SOLVENCY TESTS – THE RIGHT PATH FOR THE EUROPEAN UNION?

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Limited liability companies represent a special risk for its creditors, since its members are normally not personally liable for the company´s debts. Due to this specific rule, distribution of profit gives rise to a specific tension between the interests of creditors and shareholders. For this reason, restrictions to profit distributions are seen as a "natural complement" to limited liability.[1] The main issue to resolve will be of setting a "fair and proportionate" balance between the interest of the creditors to be paid and the interest of the shareholders to make profit out of their investments.[2]

In the Continental-European tradition the balance has been tried to be achieved through a combination of capital maintenance rules with prudent and conservative accounting rules. The Second Company Law Directive[3] introduced, in its article 17.º, capital maintenance rules regarding the distribution of profits:

(1) *"(…) no distribution to shareholders may be made when (…) the net assets as set out in the company's annual accounts are, or following such 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."*

(2) *(…)*

(3) *"The amount of a distribution to shareholders may not exceed the amount of the profits at the end of the last financial year (…)."*

In addition to the traditional "balance sheet test" laid down in article 17 (1), the fourth Directive[4] provided for accounting rules where the historic cost theory and the prudence principle played the predominant role.[5] Assets should be based on the principle of purchase price or production cost and liabilities on their nominal value.[6] Rising market values of assets were not recognised, while all depreciation must be taken into account.[7]

[1] Wolfgang Schön, "Balance Sheet Tests or Solvency Tests – or Both?", 2006, p. 183

[2] Jonathan Rickford, "Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests", 2006, p. 139

[3] Second Council Directive 77/91/EEC of 13 December 1976 recasted in Directive 2012/30/EU

[4] Directive 78/660/EEC

[5] Jonathan Rickford, "Legal Approaches…", 2006, p. 146

[6] Articles 32.º and 42.º

[7] Article 31.º (c) (cc)

At the same time, profits were only recognised in the books when realized. In contrast, losses and other risks had to be accounted if they were foreseeable or apparent.[8] This asymmetric and pessimistic treatment was seen as an element of creditor protection, since it created a "cushion" that functioned as a limit against excessive profit distributions.[9]

Nonetheless, in the recent years the above-mentioned principles have been continuously influenced by other valuation methods. With the Fair Value and the Modernization Directives, the IAS regulation and the recent approval of the new accounting Directive 2013/34/EU, the principles of "true and fair view" and "neutrality" are becoming important strongholds of modern accounting. International Financial Reporting Standards´ main purpose is to provide for the needs of modern financial markets by releasing decision-useful information to a wide range of users, such as short-term developments that are useful for short-term investors.[10]

Although It is not within the purpose of this paper to focus on all, not even the most, relevant legal aspects of modern accounting rules, there are at least two important developments worth be mentioned:

a) Since the Modernised fourth Directive[11], the recognition of unrealised profits and losses was broadened through the fair value regime[12]
b) The IAS accounting rules envisage the fair valuation of liabilities as well as assets[13]

Regarding this evolution, it is a common critic that IFRS produce higher income and equity than other accounting systems based on the cost theory approach.[14] This would lead, it is said, to a higher amount of distributable profit and would significantly decrease the protective "cushion", thus affecting the protection of creditors.

Because of this background many authors seem to be worried about the role, if any, that accounting-based capital maintenance rules should play in the future[15]. In my opinion these authors are approaching the problem from a wrong starting point. It is not the role of accounting-based capital maintenance rules that we have to worry about in the future, but of accounting. The truth is that the capital maintenance rules that we are analysing, namely, the restrictions to profit distributions have not been altered since the original text of the Second Directive. Their function is and always was to impede that wealth is transferred from creditors to owners. Pellens and Sellhorn correctly affirm that agency theory merely suggests that liquidating credits that were given in the context of debt-financed projects should be prohibited.[16] In the, as usual, very descriptive language of Law and Economics we would say that the rules try to prevent one of the common

[8] Article 31.º (c): (aa) and (bb)
[9] Wolfgang Schön, "Balance Sheet Tests…", 2006, p. 18
[10] Martin Gelter and Zehra G. Kavame, "Whose Trojan Horse? The Dynamics of Resistance against IFRS", 2014, p.58
[11] Repealed by the Directive 2013/34/EU
[12] See Jonathan Rickford, "Legal Approaches…", 2006, p. 15
[13] Ibid, p. 162
[14] Bernhard Pellens and Thorsten Sellhorn, "Improving Creditor Protection through IFRS Reporting and Solvency Tests", 2006, p. 372
[15] Ibid, p. 367
[16] Ibid, p. 371

debtor´s moral hazard behaviour in a post-contractual debtor/creditor relationship, namely "the cash in and run".[17] Moreover, we ensure that cash and assets once brought into the corporation can only be distributed to shareholders in accordance with capital reduction. A related, but nonetheless unquestionably different goal than the former is to prevent the risk of bankruptcy. This risk has been tried to be attenuated not by capital maintenance rules, but through accounting rules. Although working in a framework of restrictions to profit distribution, it was actually the asymmetric treatment of assets and liabilities that forced companies to create a "cushion" in order to confer an extra layer of protection to creditors. The question that remains to be answered is whether such "cushion" can be seen as an adequate instrument to prevent insolvency. We think not. Our main objection is that the amount of the cushion has little to do with the risk profile and the future business plan and projections of the concrete company, but will, since it works in a capital maintenance rules framework, always be constructed in proportion to the company´s share capital and former profits, being therefore arbitrary. Jonathan Rickford rightfully explains that two different companies with identical levels of share capital will always have different risk profiles towards their creditors. In addition, requirements of minimum capital are almost not existent in European Union´s legislation, being there only a requirement worth to mention for publicly traded companies.[18]

A much more adequate instrument to reduce the risk of bankruptcy through restrictions to profit distribution is the so-called solvency test that already exists, albeit in different forms, in many U.S. States and in New Zealand. Our task will now to show some of the most important aspects that the we should care about when thinking about to implement such an instrument in an European context.

So, if we were to introduce a solvency test, the first question that would arise is whether we should completely abandon the classical balance sheet test as provided in the Capital Directive. We think the answer is negative. As already mentioned, the solvency test and balance sheet test have different purposes. Moreover, facilitating distribution rules *ex ante* and making shareholders´ access to their investments only subject to the condition of a solvency test, would pave the way for managements to produce an (overly) optimistic solvency prognosis. Independently of how developed the preventive effect of liability provisions is, it seems hard to envisage that the board would abstain from abusing of its own discretion, which the solvency test necessarily implies, especially in a "last period scenario".[19]. It is true that in the U.S.A, although balance sheet tests were wide-spread, they are of almost no importance nowadays. We should, however, be careful not to forget about the essential differences between common law and civil law systems. Some authors have already warned that this evolution is due to the unwillingness of American Courts to enforce capital maintenance rules that consequently created a lack of case law, rather than to any kind of a higher evolutionary level[20].

The second question has to do with the choice between a legal and a business-orientated

[17] Christoph Kuhner, "The Future of Creditor Protection through Capital Maintenance Rules in European Company Law – An Economic Perspective", 2006, p. 349
[18] Article 6 of Directive 2012/30/EU requires a minimum capital of 25.000 €
[19] Rüdiger Veil, "Capital Maintenance – The Regime of the Capital Directive v. Alternative Systems", 2006, pp.91-92
[20] Christoph Kuhner, "The Future …", 2006, p. 359; see also Andreas Engert, "Life without Capital: Lessons from American Law, 2006, p. 656

approach[21]. In fact, the real difference between these two tests depends mainly on how we define assets and liabilities.[22] The legal approach is based on the liquidation values of assets and liabilities. If it could be shown that after the profit distribution, the difference is positive, the solvency test would be passed. The problem of this test is its weak forecasting ability about the company´s future solvency, since it takes only in account future expenses that are an existing and enforceable obligation towards a third party.[23] In contrast, the business perspective should be regarded as a prospective cash flow statement, where future expenses and profits should be evaluated in accordance with the management´s business plan. A profit distribution could be allowed if it could be foreseeable that future cash flows could cover a "going concern business" after profit distribution would have taken place. The risk of approving an overly optimistic forecast of the future business profits and of thereby shifting the risk of future business from the shareholders to the creditors, reinforces the special importance of effective liability rules to prevent such an opportunistic behaviour. But to whom should these rules primarily apply? It seems to be the dominant position between academics that the business judgement, which the solvency test requires, is to be carried out by the directors because of their comprehensive knowledge of the business operations and accounts of the company.[24] An additional argument in favour of the importance of effective liability rules is the directors´ necessary assessment of imprecise standards. While clear and precise rules provide for legal certainty, standards give a greater discretion to management in the formation of their cash flow projection. Some authors seem to disagree, believing that managers would be more reluctant and risk averse towards unlawful distributions in a context of imprecise standards than in a context of precise and unambiguous rules, because it would be harder to anticipate whether a certain distribution decision would be accepted by the courts on the grounds of the underlying assumptions.[25] My opinion is a different one, especially if we remind that American courts are very reluctant to question the discretion of the director´s business judgement. Judicial review appears to exist only in severe cases like fraud, bad faith or abuse of discretion[26]. Because the use of management´s discretion is difficult to review, procedural rules should not only clearly define the managers´ duty to give reasons, but also establish formal requirements of such a solvency test. Accordingly, the law of New Zealand allows civil liability for damages if certain procedures were not respected, like if the solvency declaration was not signed or the explanatory statement for the company´s solvency were not presented[27]. It is also important that the assumptions used for solvency testing are verifiable in order to prevent manipulations from financial budgets. More detailed questions, such as whether directors should be totally or partially liable for the unlawful distributed amounts, to what extent negligent actions should be punished, or in what situations a presumption of fault could exist, are issues that should be resolved according to the particular culture and incentive structure that exist in a particular legal system.

A last but truly decisive question is the forecast period or time horizon that should

[21] Classification used by Wolfgang Schön, "Balance Scheet..", 2006, p. 187
[22] Jonathan Rickford, "Legal Approaches…", 2006, p. 173
[23] Wolfgang Schön, "Balance Sheet Tests…", 2006, p. 188
[24] Ibid, p. 191
[25] Christoph Kuhner, "The Future…", 2006, p. 358
[26] Rüdiger Veil, "Capital Maintenance…", 2006, p. 84
[27] Ibid, p. 90

apply to the test. One of the major advantages of the solvency test in contrast to the balance sheet test is precisely the fact that the restrictions to profit distributions are not assessed regarding mainly its past, but that its forward-looking character will assess if the company will be able to fulfil its obligations in the future. Both paragraph 6.40 (c) (1) of the American Revised Model Business Corporation Act and Sec. 4 (1) of the New Zealand´s Companies Act of 1993 define the time horizon in a similar way ("*…company must be able to pay its debts as they become due in the usual/normal course of business*"). Meanwhile, paragraph 501 of the California Corporations Code requires that the company is able to "*meet its liabilities as they mature"*. We conclude that none of the three systems provides for a clear time horizon.

Regarding this specific problem, Rickford proposed a "two part solvency test" inspired in English solvency law. On the one hand, the company must be able to pay its liabilities shortly after the distribution. On the other hand, the firm should be able to pay its liabilities that will become due over the course of the following business year.[28]

Irrespective of the merits of this solution, it is important to acknowledge that a forward-looking cash flow test should be divided in a short-term and long term solvency. The level of scrutiny of the management´s decision and its consequent exposure to liability should become weaker as the time horizon grows. This does not invalidate that Directors should have the obligation of showing a consistent and sustainable business plan which makes it at least potentially possible for a company to pay its long-term liabilities, such as the important pension liabilities.

It is clear that many of the thoughts presented in this paper have a strong theoretical basis that makes it often hard to find concrete and final solutions. Furthermore, the solvency test must be acknowledged much more as one possible compromise rather than a state of the art innovation. Nonetheless, it is my humble opinion that such an instrument could bring some major advantages. When it comes to the European Union, it will be interesting to see if the European institutions and Member States are interested in introducing such tests, particularly after the publication in the year 2008 of the study, led by KPMG for the European Commission, regarding alternative measures for the "capital maintenance regime".[29] We will wait and see.

[28] Jonathan Rickford, "Legal Approaches…", 2006, p. 174
[29] Available at http://ec.europa.eu/

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