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The Guernsey Solvency Test: A Review

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What is the Guernsey solvency test?

The solvency test, found in section 527 of the Companies (Guernsey) Law 2008 as amended ("the Law"), is used to determine whether a Guernsey company is solvent. For non-regulated companies, it is a two-part test. For regulated companies there is a third part to the test[1] which concerns compliance with the solvency requirements imposed by their specific regulatory regimes. The test is cumulative, meaning that a company is insolvent if it fails any applicable part of the test.

Cash flow solvency

The first part of the solvency test, which is commonly called the cash flow test, requires a company to demonstrate that it is able to pay its debts as they become due[2]. The cash flow test has an element of futurity which is imposed by the phrase "as they become due". In other words, a company must show that on the present facts it can in the future meet its debts as they mature and become legally payable. This aspect of "looking to the future" arguably better reflects the commercial situation when a company may be able to pay its debts due right now but will inevitably fail due to future debts.This point was admirably made by Mr Justice Briggs in Re Cheyne Finance plc (No 2)[3] in the context of the similarly worded English "as they fall due" test:

"It is clear... that ... cash flow or commercial insolvency is not to be ascertained by a slavish focus only on debts due as at the relevant date. Such a blinkered review will, in some cases, fail to see that a momentary inability to pay is only the result of a temporary lack of liquidity soon to be remedied, and in other cases fail to see that due to an endemic shortage of working capital a company is, on any commercial view, insolvent, even though it may continue to pay its debts for the next few days, weeks or even months before an inevitable failure."[4]

Unlike in other jurisdictions, there is no fixed timeframe as to how far in the future the company must look with regard to when the debts become due. However, some persuasive guidance can be found from the Supreme Court case of BNY Ltd v Eurosail[5] ("BNY") where Lord Walker, when commenting on very similar wording in English legislation, considered that the reasonable near future will depend on all the circumstances of the case, but especially on the nature of a particular company's business[6]. In practice, directors can take a conservative approach and consider not only all debts which the company has a legal obligation to meet but also contingent liabilities (at their highest value) irrespective of when they become due.

Balance sheet solvency

The second part of the test, often called the balance sheet test, requires a company to show that the value of its assets is greater than the value of its liabilities[7]. The directors must have regard to[8] the most recent accounts for the company, all circumstances that the directors know or ought to know affect or may affect the value of the company's assets and liabilities and they may also rely on reasonable valuations of assets or estimates of liabilities. They should also take in account all contingent and prospective liabilities. In BNY Lord Walker agreed with the view that the balance sheet test involves the court making a judgment as to whether it has been established, when looking at the company's assets and making proper allowance for its prospective and contingent liabilities, that it cannot reasonably be expected to be able to meet those liabilities. If it cannot, then it will be deemed insolvent even if it is currently able to pay its debts as they fall due. It follows from this that the more distant the liabilities, the harder it will be to establish whether or not it can reasonably be expected to meet them.

In practice, directors can take the cautious route of disregarding contingent assets but including all contingent and prospective liabilities.

Why is the test important?

The test is important in various situations including:

- when a company is considering distributing a dividend[9] or when making other distributions[10]:
    - When a company decides to make a distribution the directors must ensure that the solvency test will be met immediately after the distribution is made and sign a certificate to that effect. Directors can be held personally liable for distributions which are made when the solvency test is not met.

- when considering issues of wrongful trading[11]:
    - A liquidator, creditor or member of a company can make an application to the court for a declaration that a director is liable to contribute to a company's assets if, at some time before the company entered insolvent liquidation, the director knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation. In the Royal Court decision of Carlyle Capital Corporation Limited v Conway Others[12] ("Carlyle") it was stated that "no reasonable prospect" means that a

director would not fall foul of wrongful trading if s/he can show that, at the relevant time, the company, even while having a balance sheet deficit and/or cash flow shortfall, still had reasonable prospects of trading out of that difficulty, notwithstanding the fact that ultimately the decision to carry on led to the company's insolvent liquidation[13]. This offence is really aimed at situations where directors continued in business when there could be no reasonable belief that the company could pull through and pay its creditors[14].

- in ascertaining when the fiduciary duty of directors to take into account the interests of creditors has been engaged:
    - In Carlyle the Royal Court confirmed that directors have a fiduciary duty to take proper regard of the interests of creditors when a company is on the brink of insolvency[15] and that this duty will require giving precedence to creditors' interests where necessary in particular situations[16].
    - In the recent English Court of Appeal case of BTI 2014 LLC v Sequana and others[17] ("Sequana"), the judges rejected the use of terms such as "brink of insolvency" to determine when this fiduciary duty arises. They instead stated that the duty arises when the directors knew or ought to have known that the company was likely to become insolvent. This new formulation is likely to be persuasive when this issue arises in future Guernsey cases.
- when determining whether a company meets the test for liquidation or administration:
    - One of the grounds upon which the court can order that a company be placed into compulsory liquidation is if it is deemed unable to pay its debts[18], the definition of which includes if it is proved to the satisfaction of the court that the company fails to satisfy the solvency test[19]. Once the recent Guernsey insolvent law amendments, which were passed on 15 January 2020 by the States of Guernsey ("2020 Insolvency Law Amendments") come into force, non-Guernsey companies will also be wound up by the Guernsey court if they are unable to pay their debts and have a sufficient connection with Guernsey.
    - Two conditions must be satisfied before the court can make an administration order[20]. The first condition is that the company does not satisfy or is likely to become unable to satisfy the solvency test. The Royal Court decision In the matter of Propinvest Group Limited[21] is an example of where the court did not find that the company met the solvency test when considering an administration order application. The second condition is that the court considers that the making of an order under this section may achieve the survival of the company, and the whole or any part of its undertaking, as a going concern, or, that it will achieve a more advantageous realisation of the company's assets than would be effected on a winding up[22].
- when determining if a liquidator can set aside a transaction for being a preference[23]:

    - If a company makes a transaction at a time when a company is unable to pay its debts[24] or if it becomes unable to pay its debts as a result of the transaction (any payments made within 6 months preceding an application or resolution to wind up being caught, or 2 years if it was with a connected party), then a liquidator of that company can apply to have that transaction set aside.

- when determining if a liquidator or administrator can set aside a transaction at an undervalue:
    - At present liquidators have limited (customary) powers[25] to set aside transactions at an undervalue when a company is insolvent or becomes insolvent as a result of the transaction.

    - Once the 2020 Insolvency Law Amendments come into force, liquidators and administrators will have statutory powers to apply to the court to set aside transactions at an undervalue when a company is insolvent or becomes insolvent as a result of the transaction. The transaction must have occurred within 6 months (or two years where the third party is connected to the company) of the company entering insolvency. Where transactions at an undervalue occurred outside the 6 month or 2 year period, liquidators and administrators will still be able to use customary powers to set them aside

- when members wish to voluntarily wind up their company:
    - At present members who wish to voluntarily wind up their company can do so through passing a special resolution even if the company is insolvent.

    - However, once the 2020 Insolvency Law Amendments come into force, when members wish to place their company into a members' voluntary wind up, the directors must declare that the company is able to satisfy the solvency test. If they cannot declare that it is solvent, then the company must be wound up by an independent third party (normally a professional insolvency professional).

- when restoring a company:
    - in deciding whether or not to restore a company to the register of companies, the court will take into account, along with other factors, whether or not the company would meet the solvency test if it is restored (unless the application is made by a creditor).[26]

Conclusion

To avoid potential liabilities, directors should carefully consider whether their company meets the solvency test not only when it has entered into significant financial difficulties but also before they make any decisions which are likely to have a significant impact on its finances. At these critical moments directors may be greatly assisted and often reassured by taking independent legal and accountancy advice to ensure that the steps they take do not have undesirable consequences for them personally in the future.

[1] Section 527 (1) (c) of the Law

[2] Section 527 (1) (a) of the Law

[3] [2008] BCC 182

[4] Paragraph 51

[5] [2013] 1 WLR 1408

[6] Paragraph 37

[7] Section 527 (1) (b) of the Law

[8] Section 527 (2) of the Law

[9] Sections 304 of the Law

[10] Section 303 of the Law

[11] Section 434 of the Law

[12] Judgment 38/2017

[13] Paragraph 603 of Carlyle

[14] Paragraph 607 of Carlyle

[15] Paragraph 441

[16] Paragraph 455

[17] [2019] EWCA Civ 112

[18] Section 406 (e) of the Law

[19] Section 407 of the Law

[20] Section 374 (1) of the Law

[21] Judgment 34/2012

[22] Section 374 (3) of the Law.

[23] Section 424 of the Law

[24] Within the meaning of section 407 of the Law

[25] Such as bringing a customary Pauline action, see Royal Court decision in Flightlease Holdings (Guernsey) Ltd v International Lease Finance Corporation, October 26th, 2005

[26] Section 371 (3) (a) of the Law

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