Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

Solvency Regime – A Critical Element of the Legal Framework in Sri Lanka

W. Indira Nanayakkara[1*]

[1] Dept. of Commercial Law, Faculty of Law, University of Colombo, Sri Lanka

*Corresponding Author: indira@law.cmb.ac.lk

Accepted: 15 February 2021 | Published: 1 March 2021

Abstract: *The Solvency Test, which was established in Sri Lanka by the Companies Act No.7 of 2007, requires companies to satisfy the "cash flow test" (trading solvency) and the "assets test" (balance sheet solvency - that the assets of a company must be greater than its liabilities) in order to be deemed solvent. The test plays an important role in the management of companies and presents challenges to the board of directors of a company as to how a company enhances its solvency position. During last few decades, Sri Lanka witnessed cases of corporate failures, especially in finance companies. The economic impact of such failures would only reverse the development of any country affected by such. In the present social context, a company cannot stand in isolation - its actions and behaviour affect society, the lives of people it transacts with and the nation at large. Sri Lanka until the 2007 Companies Act, through a capital maintenance approach protected the creditors of a company. This paper identifies the short-comings of the previous framework which was detrimental to the creditors' interests, whilst also discussing the improvements made to shareholder and creditor protection by the 2007 Act. Also explores and evaluates the practical impact and importance of the solvency test as a mechanism to provide effective protection to stakeholders of a company. The paper is based on the hypothesis that the solvency regime is a major step in ensuring the integrity of the corporate sector and it provides a better protection to stakeholders of a company, as opposed to the protection afforded by capital maintenance rules.*

Keywords: Solvency test, capital maintenance, corporate failures

---

1. Introduction

A resulting consequence of Sri Lanka being a colony under the British rule was that the Companies Act No. 17 of 1982 (the 1982 Act), which governed our corporate regime till the 2nd of May 2007, was modeled on the English Companies Act of 1948 which, at the time, was almost sixty years old and has been considered outdated even from its inception. The corporate law regime is a fast-moving and rapidly changing area of law which needs to be up to date, in order to cater to the modern commercial realities and the constantly changing patterns of the society in which it operates. Therefore, this reality resulted in the realization that the Sri Lankan corporate regime was in dire need of a new law to govern its corporate sector. Under these circumstances, an attempt was made to modernize the country's company law and the drafting of this new law began in 1994. After a study of the company law in several developed countries, the Companies Act No 7 of 2007 was based primarily on the New Zealand Companies Act No 105 of 1993 (the NZ Act). It repealed the 25-year-old Companies Act No. 17 of 1982, became law on the 20th of March 2007 and was operative from the 3rd of May 2007. The Companies Act No 7 of 2007 (hereinafter referred to as the 2007 Act), which was a direct departure from the old legislation, marked a significant milestone in the development of company law in Sri Lanka by introducing several far-reaching changes to the country's corporate law regime.

A significant innovation of the new law was the introduction of the 'Solvency Test' which deals with the solvency of a company. The Board of a company is required to satisfy the solvency test and to obtain a certificate of solvency from the auditors when certain transactions are proposed. This provision relating to the solvency regime provides a useful safeguard for the financial health of a company, as it regulates the payment of dividends whilst making other distributions to shareholders. It has paved the way for companies to contemplate action that was previously prohibited or was allowed subject to stringent requirements - i.e the reduction of capital, repurchase of own shares and providing financial assistance in the purchase of own shares. In addition, it also minimizes the concerns of the creditors as the safeguards built in by the solvency regime focus on the net assets of the company, its ability to pay debts and requires the company to act in a more transparent manner. The solvency test plays an important role in the management of companies, and whilst it gives the directors more freedom, it also presents the challenges of greater responsibility and potentially increases the liability of directors. The law makes the directors more vigilant in exercising their power and discretion, which could otherwise stultify the stability of the company. The directors will not incur liability merely for getting the solvency test wrong, but they will however incur liability if there is no reasonable justification for the stance taken in their assessment of the solvency test. It is required that they are capable of ensuring that the company has sufficient financial resources at all times, so that there is no significant risk of the company being unable to fulfil their obligations when they are due. The directors, as risk-taking entrepreneurs, should be given the space to arrive at the best possible judgment in the interest of the company.

2. Methodology

This is a qualitative research attempted from a theoretical and empirical perspective and carried out by reference to secondary data. Reference was made to including relevant statutory provisions on the subject including newspaper articles and the worldwide web as a source for collecting secondary data. Reported judgements in foreign jurisdictions were examined to critically evaluate the justifications and views adopted by the courts. For the purpose of identifying the gaps of existing laws in Sri Lanka, a concise comparative legal analysis was carried out with the corresponding statutory provisions of New Zealand Law. The research was based on a critical evaluation method to analyze the gathered information.

The scope of the research was limited to the main provisions[1] of the instances stipulated under the 2007 Act relating to the solvency regime, but it was compared with the developments in New Zealand to comprehend where we stand. The reported and unreported case law on the topic is hardly found, due to the inadequate breathing space for the litigation to conclude soon after the enactment of the 2007 Act. The practical application of the sections of the 2007 Act is yet to be explored, in comparison to the other jurisdictions, due to the absence of in-depth local writing on the subject. In this backdrop, it is unlikely to achieve the objectives of this paper unless the Sri Lankan position is compared with other jurisdictions. Hence, the paper reviews the position in New Zealand in relation to the solvency regime. 2007 Act is mainly founded on the New Zealand Companies Act. Therefore, the practical implications of the sections could be easily grasped in relation to New Zealand's position.

[1] That is because a lengthy discussion on all the relevant sections in the 2007 Act is not pertinent as it makes the paper too long.

Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

Protection of Creditors

One of the defining features of a corporation is the principle of limited liability. The doctrine of limited liability means that in the event of insolvency the shareholders of a company, limited by shares, are liable to contribute only a limited amount to its assets i.e., any amount unpaid on shares. Thus, the shareholders of a company have no further obligation after they have paid the amount due on their shares, and cannot be required to contribute over and above their subscribed amount to settle debts owed by the company to third parties or to creditors of the company. This is a guarantee given to the investors that the worst fate that can befall them is the loss of the entire investment that they have paid, or have agreed to pay on shares, and that their personal assets are untouchable. Therefore, the claims of the creditors of a company are confined to the assets of the company and they have no resort against the shareholders of a company. As a result of this situation, company law laid down rules about capital maintenance with the intention of protecting the creditors.

However, in the event of a state of insolvency the creditors are paid before the shareholders. Further, in the event a company is financially distressed, the creditors are warranted some special consideration as there is the possible risk that the directors may dissipate company property to embark on new ventures without considering the interests of the creditors. The courts have been vigilant to give effect to the interests of the creditors on the basis that the creditors' interests are ultimately the interests of the company. This is on the basis of the fiduciary responsibility owed by the directors to the creditors, in order to ensure that its affairs are properly administered and to keep the company's property inviolate and available for the repayment of its debts[2]. Similarly, in *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*[3] it was held that a resolution by the board of directors would be open to challenge if it was passed at the time the company was insolvent, without proper consideration of the interest of creditors by certain directors. In New Zealand too the Courts have recognized the duty of the directors to take into account the interests of the creditors at the time the company is financially distressed[4].

By recognizing that the interests of the creditors become the interest of the company at a time of insolvency, the courts have established the general view that the duty of the directors towards the creditors is one which is mediated through the company as opposed to an independent duty. The identification of this duty becomes paramount in the event that the directors are held personally liable for the breach of such duty. In Sri Lanka, the 2007 Act has statutorily given effect to the judicial recognition of the duty of directors towards creditors. It is enumerated under section 219[5] of the 2007 Act as the duty of directors at insolvency.

[2] Winkworth v Edward Baron Development Co Ltd [1986] 1WLR 1512
[3] [2003] 2 BCLC 153
[4] Re Avon Chambers Ltd [1978] 2 NZLR 638; Nicholson v Permakraft (NZ) Ltd (in liq) (1985) 3 ACLC 453 ('Permakraft'); Hilton International Ltd v Hilton [1989] 1 NZLR 442
[5] However, section 219 will not be dealt in this paper when looking at the instances of introduction of Solvency test into the Sri Lankan law under the 2007 Act. Under section 219 if a director has failed to exercise his duty of care in calling a meeting of the board of directors when the company is unable to pay its debts, he is personally responsible to contribute to the loss suffered by the creditors as a result of the failure to exercise his duty properly.

The doctrine of Capital Maintenance

An evaluation of the efficiency of the solvency regime would essentially require a clinical evaluation of its predecessor, which is the doctrine of maintenance of capital, as they both sought to achieve the same goal i.e. protection of creditors in a limited liability regime. According to the capital maintenance rules, a company cannot return capital to its shareholders other than in compliance with statutory provisions. Similarly, a company cannot reduce its share capital without passing a special resolution and obtaining the approval of the Court at a hearing where creditors or other interested persons could object. Thus, until the 2007 Act, Sri Lanka (like most other jurisdictions) protected the creditors of a company through a capital maintenance approach. The objective of this approach was to prevent companies from returning funds to shareholders by distributing or providing financial assistance for the purchase of its own shares or by reducing its capital in order to ensure that there is a pool of money on which the creditors could rely. This rationale was explained by Jassel MR in *Re Banking Exchange Co (Flitcrotf's case)*[6] by stating that because a limited company declares in its Memorandum of Association that its capital is to be applied for business purposes, it cannot reduce capital except in the manner provided for by statute. It was stated that this understanding forms an implied contract between the creditors and the business, hence providing the creditor the right to state that the company should not return its capital to its shareholders - although this right may not be enforceable except through the means of a winding-up order.

This perceived need to maintain capital led to the development of what became universally known as the 'doctrine of capital maintenance'. In the House of Lord's decision of *Trevor v Whitworth*[7], Lord Watson explained the rationale of creditor protection. He stated that those who deal with a limited company naturally rely on the fact that the company is trading with a certain amount of capital already paid, and are entitled to assume that no part of the capital paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business.

However, the extent to which the capital maintenance rule provided the creditors protection was questionable. The term 'capital maintenance' was misleading, as it was viewed as a guarantee fund or a permanent fund intended for the payment of the creditors' claims which would consequently not be reduced nor returned to the shareholders except in the manner provided by law. As pointed out by Lord Halsbury in *Ooregum Gold Mining Company of India v Roper*[8], the capital is both fixed and certain, and every creditor is entitled to consider such capital as his security.

However, it was not required that a company kept its capital intact nor was the company under a legal obligation to make good the capital or wind up the affairs of the company if it was lost (for example, in the course of trading). Hence, the requisite was not that the company must maintain the capital that it raises, but rather that it should raise the capital which it purports to rise and that it could not return capital to its shareholders other than in compliance with and as authorized by explicit statutory provisions.[9] Hence, the issued or paid-up capital of a limited liability company formed a fund available to the creditors of the company to meet their legitimate claims against the company. However, with the evolution of corporate law the

---

[6] (1882) 21 Ch 519
[7] (1887) 12 App Cas 409
[8] (1892) AC 125
[9] Ewang, F. 'Regulating Share Capital Transactions and creditors and creditor protection: a multi faceted model' Australian Journal of Corporate Law 2007, p 51

creditor protection provided through the capital maintenance doctrine became more theoretical than real.

Transition from authorized share capital to stated capital

The authorized capital, which refers to the specified maximum amount of shares that could be issued by the company, has now been eliminated. It has been replaced by the principle of 'stated capital', which has a more practical application in the modern economic environment. Prior to the operation of the 2007 Act, any increase above the authorized capital limit required a special resolution of the company. Now, there is no upper limit within which capital can be infused to the business[10]. The old authorized share capital of the company was restrictive, made no commercial sense and did not realistically reflect the company's creditworthiness. In the event that a company needed to issue shares for strategic reasons such as business expansion, acquisition of another company or for the settlement of high interest rate loans, the imposition of such a restrictive upper limit is not needed on the issue of shares. Furthermore, this limit decided at the time of incorporation of the company may not be suitable after 25 or 30 years. It misleads the general public as it is merely a figure indicated in the Memorandum of Association and does not reflect the daily affairs of the business. Accordingly, under the present regime a company will not have an authorized capital, which was an important ingredient of the capital maintenance doctrine.

With the introduction of the solvency regime, coupled with the relaxation of the doctrine of maintenance, the shares issued by a company no longer have a par value (also known as the nominal value). Under the old regime, the par value was the limit placed on the shareholder's liability to contribute to the debts of the company in the event of an insolvent liquidation. The shares had to be issued at a nominal or par value or at a premium over par, but a company could not issue shares at a lesser value without passing a resolution specifying the maximum rate of such a discount. In addition, the consent of the court was essential to issues shares less than the designated value even though the actual value of the shares had increased or decreased. Professor Gower[11] has expressed the opinion that the 'insistence that a company's share capital be determined exclusively by a fixed nominal share value is both unnecessarily complicated and confusing'.

Similarly, it has been stated that such par value is misleading to unsophisticated investors as it ceases to have relevance to the actual market value of the shares[12]. It has been further observed that "unless the company was suspended in time, the market value of its shares would have either increased or decreased depending on its performance. If performance had improved, new shares could be issued at a premium. On the other hand, if the company had underperformed, it was prevented from issuing further shares because shares could not be issued at a price below par value"[13]. This concept of par value has been subjected to substantial criticism due to its misleading nature. As a result, jurisdictions such as New Zealand have abandoned the concepts of nominal capital and par value on the basis that it is arbitrary and misleading, and instead

---

[10] Under the old regime Memorandum of association had to be amended if a company wished to issue shares above the upper limit of the authorised share capital which meant the value of the assets contributed to the company by the shareholders in exchange for company's shares.

[11] Paul L. Davies & Sarah Worthington, 'Gower & Davies' Principles of Modern Company Law', 5th Edition at p. 242.

[12] Farrar, JH., Furey, NE., Hannigan, BM., & Wylie, P. (1991). Farrar's Company Law (Third edition). Butterworths at P. 159

[13]sanvada.org/policyanalysis/Pathfinder
http://savanda.org/policyanalysis/savandhaComAct6.company%20law%

introduced more distinct safeguards for the protection of creditors and shareholders[14]. As per S.49 (4) and 52 of the 2007 Act, the par value of a share has now been abolished. The Board of directors must now determine the consideration of the shares to be issued[15] and such consideration has to be fair and reasonable to the company and all existing shareholders.[16] Consideration can be in any form be it cash, promissory notes, future services, property of any kind or securities of the company[17].

Thus, capital maintenance has been removed and stated capital has now been introduced. With the abolition of the concept of par value, the company's stated capital will be equivalent to the total of all amounts received by the company in respect of the issuing of shares and in respect of calls on shares previously treated as "paid up capital". This provides a more meaningful idea as it refers to the actual contribution of the shareholders. The abolition of par value will also take away the concepts of Share Premium Account[18] and of the Capital Redemption Reserve fund, thereby making the Balance sheets simpler.

Stated capital

Stated capital is defined in the 2007 Act[19] to mean the total of all amounts received by the company, or due and payable to the company, in respect of the issue of shares and calls on shares. A company may, by way of a special resolution, reduce its stated capital to an amount it thinks appropriate in compliance with the provisions of the Act[20]. Public notice of not less than sixty days is required before passing the resolution regarding the proposed reduction of a company's stated capital[21]. As per Section 59(3), if a company agrees in writing with a creditor of the company that it will not reduce its stated capital below a specified amount, and if such company breaches such agreement by passing a resolution to reduce its stated capital without the prior consent of the creditors or without satisfying the specified conditions at the time of such reduction, then such resolution will be invalid and shall have no effect. This can be considered as a major step forward in the development of company law, as the new provisions do not require the company to follow cumbersome formalities such as the sanction of court when reducing its stated capital.

In summary, the new regime places no obligation on a company to maintain a specific amount of share capital and thereby allows the company a greater sense of freedom in the distribution of their money and property. However, this is subject to the condition that the directors of the company must be satisfied that the company will satisfy the solvency test immediately after making certain transactions.

Sri Lankan development

The solvency test introduced by the 2007 Act strives to achieve its goal in two ways. Firstly, it acts as a sign of warning to the management and the board of directors of a company, in order to ensure that they are informed of the company's financial stability and can make sure that the company is financially healthy. Secondly, if the company is already insolvent, the test lays down the plight of the company, its officers and the penalties.

---

[14] New Zealand Law Commission Report No 9, Para 84.
[15] Section 52 (1) a.
[16] Section 52 (1) b
[17] Section 52 (2). When a share is issued for consideration other than in cash the Board shall determine the cash value of such consideration for purposes of this definition-section 58(2).
[18] When shares were issued at a price higher than par, that excess was credited to a "premium" account.
[19] Section 58 (1).
[20] Section 59 (1).
[21] Section 59 (2).

Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

As mentioned earlier, section 57(1) of the 2007 Act states that a company shall be deemed to have satisfied the solvency test if it satisfies two conditions. Firstly, if the company is able to pay its debts as they become due in the normal course of business and secondly, if the value of the company's assets are greater than its liabilities and stated capital. In considering whether a company meets the test, section 57(2) of the 2007 Act provides guidance in the application of the solvency test. It requires that the most recent financial statements prepared in accordance with Section 151 of the 2007 Act shall be taken into account. Section 151(2) (b) of the 2007 Act requires that such financial statements shall comply with the requirements which apply to it under any other law. Section 6 of the Accounting & Auditing Standards Act No. 15 of 1995 makes it compulsory for any ‘specified business enterprise’ to apply Sri Lanka Accounting Standards (‘SLAS’) in the preparation of its financial statements. Accordingly, companies that are ‘specified business enterprises’ are required to follow SLAS in the preparation of their financial statements referred to in section 151 of the 2007 Act.

Making Distributions and Dividends

The policy of creditor protection evident in the solvency test, as established by the provisions relating to distributions and dividends, heavily regulates a company’s power to make them and requires a solvency certificate prior to making distributions and dividends. The word ‘distribution’ in relation to company law refers to the distribution of company assets among its respective shareholders. They enhance the wealth of the members at the expense of the company and hence pose a significant threat to the creditors. Therefore, all distributions must comply with the provisions of the 2007 Act, which requires a resolution of the board, shareholder approval and the satisfaction of the solvency test.

The wide definition of a ‘distribution’ in section 529[22] of the 2007 Act undoubtedly includes dividends, repurchase of shares and also redemption of shares. As a result, dividends are clearly subject to the rigour of the solvency test and the following mandatory guidelines in the relevant provision[23] apply to dividends, as dividends are recognized as a distribution to the shareholders. The board must authorise the payment of dividends, unless the article requires the shareholders consent by ordinary resolution[24]. It is important to note that the board can authorize a dividend at its discretion, but the section anticipates a procedure. Immediately after the distribution is made, the board must first ensure that the solvency test has been satisfied and proceed to obtain the solvency certification from the auditors as required by section 56(2) of the 2007 Act. The directors who vote in favour of the distribution of the dividend must sign a certificate stating that they opine that the company will satisfy the solvency test after the payment of the dividend[25]. Thus, in the application of the solvency test in this regard, “debts’ including the amount payable on shares entitled to fixed preferential returns (which rank above the shares on which dividends are payable except such preferential dividend), is subject to specific board authorization[26].

[22] The definition section of the 2007 Act, Section 529(1) interprets the distribution as ‘the direct or indirect transer of money or property, other than the shares of a company, to or for the benefit of a shareholder or the incurring of a debt to or for the benefit of a shareholder, in relation to a share or shares held by that shareholder, whether by means of a payment of a dividend, a redemption or other acquition of the share or shares, a distribution of intebtedness or otherwise.’
[23] Section 56
[24] Section 56(1) and (2)
[25] Section 57(3)
[26] Sections 57(2) and 57(4)

Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

The penal sanction contained in section 56(5) of the 2007 Act makes it mandatory for the board to consider the certificate in authorizing the distribution. This makes it necessary for them to set out a statement that in their opinion the company will satisfy the solvency test immediately after the distribution is made. Hence, prior to making a distribution under section 61(1) of the 2007 Act, it should be authorized by the board and be approved by an ordinary resolution of shareholders. Further, it should be accompanied with a certificate of directors who vote in favour of the distribution. The above section 61 further contemplates how the directors could be personally liable to repay the company the amount that cannot be recovered from the shareholders in the event that the company does not satisfy the solvency test immediately after distribution.

The 2007 Act makes the directors personally liable to repay the company the amount that cannot be recovered from the shareholders after a distribution is made[27]. In order to hold them liable, there should be a breach on their part either due to not following the procedure set out under section 56 or due to signing the certificate at a time no reasonable grounds existed for believing that the company would satisfy the solvency test.

A dividend is a distribution of profits of a company, other than a distribution by way of redemption or acquisition of any of the company's shares[28]. The board of a company must not authorise a dividend in respect of some but not all the shares in a class. In other words, the directors must authorise the same dividend to all shareholders of the same class. This is subject to the exceptions that the amount of dividend in respect of a share of that class is proportionate to the amount paid to the company in satisfaction of the liability of the shareholder under the articles of the company, or that under the terms of issue of the share the shareholder has agreed in writing to a lesser or no dividend[29].

The directors are required to follow the procedure set out under section 56 of the 2007 Act in approving a distribution. Accordingly, if a company is to make a distribution to its respective shareholders, the board of directors must resolve that it is appropriate to do so and should be satisfied that the company will satisfy the solvency test immediate to the distribution being made.

Repurchasing, Redemptions and providing financial assistance for acquiring the company’s own shares.

Another method of distribution is through the redemption of shares, purchase of own shares or providing financial assistance for acquiring the company’s own shares, and this is one of the most important reforms included in the 2007 Act. Prior to the 2007 Act, these transactions were severely restricted. Purchase of own shares was not allowed and financial assistance was prohibited. The 2007 Act relaxes these prohibitions by permitting companies to purchase and acquire their own shares in specific situations, and thereby providing far greater scope for all three transactions.

Repurchasing

Prior to the 2007 Act, there was no provision either permitting or prohibiting purchase of own shares. The prohibition came from the common law as a corollary of the doctrine of capital maintenance. Since it would result in a reduction of capital, a company was prohibited from

[27] Section 61(2)
[28] Section 60 (1)
[29] Section 60(2)

Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

buying its own shares by the rule in *Trevor v Whitworth*[30] even though the memorandum explicitly allowed it. This decision by the House of Lords held that the transaction was invalid as a circumvention of the then statutory rules for capital reduction. The 2007 Act allows a company to purchase its own shares, if the articles of such company provide for such purchase. Section 64 of the 2007 Act requires that the directors resolve and certify that the acquition is for the best interests of the company and that the terms of the offer or the agreement and the consideration to be paid for the shares is fair and reasonable. The board must also resolve that they are not aware of any material information that has not been disclosed to the shareholders, which would make it unfair for the shareholders accepting the offer.

The purchase under section 95[31] of the 2007 Act does not require following the procedure under section 56 of the 2007 Act, but does require that the directors sign a certificate setting out that they opine that the company will satisfy the solvency test immediately after the purchase of the shares. Therefore, if the company fails to satisfy the solvency test immediate to such share purchase, then each director who signed the certificate becomes personally liable to the company for signing the certificate despite having reasonable grounds to believe that the company will satisfy the solvency test.

Redemptions

The 1982 Act authorised and regulated redeemable preference shares. As provided in section 57 of the 1982 Act, if so authorised by the articles, a company had the power to issue preference shares which were redeemable. However, such shares could be redeemed out of profits proceeding from a fresh issue of shares made for the purpose of such redemption. Any premium payable on redemption had to be provided for out of the company's profit or from the share premium. Whilst the 2007 Act recognises and allows redemption, it also heavily regulates it, and a company can proceed with such redemption by way of a special resolution. As the redemption qualifies as a distribution and one of the ways in which the stated capital could be reduced, the board must also comply with resolution and certification requirements of section 56(2) of the 2007 Act.

Providing financial assistance for acquiring the company's own shares

In terms of section 55 of the 1982 Act, a company was prohibited from financially assisting a person to acquire the company's or its holding company's shares[32]. Such assistance could only be given in narrowly defined cases - namely, if lending money was a part of the ordinary business of the company; if it was provided by the company for the purchase or subscription of fully paid shares in the company or its holding company under an employee share scheme; or as a loan to employees in the bona fide employment of the company for the purchase of the company's shares[33].

The 2007 Act's regime for financial assistance has relaxed the earlier rigid rules on financial assistance for the purchase of its own shares. While recognizing the rule prohibiting the provision of financial assistance[34], the new law authorises the company to provide such

---

[30] (1887) 12 App Cas 409

[31] That is, in case of minority buyouts under section 93 of the 2007 Act, when a company is forced to buy out a dissenting minority shareholder at a "fair and reasonable price".

[32] Section 55 of the 1982 Act, prohibited from providing financial assistance by way of a loan, guarantee or security for the purchase of or subscription for its own or its holding companies shares.

[33] Proviso to the Section 55 of the 1982 Act.

[34] Section 70(1)

Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

assistance through the regulation of financial assistance provided for the purchase of its own shares. Section 70(2) of the 2007 Act requires the board to resolve that the assistance is in the best interests of the company, and that the terms and conditions are fair and reasonable to the company as well as to those shareholders not receiving assistance. Whilst this assistance is not included within the definition of distribution in section 56 of the 2007 Act, financial assistance is subject to the solvency test and thus the company will have to satisfy the solvency test immediately after providing such assistance. If financial assistance, inclusive of other outstanding amounts so given, exceed ten percent of the stated capital, the company has to obtain a certificate from the company auditor (or a person so qualified) to confirm that the board's belief that the solvency test will be satisfied is reasonable. The granting of financial assistance under section 70 of the 2007 Act is not treated as a distribution for the purpose of section 56"[35]. Section 70(5) of the 2007 Act provides that failure to comply with the rules relating to financial assistance amounts to an offence, punishable by making every officer of a company in default liable to a fine of up to a million rupees or imprisonment up to five years or both.

The 2007 Act also provides for certain classes of transactions which are capable of being implemented without those procedures, following the model in section 153 of the English Companies Act of 1985. Thus, the following forms of financial assistance will not be subject to provisions of section 70 of the 2007 Act. Financial assistance that is not provided for the acquisition of company shares, or is provided as an incidental part of any other larger purpose of the company, is exempted from Section 70, provided that it was given in good faith, for the company's best interests. The justification of this restriction is two-fold. Firstly, as the company would be severely jeopardized if it failed after providing funds or guaranteeing the purchase of its own shares. Secondly, as there is a possibility that directors could abuse such facilities to further their own interests[36].

Methods to determine insolvency

There are two tests to ascertain the insolvency of a company. In Sri Lanka, companies need to satisfy two tests to be regarded as being solvent; the first is the "cashflow" test or trading solvency. The second test is sometimes known as the 'assets test' or balance sheet solvency, meaning that the assets of a company must be greater than its liabilities.

The Cashflow Test

The Cashflow Test, or the Commercial Insolvency Test, inquires whether the company is able to pay its debts when they fall due for payment[37]. For this purpose, the fact that its assets exceed its liabilities is irrelevant. If the company is unable to pay its debts when they fall due, it is considered to be insolvent. On the other hand, according to the Balance Sheet Test, if a company or the company's assets are exceeded by its liabilities, then the company is regarded as insolvent.

On the question of the inability to pay debts and when they are due, Chief Justice Griffith's and Justice Isaac's approach in *Bank of Australasia v Hall*[38] has been set out in *Rees v Bank*

[35] sanvada.org/policyanalysis/Pathfinder... http://savanda.org/policyanalysis/savandhaComAct6.company%20law%

[36] ibid

[37] Section 4 (1) (a) of the NZCA require that a company must be able to pay its debts as they become due in the normal course of business.

[38] (1907) 4 CLR 1514 per Griffith CJ at 1528 and per Isaacs J at 1543

Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

of New South Wales[39] by Justice Taylor, who drew emphasis to the distinction between a temporary lack of liquidity and an endemic shortage of working capital. He pointed out that in the cases of the latter, liquidity could only be restored through successful business ventures where the working capital has been deployed.

Thus, according to the decision in *Bank of Australiasia v Hall,* when determining whether a debt is due and payable, the court looks at the overall financial position of the company and adopts a commercial rather than a technical view of solvency. Inability to pay debts as they fall due indicates a continuous succession of debts rather than a calculation of debts existing on any particular day. The essential question, according to the court, is whether the company's financial position is such that it can continue in business and still pay its way. Thus, the court is required to consider whether the issue of liquidity is temporary and could possibly be cured in the near future. For this purpose, the court will have to regard not only the debts due and payable at the date for assessment, but also claims falling due in the near future.

In *Hymix Concrete v Garritty*[40], Justice Taylor set out some passages which have an important bearing to the above issue, from the judgment of Barwick CJ[41]. It was stated that a trader, to remain solvent, it does not need to have ready cash by him to cover his commitments as they fall for payment and that the realizable assets of a trader should be paid regard to, in order to determine whether debts could be paid as they become due. This is due to the fact that nature of the assets and the nature of the business would be surrounding circumstances which would affect or prevent a conclusion of insolvency.

Similarly, in *Sandell v Porter*[42] it was established that although Section 95 expresses insolvency as an inability to pay debts as they fall due, insolvency is only accurately indicated by gauging the debtor's financial position in its entirety. This is due to the fact that the debtor's money is not limited to cash immediately available, but also extends to those he can procure by sale, mortgage or pledging of his assets. The inability to use the combination of such assets to pay debts when they become due would indicate insolvency.

Justice Emmett in *Quick v Stoland Pty Ltd*[43], in considering an appeal from an action against a director for insolvent trading, stated that in order to determine the solvency of a company at a given time, it is necessary to consider certain factors. Such as the existing company debts in order to determine whether they were due and payable; the existing company assets to determine its liquidity or its ability to be realizable to pay off debts; the existing business transactions to determine the net cash flow and existing company arrangements to determine if any shortfall could be compensated for through borrowings which could be repaid after the settlement of debts[44]. His Honour further elaborated that the notion that a company is insolvent if its assets exceed its liabilities is merely a rule of thumb. This was on the basis that despite a net asset deficiency, the company may able to generate enough profits through business transactions in order to pay long-term debts when due, thus making it solvent[45].

---

[39] (1964) 111 CLR 210 at 229–30; [1965] ALR139 at 149–50
[40] (1977) 13 ALR 321
[41] ((1964)) 111 CLR at 218–9; [1965] ALR at 141–2)
[42] (1966) 115 CLR 666, at 670.
[43] (1998) 29 ACSR 130
[44] Ibid at page 138
[45] Ibid at page 139

Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

Thus, it is not uncommon for insolvency as a temporary inability to pay current obligations not being established merely due to the sole proof of a creditor's debts not being paid. The test laid down by section 95(a) of the 2007 Act requires the ascertainment of the company's existing debts, its debts within the near future and its due date for payment, as well as the company's present and expected cash resources along with when it shall be received[46]. Although the availability of cash to a company is critical in ascertaining its solvency, it is also correct to conclude that since the ability to pay is not extinguished due to a temporary inability to pay debts, a temporary cash flow problem will not amount to insolvency.

Balance Sheet Test

The balance sheet test, which is another alternative mechanism for ascertaining solvency, is to determine whether the company's debts are greater than its assets at the time of the transaction in question i.e. upon the distribution being made[47]. In other words, this test is to determine whether the remaining equity (i.e. left overs, after subtracting the market value of a company's liabilities from the market value of its assets) as of a particular date, is sufficient to discharge the company's liabilities. One of the key issues of this test is the identification and valuation of assets and liabilities, especially as the 2007 Act does not define 'assets' and 'liabilities'.

It is possible for a debtor to be legally solvent from a balance sheet perspective, but unable to pay its bills, most assets are in the form of machinery, equipment, real estate, or other illiquid forms. Intangible property such as trade names, patents, and property rights can be included in the fair value of assets used for a solvency test, even though these are not easily converted to cash for use in paying bills. It is also possible for a debtor to be legally insolvent (liabilities exceed the fair value of the assets), but currently paying its debts as they mature. Note that as long as debts are being paid, there is little likelihood of creditor action against the insolvent debtor, and creditors are probably not even aware of the insolvency.

In determining whether the value of a company's assets is greater than its liabilities at the time of the transaction in question, the board of directors must do the test before the transaction and determine if the company's value minus its liabilities is positive or negative. A company is considered as insolvent if its debts are greater than the assets.

In valuing the assets and liabilities under the balance sheet test, they must consider the most recent financial statements of the company, as well as other reasonable circumstances which the directors know or ought to know that affect, or may affect the value of the company's assets and liabilities. There is a fundamental difference between the NZ Act and the 2007 Act, in that the NZ Act makes a specific reference to contingent liabilities, while there is no reference to either contingent assets or liabilities in the 2007 Act. Hence, one could argue that that the non-reference to contingent liabilities in the 2007 Act is deliberate and that therefore contingent liabilities ought to not be taken into consideration when ascertaining the solvency test. However, they are taken into account, the justification for which is provided in the guidelines as set out in section 57(2) of the 2007 Act.

---

[46] Bank of Australian v Hall (1907) 4 ALR 321 at 328. A.R. Keay, "The insolvency Factor in the Avoidance of Antecedent Transactions in corporate Liquidation' [1995] Monash University Law Review 305 at p. 307.

[47] Hence under the balance sheet test, after a distribution has been made, the company's assets must still exceed its liabilities.

3. Brief Analysis

The 2007 Act has introduced the solvency test under section 57 of the said Act as a means of determining the financial stability of a company. As mentioned above, the test is a direct borrowing from the NZ Act but departs from its counterpart in valuing the liabilities of a company. The 2007 Act does not require the consideration of contingent liabilities under section 57(1)(b)(i) of the 2007 Act, whereas it is a necessary ingredient under section 4(1)(b) of NZ Act in valuing the liabilities of a company.

Section 4(1) of the NZ Act enumerates the ingredients of the solvency test. A company is solvent if it is able to pay its debts as they become due in the normal course of business and when the value of a company's assets is greater than its liabilities (including contingent liabilities). The first element has been referred by Farrar as trading solvency whilst the second element has been referred to as the balance sheet solvency[48]. Section 4(2) of the NZ Act provides materials for the board to ascertain whether a company could pay its debts when due. The board should look at the most recent financial statement of the company, which complies with section 10 of the Financial Reporting Act of 1993 (NZ), and all other circumstances which the directors know or ought to know that will affect the balance sheet solvency. The board also can rely on other valuations of the assets and liabilities that are reasonable in the circumstances. Distribution is a clear instance to make the directors personally responsible if the company has failed to satisfy the solvency test immediately after a distribution.

Recovery of distribution to shareholders under section 61 of 2007 Act is a clear instance which requires the directors to satisfy the solvency test prior to making a distribution. The NZ Act sets out the same requirement under section 56 the Act, but its wording is more specific and clearer in comparison to 2007 Act. For instance, section 61(2) of 2007 Act provides no guidelines as to what would amount to reasonable grounds for the directors to sign the certificate before approving a distribution. In contrast, section 56(2)(b) of the NZ Act has specifically stated the relevant sections to determine what would amount to "reasonable grounds".

4. Conclusion

As opposed to the doctrine of capital maintenance, which failed in its sole objective of protecting creditors, the solvency regime provides increased flexibility in the return of capital to the shareholders whilst ensuring that such activities would not impair the growing concern of the company - which is in the interests of creditors as well as other stakeholders. The solvency regime enhances the flexibility by which a company can return money to its investors from two perspectives. Firstly, the definition of distribution is wide and it includes share redemptions, buy backs and financial assistance in repurchase of own shares. Secondly, the circumstances have changed from a position where only profits were distributable to a position where companies have the freedom to distribute earnings as well as capital.

However, similar to how each legal theory poses its own advantages and disadvantages, the solvency test too has its shortcomings. If such shortcomings could be acknowledged and addressed, it would most certainly pave the way to achieving the objectives for which it was introduced.

[48] JH Farrar, 'The responsibility of directors and shareholders for a Company's debt' at p 8, http://www.nzlii.org/nz/journals/CanterLawRw/1989/2.pdf

Asian Journal of Law and Governance
e-ISSN: 2710-5849 | Vol. 3, No. 1, 33-46, 2021
http://myjms.mohe.gov.my/index.php/ajlg

References

Ameresekere N. S. Salient Features of Companies Act No. 7 of 2007 https://www.consultants21.com/pdf/Enactment%20of%20Companies/Salient%20Features%20of%20Companies%20Act%20No.%207%20of%202007.pdf

Cabral, H. 'Companies Act No. 7 of 2007 and the Corporate Law of Sri Lanka' (2007)

Ewang, F. 'Regulating Share Capital Transactions and creditors and creditor protection: a multifaceted model' Australian Journal of Corporate Law 2007, p 51

Farrar, J.H. The responsibility of directors and shareholders for a Company's debt' at p 8. http://www.nzlii.org/nz/journals/CanterLawRw/1989/2.pdf

Farrar, JH., Furey, NE., Hannigan, BM., & Wylie, P. (1991). *Farrar's Company Law (Third edition)*. Butterworths at P. 159

Kanag-Iswaran, K. Wijayawardana, D., 'Company Law' (2014)

Keay, A. R. "The insolvency Factor in the Avoidance of Antecedent Transactions in corporate Liquidation' [1995] Monash University Law Review 305 at p. 307.

Paul L. Davies & Sarah Worthington, *'Gower & Davies' Principles of Modern Company Law'*, 5th Edition at p. 242.

sanvada.org/policyanalysis/Pathfinder http://savanda.org/policyanalysis/savandhaComAct6.company%20law%