

## GUERNSEY COMPANY DIVIDENDS & DISTRIBUTIONS POST 1 JULY 2008

### Introduction

Guernsey companies are governed principally by the Companies (Guernsey) Law, 2008 ("the 2008 Law"), which came into force on 1 July 2008.

One of the many developments introduced by the 2008 Law was a complete overhaul of the rules governing the declaration of dividends and the making of distributions.

The revised system, which abolishes the doctrine of capital maintenance, gives much greater flexibility whilst protecting creditors of a company by requiring directors to expressly consider the solvency of a company before declaring a dividend or making a distribution. However, we have witnessed instances where company boards have inadvertently fallen foul of the prescribed procedures due to failing to take proper advice and applying the previous regime to their deliberations, rather than the current law.

These seemingly innocent departures from the statutory provisions can have very serious ramifications and could, in certain cases, lead to personal liabilities on the directors.

This note is intended to explain the new dividend process and the differences compared with the old as well as setting out other issues that should be considered by any board contemplating declaring a dividend.

## THE REGIME BEFORE THE 2008 LAW CAME INTO FORCE

Immediately before the enactment of the Law, Guernsey companies were governed principally by the Companies (Guernsey) Law, 1994 (as amended). Section 33 of this law stated:

"A company shall not pay a dividend except from profits available for the purpose"

That was (in most cases) the extent of the statutory restraint on the payment of a dividend. Therefore the directors could lawfully declare a dividend so long as the company in question had accumulated sufficient profits or reserves over time. They did not need to consider the cash flow or solvency of the company, although prudence dictates they should have done so.

## REASONS FOR CHANGE AND THE NEW REGIME

When Guernsey was developing the 2008 Law, the international business climate was one of credit tightening, recession and corporate failures and insolvencies.

It was quite rightly, therefore, deemed appropriate that the priorities of a board when considering the declaration of a dividend should be the current financial health of the company and not the historical accumulations of accounting profit.

Thus the 2008 Law introduces a new test, known as the Solvency Test that is required to be applied whenever a distribution of any nature is contemplated (see below). If the company cannot be shown to pass the Solvency Test immediately after the distribution, then it is not lawful. Section 304 of the 2008 Law states that:

"(1) a company may pay a dividend if - (a) the board of directors is satisfied on reasonable grounds that the company will, immediately after payment, satisfy the solvency test, and (b) it satisfies any other requirement in its memorandum and articles"

Further:

"(6) the board of directors must approve a certificate stating - (a) that in their opinion the company will, immediately after payment of the dividend, satisfy the solvency test, and (b) the grounds for that opinion.

## THE SOLVENCY TEST

So what is the Solvency Test and how does a company pass it?

Section 527 of the 2008 Law states that:

"(1) For the purposes of this Law a company satisfies the solvency test if - (a) the company is able to pay its debts as they become due, (b) the value of the company's assets is greater than the value of its liabilities (c) if the company is a regulated entity it must pass any additional regulatory solvency requirements.

(2) ..... the directors - (a) must have regard to - (i) the most recent accounts of the company, and (ii) all other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of the company's liabilities, and (b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances."

Assuming the board are able to satisfy themselves that the company does (and will immediately after dividend declared) satisfy the Solvency Test, what form should the 'certificate' referred to in Section 304 (6) take?

This is not specified in the 2008 Law and, if appropriately worded, the minutes of the meeting at which the board considered and reached its decision could itself represent this certificate. Alternatively a separate certificate may be drawn up for signature.

There is no requirement that the certificate (in whatever form) be lodged or filed with any external party.

## POSSIBLE SNARES TO TRAP THE UNWARY

### Failure to document the consideration of the Solvency Test

It can be all too easy, when performing what may be seen as a routine, recurring task such as the declaration of a dividend, to refer back to previous minutes and repeat this process year on year. This is especially common when the services of an experienced Company Secretary have not been engaged as is often the case with owner managed companies. However, when the previous actions were taken under a now-repealed law, this can lead to problems.

It need not even be the case that the company would have failed the Solvency Test if properly applied. If the procedures laid out in the 2008 Law are not followed and documented, then it is likely that an unlawful dividend has been declared and remedial action would need to be taken as a matter of urgency.

### FAILURE TO CONSIDER THE COMPANY'S ARTICLES

This is more a trap for those seeking to comply with the 2008 Law, but forgetting to check what the company's Articles have to say about dividends. Companies formed before 1 July 2008 will have most likely had their Articles based on long established precedents of the Advocates who undertook the incorporation for them. These have generally been found to state (not unreasonably given the laws under which they evolved) that dividends can only be declared out of profits available for the purpose (mirroring the now repealed Companies (Guernsey) Law, 1994).

A company which has not updated its Articles to remove or amend this wording will need to comply with both subsections of Section 304(1) as above and apply the Solvency Test as well as establishing that it also has profits available for the purpose and documenting both issues.

The simplest solution to this duality of tests is to update the company's Articles so that only the Solvency Test need be applied.

## FAILURE TO APPLY THE SOLVENCY TEST TO OTHER TRANSACTIONS THAT NOW QUALIFY AS DISTRIBUTIONS

As well as the more easily identifiable dividends, the 2008 Law specifies a list of other transactions that are now classed as distributions and for which the Solvency Test must be applied (and passed) by the board before sanctioning. These are:

- An issue of shares as fully or partly paid bonus shares
- A redemption or acquisition of any of the company's own shares or financial assistance for an acquisition of the company's own shares
- A reduction of share capital
- A distribution of assets to members during and for the purposes of its winding up
- A distribution of assets to members during and for the purposes of an administration order
- A distribution of assets to members of a cell of a protected cell company during and for the purposes of a receivership order, or
- A distribution of assets to members of a cell of a protected cell company during and for the purposes of the termination of the cell.

In all of the above examples, it is vital that the board apply the Solvency Test and properly sign a certificate certifying its having been passed.

### DIRECTORS' LIABILITIES IN THE MATTER OF UNLAWFUL DISTRIBUTIONS

Section 309 of the 2008 Law states that: "[an unlawful distribution] may be recovered by the company from the member except to the extent that - (a) the member received the distribution in good faith and without knowledge of the company's failure to satisfy the Solvency Test, (b) the member has altered his position in reliance on the validity of the distribution, and (c) it would be unfair to require payment in full or at all."

Section 309 (2) continues to state that, where the relevant sections of the Law have not been followed or that reasonable grounds for believing the company would satisfy the Solvency Test did not exist at the time the certificate was signed: "a director who - (i) failed to take reasonable steps to ensure the procedure was followed, or (ii) voted to approve the certificate (as the case may be) - is personally liable to the company to repay to the company so much of the distribution as is not recoverable from the members."

Thus the importance of following the correct procedure and ensuring that appropriate consideration by the board of what is reasonable evidence is taken, can be seen.

## FURTHER DEVELOPMENTS TO THE DISTRIBUTION REGIME IN THE 2008 LAW

At the time of writing, a consultation process has recently ended as part of a general tidying up of certain parts of the 2008 Law.

One of the questions raised in consultation concerns the possible removal of the part of the Solvency Test that applies to the comparison of Asset values to Liability values (the 'Balance Sheet Test') and, instead, a focus purely on the ability to meet debts as they fall due (the 'Cash Flow Test').

Perhaps of most importance and interest to directors are proposals to introduce some form of 'Whitewash' provisions to relieve the liability of directors where distributions have not been properly declared in accordance with the 2008 Law but it can be demonstrated that, had the proper procedures been followed, the company would either have passed the Solvency Test at the time of the original declaration and/or (not confirmed which yet) would pass the Solvency Test at the time of the ratification.

These proposals, if implemented, should allow for an appropriate level of relief for innocent mistakes by boards where the breach is procedural rather than due to financial deficiency and would avoid the costly process of applying for relief from the Courts (which is the only currently available source of relief).

## FURTHER DEVELOPMENTS TO THE DISTRIBUTION REGIME IN THE 2008 LAW

The best advice is to seek legal assistance from a Guernsey lawyer as soon as an individual director or the board become aware of the breach in the distribution process.

However, we have witnessed differing opinions on the appropriateness of certain remedies, including: restatement of dividends into loans until a fresh dividend can be declared properly to clear recovery of distributions from members ratification of past breaches by board or members and so complete certainty may be hard to achieve. It should be noted that reliance on the last of the above is particularly dangerous in the absence of any statutory whitewash provisions.

We do not advise any course of action be taken without very careful consideration and the taking of appropriate legal advice. As always, the best approach is to avoid the breach in the first place. GTC has a wealth of experience in providing corporate secretarial services and in assisting with the drafting of resolutions and ancillary documentation. If consulted in advance of the contemplation of declaring a distribution, we can advise on the above issues and on how to ensure any such distribution is lawfully declared.

Should you wish to discuss how we can assist your business in ensuring compliance with the relevant legal requirements, as well as for assistance with your drafting requirements,



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