

Solvency, liquidity and the test of fairness

THE requirements with which a company must comply when it provides financial assistance for the purchase of shares in such an entity have been widely debated over the last few years.

The Corporate Laws Amendment Act 2007 introduced an exception on the ground that the so-called solvency and liquidity requirements are met.

In a further development, the Companies Bill, 2008 seems to have accepted the solvency and liquidity requirements, subject to a number of refinements.

It is now specifically indicated that any decision of the board of directors of the company that does not comply with the relevant requirements, will be void. A director will also be personally liable if he or she was present at the meeting when the board approved the relevant financial assistance (or the director participated in the making of such decision) and failed to vote against the resolution despite having knowledge that the provision of financial assistance was inconsistent with the prescribed requirement.

The memorandum of incorporation of a company can provide further requirements and restrictions which must be complied with before financial assistance can be provided.

The concept of financial assistance is now defined with reference to a loan, guarantee, the provision of security or otherwise to a person. There is no longer a re-



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quirement that the prohibition extends to direct or indirect financial assistance. It merely refers to financial assistance for the purpose of or in connection with the subscription of any option, or any securities, issued or to be issued by the company or a related or interrelated company or for the purchase of such securities.

The concept of securities is not only limited to ordinary shares, but would also include preference shares, stocks, depository receipts, derivative instruments, bonds and debentures.

A holding company previously could have provided financial assistance for the purpose of subscription or purchase of shares in its subsidiary.

The current proposal refers to the purchase or subscription of shares of the company or a related or interrelated company.

It is indicated that a juristic person is related to another juristic

person if:

- Either of them directly or indirectly controls the other, or the business of the other;
- Either is a subsidiary of the other; or
- A person directly or indirectly controls each of them, or the business of each of them.

The provision extends much further than was previously the case as a co-subsiary could also have provided financial assistance for the purchase or subscription of shares in another co subsidiary.

It is also specifically provided that the shareholders must approve the relevant financial assistance within a period of two years (from the date of the giving of the financial assistance). The approval must either relate to assistance for a specific recipient, or generally for a category of potential recipients (in which case the specific recipient must fall within such category). The only instance where a shareholders' resolution is not required, is if the financial assistance is given pursuant to an employee share scheme (that would in any event have been approved to the extent that one is dealing with a listed company).

Apart from the shareholder requirement, the board must also be satisfied that:

- Immediately after providing the financial assistance, the company would meet the so-called solvency and liquidity tests; and
- The terms under which the fi-

nancial assistance is proposed to be given are fair and reasonable to the company.

The latter requirement relating to the terms of the financial assistance being fair and reasonable to a company, is new. In other words, the board must specifically consider whether such assistance is reasonable to the company, having regard to all of the requirements.

The liquidity test requires that the company should be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the financial assistance has been given.

The solvency test requires that the assets of the company, fairly valued, must be equal to or exceed the liabilities of the company. Should the company be a member of a group of companies, one should consider the consolidated assets compared to the consolidated liabilities of the company. This answer may be quite different compared to the situation where one compares only the position of the company. Further, it does not seem to distinguish between whether or not the company is a holding company or merely a subsidiary of the group.

In determining whether the solvency and liquidity tests are met, one should consider the financial information concerning the company based on accounting records or financial statements that comply with the company law requirements. With reference to the assets and liabilities of the

company, a director should consider a fair valuation thereof, including any reasonable foreseeable contingent assets and liabilities, irrespective of whether or not arising as a result of the proposed financial assistance. In other words, the very financial assistance itself should be taken into account. This is one of the problem areas even with the current wording as the nature of the financial assistance is generally of such a scale that the liabilities of the company would actually exceed its assets given the fact that such financial assistance may comprise a contingent liability. It also seems that one is dealing with a test to be applied when the financial assistance is given. On such a day one would not know whether the financial assistance may have increased over the period thereof, especially in circumstances where the financial assistance may endure for a substantial period, say, ten years.

To the extent that the Companies Bill 2008 is promulgated, great care will have to be taken with reference to the financial assistance provisions.

Apart from the fact that the general prohibition has been substantially expanded, it may not be that easy to comply with the requirements relating to solvency and liquidity as well as the fair and reasonableness test.

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