the solvency based regime, this paper settles on the point that the arguments against legal capital rules in one sense make out the case for the solvency test as an appropriate alternative to the legal capital rules when it comes to the protection of creditors against opportunistic shareholder behaviour²⁹⁸.

The major criticism drawn out of economic theory is that the mandatory legal capital rules impose restrictions on companies which are ill-tuned to the needs of contracting parties

²⁹⁴ See chapter 3 para 3.1.2.4.

²⁹⁵ See JJ Hanks (n168).

²⁹⁶ See K Van der Linde op cit (n4) 226.

²⁹⁷ Ibid.

²⁹⁸ See chapter 2 para 2.1.1.

(creditors and the company) such that on the whole the costs of such restrictions outweigh their benefits²⁹⁹.

5.1.4 Matters to consider when applying the solvency test

Firstly, when making a determination of assets, liabilities and their valuation for purposes of the solvency test, assets of a company should be valued on the basis of their market value rather than the historical cost that might be recorded in the company's financial accounts³⁰⁰. These assets should include contingent assets which are assets that the company may acquire in the future³⁰¹. Similarly, liabilities should include contingent liabilities³⁰². The reason for including contingent assets and contingent liabilities in the determination of assets and liabilities is that contingent assets and contingent liabilities are not required to be reported in financial statements and prescribing them in a statute should provide better guidance to directors when they apply the solvency test³⁰³.

Secondly, solvency based standards are underpinned by personal liability attaching to directors in the event of irregularity³⁰⁴. It is therefore appropriate that even where statutes impose a lower standard for directors to meet when determining whether a company satisfies the solvency test, directors must have reasonable grounds for determining that a company will meet the test in a relevant transaction and where possible should document the reasons for their decision³⁰⁵.

5.1.5 Recommendations

Firstly, there is no justification for using stated capital in the definition of the balance sheet solvency element as is the case under the Companies Act, 2013³⁰⁶. The explanation in the literature is that jurisdictions that continue to use the arbitrary stated capital figure in the computation of their balance sheet solvency test intend to provide for a stricter solvency test than

²⁹⁹ J Armour Share Capital and Creditor Protection op cit (n83) 377.

³⁰⁰ *Cudden –v- Rodley* supra (n276).

³⁰¹ See chapter 4 para 4.1.

³⁰² These are possible liabilities and should be distinguished from provisions which are recorded in financial statements. Ibid.

³⁰³ Ibid.

³⁰⁴ E Ferran and L Chan Ho op cit (n2).

³⁰⁵ See chapter 4 para 4.3.1 and 4.3.2.

³⁰⁶ See chapter 3 para(s) 3.1.2.1, 3.1.2.2, and 3.1.2.3.

the net assets test³⁰⁷. Instead of utilising stated capital in its balance sheet solvency test, Malawi should follow the approach of California (2011 amended Corporations Code) where the law prescribes the retained earnings test and the adjusted net worth test³⁰⁸.

Further, to avoid any ambiguities in the definition of the solvency test, the current introductory text read together with paragraphs (a) and (b) of section 2 (5) of the Companies Act, 2013 should also be amended. An amended section 2 (5) (a) of the Act could read as follows:

‘(a) For the purposes of this Act, a company satisfies the solvency test if –

- (i) the company is able to pay its debts as they become due in the normal course of business; and*
- (ii) the amount of retained earnings of the company, immediately prior to the distribution, equals or exceeds the sum of –*
 - (aa) the amount of the proposed distribution plus;*
 - (bb) the preferential dividends arrears amount; or*
- (iii) the value of the company’s assets is greater than the sum of –*
 - (aa) the value of its liabilities; and*
 - (bb) the preferential rights amount.’ (My emphasis)*

The usage of the retained earnings test as well as the adjusted net worth test provides for a solvency margin, thus a stricter solvency test for regulating distributions.

Secondly, for purposes of determination of assets and liabilities and their valuation in the application of the solvency test, the Act should provide that contingent assets and contingent liabilities must be taken into account by the board. Further, the equity solvency element of the test should be based on reasonably foreseeable financial circumstances of the company. An amended section 2 (5) (b) of the Act could read as follows:

- ‘(b) other than in relation to compromises, reconstructions and takeovers, in determining whether the value of a company’s assets is greater than the value of its liabilities, including contingent assets and contingent liabilities, the board may take into account –*
 - (i) in the case of a public company or a private company, apart from the most recent financial statements of the company prepared in accordance with IFRS, all reasonably foreseeable financial circumstances of the company; and*

³⁰⁷ See the discussion in para 3.1.2.3 of this paper.

³⁰⁸ Section 500 of the California Corporations Code.

(ii) a valuation of assets and estimates of liabilities that are reasonable in the circumstances.’ (my emphasis)

Finally, in line with the amendments proposed herein, the remaining paragraph of section 2 (5) of the Act should be amended to read in this manner:

‘(c) for the purposes of determining whether the value of the compromise, reconstruction or take-over company’s assets is greater than the value of its liabilities *and the preferential rights amount, including contingent assets and contingent liabilities*, the directors of each compromise, reconstruction or take over company –

(i) shall have regard to –

(aa) financial statements that are prepared in accordance with IFRS and that are prepared as if the compromise, reconstruction or take over had become effective; and

(bb) *all other reasonably foreseeable financial circumstances* that the directors know or ought to know would affect, or may affect, the value of the compromise, reconstruction or take over company’s assets and the value of its liabilities;

(ii) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.’ (My emphasis)

Admittedly, whilst this paper proposes the usage of the retained earnings test together with the adjusted net worth test following the approach of California, further research could be done to examine the effectiveness of the retained earnings/adjusted net worth test vis-à-vis how it operates in providing a solvency margin, thus a stricter test than the approach used in South Africa, New Zealand or under the Revised Model Act³⁰⁹. Further, it may also be prudent to investigate the efficacy of providing a method of valuation of contingent assets and contingent liabilities in the manner which the New Zealand Companies Act, 1993 has provided³¹⁰, instead of merely leaving it to directors to ‘take into account a valuation of assets and estimates of liabilities that are reasonable in the circumstances’³¹¹. Thus, there is an opportunity to further strengthen the solvency based regime under the Malawian Companies Act, 2013.

To conclude, this paper suggests an amendment to section 2 (5) of the Companies Act, 2013 which defines the solvency test. In its current reading (the current definition of solvency test is reproduced in full in chapter 3 paragraph 3.1) the test will not afford adequate protection

³⁰⁹ The more common modern approaches.

³¹⁰ See section 4 of the New Zealand Companies Act, 1993.

³¹¹ This is the approach in section 2 (5) of the Companies Act, 2013.

to creditors during company distributions and other company transactions. The amended section 2 (5) of the Act should read as follows:

- ‘(a) For the purposes of this Act, a company satisfies the solvency test if –
- (i) the company is able to pay its debts as they become due in the normal course of business; and
 - (ii) the amount of retained earnings of the company, immediately prior to the distribution, equals or exceeds the sum of –
 - (aa) the amount of the proposed distribution plus;
 - (bb) the preferential dividends arrears amount; or
 - (iii) the value of the company’s assets is greater than the sum of –
 - (aa) the value of its liabilities; and
 - (bb) the preferential rights amount.
- (b) other than in relation to compromises, reconstructions and takeovers, in determining whether the value of a company’s assets is greater than the value of its liabilities, including contingent assets and contingent liabilities, the board may take into account –
- (i) in the case of a public company or a private company, apart from the most recent financial statements of the company prepared in accordance with IFRS, all reasonably foreseeable financial circumstances of the company; and
 - (ii) a valuation of assets and estimates of liabilities that are reasonable in the circumstances.
- (c) for the purposes of determining whether the value of the compromise, reconstruction or take-over company’s assets is greater than the value of its liabilities and the preferential rights amount, including contingent assets and contingent liabilities, the directors of each compromise, reconstruction or take over company –
- (i) shall have regard to –
 - (aa) financial statements that are prepared in accordance with IFRS and that are prepared as if the compromise, reconstruction or take over had become effective; and
 - (bb) all other reasonably foreseeable financial circumstances that the directors know or ought to know would affect, or may affect, the value of the compromise, reconstruction or take over company’s assets and the value of its liabilities;
 - (ii) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.’

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