Creditor Protection and the Application of the Solvency and Balance Sheet Tests under the Company Laws of Finland and New Zealand

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Nordic Journal of Commercial Law
issue 2008#1

I. Introduction

Creditor protection in the recently adopted Finnish Limited Liability Companies Act (FLLCA)[1] has gone through structural changes compared to the preceding Finnish Limited Liability Companies Act of 1978[2]. Novelties in the creditor protection of the FLLCA is that asset distribution is tied to maintaining the solvency of the company and contrary to the 1978 Act, creditor protection now covers also the company's distributable reserves of unrestricted equity. Consequently, assets may be distributed only if the company has adopted a financial statement,[3] which indicates the amount of the company's reserves of unrestricted equity that may be distributed,[4] unless otherwise ensues from a solvency test.

The solvency requirement is set forth in Chapter 13, section 2 of the FLLCA:

> "Assets shall not be distributed, if it is known or should be known at the time of the distribution decision that the company is insolvent or that the distribution will cause the insolvency of the company."

It is important to notice that the solvency test applies not only to the distribution of reserves of unrestricted equity, but also to restricted equity even when the creditors have consented to its distribution in accordance with the creditor protection procedure laid down in chapter 14 of the FLLCA.

[1] Finnish Limited Liability Companies Act (624/2006).

[2] Finnish Companies Act (734/1978).

[3] In accordance with an amendment (461/2007) adopted on 1 July 2007, chapter 13, section 3 of the Limited Liability Companies Act will be as follows: The distribution of assets shall be based on the latest adopted financial statement. If so provided in this Act or the Articles of Association, the company must select an auditor and the financial statement must be audited. The essential changes in the financial position of the company after the completion of the financial statement shall be taken into account in the distribution.

[4] In accordance with chapter 13, section 5 of the Limited Liability Companies Act, unless otherwise ensues from the application of chapter 13, section 2 therein, the company may distribute its reserves of unrestricted equity, less the assets that are to be left undistributed under the Articles of Association. In addition to possible articles of association, the distribution of a company's reserves of unrestricted equity is limited by the shares that have been purchased or redeemed by the company or that are in its possession, which shall be included in the reserves of unrestricted equity as a negative item. Under section 17, subsection 3 of the act on the entry into force of the Limited Liability Companies Act (625/2006), if the company balance sheet has active incorporation and research expenses which have been removed by 31 December 2004 in accordance with the provisions of the Accounting Act in force (1336/1997), a corresponding amount shall, in the application of chapter 13, section 5 of the Limited Liability Companies Act, be taken into account as an undistributed item.

The aim of this paper is to discuss the solvency test and the balance sheet test[5] in chapter 13, section 5 of the FLLCA respectively, and assess how they should be carried out as well as what should be taken into account when doing so. Moreover, as an example I will compare the tests to creditor protection in the New Zealand Companies Act (NZ CA)[6], with a special focus on whether the solvency test therein could help in the application or practical development of the solvency and balance sheet tests in Finland.

The extreme distance of New Zealand to Finland and the fact that the common law system differs in both history and content from the Finnish legal system, were not the only reasons for selecting this creditor protection system as the point of comparison. It was chosen as an example of how two legal systems with different historical backgrounds and in two countries far apart can end up with rather similar mechanisms for solving conflicts of interest between creditors and shareholders, with the aim to prevent the opportunism of insiders, i.e. management and controlling shareholders. The comparison also serves as a tool for examining the control mechanisms of basically dispositive company legislation *ex ante*.

The 1993 NZ CA reform is a valid reference point also in other respects, because its ideas and goals for modernisation were similar to those prevailing in the reform process of the FLLCA. Accordingly the NZ CA aims:

> "To encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power."[7]

In their extensive commentary of the NZ CA reform, Ross Grantham and Charles Rickett maintain that the act should

1) be understood as a model agreement between different interest groups in a company,
2) prevent any opportunistic behaviour of management and controlling shareholders,
3) in its extent and nature correspond to the risk of abuse of controlling positions and not prevent financial activities, and
4) be sufficiently simple and not too detailed.[8]

[5] Chapter 13 section 5 of the FLLCA.

[6] New Zealand Companies Act 1993 No 105, NZ CA.

[7] The preparatory work for the Limited Liability Companies Act (Government proposal 109/2005) states that the new act is more transparent and comprehensive than the previous one. The act would increase companies' scope of activity and guarantee sufficient protection for minority shareholders and creditors.

Thus it is no surprise that both the FLLCA and the NZ CA include provisions on creditor protection based on the maintenance of company solvency in addition to the traditional balance sheet test now used for determining the amount of net assets.

The adoption of the solvency test also required reform of the regulation of modern limited liability companies and their activity. The traditional balance sheet and share capital-oriented creditor protection cannot be considered a sufficient means of meeting the requirements of good and efficient company legislation that protects all interest groups. The purpose of the solvency test is very simple. It aims to ensure the allocation of creditors in terms of assets and liabilities, by preventing such distribution of assets that would endanger the timely payment of receivables to creditors in the proper amount.

Under NZ CA the solvency test is applied not only to the protection of creditors, but to fixed preferential returns on shares ranking ahead of those in respect of which a distribution is made.[9] Technically, this entails that in the application of the solvency test under NZ CA the above-mentioned shares are considered debt according to their financial character.

II. Background of the Solvency Test

In Finland, creditor protection has traditionally been connected to the amount of capital invested in a company in the form of shares, and the permanence of its other reserves of restricted equity (*the Capital Maintenance Doctrine*). This was apparent in the Finnish Limited Liability Companies Act of 1978, which provided that for each subscription to a share, the par value or its counter value for accounting purposes was to be credited to the share capital and the rest to the share premium reserve. In addition, subscriptions to shares could not be made without crediting the par value of the share price, or its counter value, to the share capital for each subscription price paid or other balance assets. Under the Finnish Limited Liability Companies Act of 1978, the share capital and share premium reserve were, along with the legal

[8] *Ross Grantham & Charles Rickett*: Company and Securities Law commentary and materials. Brookers Ltd 2002 (Grantham & Ricket), pp. 38-39. For further details on the aims of the New Zealand Companies Act reform, see New Zealand Law Commission, Report 9, 1989 and especially pp. 1-2. Comparing the aims of the New Zealand Companies Act reform and the Finnish Limited Liability Companies Act reform – legislation that is more transparent, flexible, guaranteeing a more extensive scope of action for companies, improving the operational preconditions, competitiveness and employment possibilities of both large and small companies – we must acknowledge that the similarities are remarkable. Both acts are based largely on dispositive provisions, subject to mandatory provisions on the company institution's essential parts. This is understandable because both reforms have been influenced by e.g. the American Model Business Corporations Act.

[9] NZ CA, section 52, subsection 4. See e.g. *Mike Ross*: The Statutory Solvency Test. Company Law Writings: A New Zealand Collection 2002, pp. 177-202, (Ross), p. 189.

and revaluation reserves, the company's restricted equity, which could not be distributed without observing the creditor protection procedure in accordance with chapter 6 of the act.[10]

> The provisions of the Finnish Companies Act on the permanence of capital and the distribution of assets corresponded to the requirements of the Second Company Law Directive (77/91/EEC). As the directive required, the Finnish Limited Liability Companies Act of 1978 tied the distribution of assets solely to the amount of unrestricted equity indicated in the balance sheet.[11]
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> Under Article 15 (1) (a) of the Directive, except for cases of reductions of subscribed capital, no distribution to shareholders may be made when on the closing date of the last financial year 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.
>
> Under Article 15 (1) (c) the amount of a distribution to shareholders may not exceed the amount of profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes. Pursuant to Article 15(1)(d) the expression "distribution" used in these provisions includes in particular the payment of dividends and of interest relating to shares.

The content of the solvency test is currently influenced by the reformed capital system, which, within the limits of the minimum share capital requirement, allows crediting the subscription price paid for a share to the reserves of unrestricted equity. Other influences are legal problems relating to the implementation of international financial statement standards, and especially valuation problems in accounting related to the traditional balance sheet test. These problems involve taking into account unrealised changes in value because such changes are taken into consideration in different balance sheet tests only to a certain extent.[12]

[10] The revaluation reserves under the 1978 Finnish Companies Act could not be distributed, but they could be used to increase the capital stock through reserve issue and new subscriptions in mixed issue. Under the new Limited Liability Companies Act, however, the use of reserves to increase the capital stock is not possible. Revaluation reserves under chapter 8, section 1, subsection 1 are absolutely undistributable.

[11] See the Finnish Companies Act, chapter 12, section 2, under which profit distribution was not to exceed the sum total of the profit confirmed in the balance sheet for the latest entire financial period and the company's other reserves of unrestricted equity, less the losses indicated in the balance sheet and other undistributable items which were defined in section 2, subsection 1, paragraphs 1, 1 a, 2 and 3.

[12] A working group for the development of corporate taxation, appointed by the Ministry of Finance in 2005, has proposed that only unrealised increases in value entered into the accounting records of financial instruments credited in accordance with the resulting income and expenses to the fair price of the share should be taxed income and unrealised value decreases tax-deductible expenses. Unrealised value increases of financial instruments credited directly to equity would not be taxed income and similar unrealised depreciation would not be deductible. See Verotus, tilinpäätös ja yhtiöoikeus 2006, pp. 38, 40-42, 61-63, 76 and 80.

In the non-nominal value capital system under the FLLCA, shares have no nominal value. The link between a share and the share capital has also been removed. Consequently, crediting the subscription price of a share to the corresponding items in the balance sheet – the share capital and reserves of invested unrestricted equity – is in the establishment of the company connected to the provisions of the memorandum of association, and in subsequent share issues to the contents of the decision to issue shares or to the articles of association.

Pursuant to the FLLCA, unless otherwise provided on crediting the subscription price, crediting is carried out as follows:

The subscription price shall be credited to the share capital, unless it is provided in the memorandum of association or articles of association that a part of it is to be credited to the reserve for invested unrestricted equity, or unless it is otherwise provided in the Accounting Act.[13] Under chapter 9, section 6.2 of the FLLCA, the situation may be inversed, depending on whether the share issue involves new shares or ones already in the company's possession.

Provisions on the subscription price of shares allow new subscriptions to them to be credited entirely to the reserve of invested unrestricted equity.

III. The Contents of the Balance Sheet and Solvency Tests in Finland and New Zealand

III. A Finland – the FLLCA

Chapter 13, section 5 of the FLLCA corresponds to Article 15 of the Second Company Law Directive. Pursuant to this section, unless the assets are to be left undistributed under the articles of association or after application of the solvency test, the company may distribute its reserves of unrestricted equity[14]. Hence, the FLLCA limits the distribution of unrestricted equity with the balance sheet test,[15] the solvency test[16] and the requirement that the distribution of assets shall be based on the latest adopted (and audited) financial statement[17]. [18] In addition,

[13] FLLCA Chapter 2 section 4.

[14] The articles of association may order, for example, that half of the profit from the financial year shall not be distributed.

[15] Pursuant to chapter 13, section 5.

[16] Pursuant to chapter 13, section 2.

[17] In chapter 13, section 3.

[18] According to the second sentence of chapter 13, section 3.

essential changes in the financial position of the company after the completion of the financial statement shall also be taken into account in the distribution.[19]

As the FLLCA enables crediting subscription prices to unrestricted equity, and as unrestricted equity has traditionally been based on the free disposition by shareholders[20], it is rather clear that contemporary creditor protection was designed to prevent opportunistic share holder-behaviour at the expense of creditors. As indicated by the collocation of creditors[21], it is in the creditors' interest that the company is able to pay its liabilities. More specifically it should be able to do so in accordance with agreements, at the proper time, in the proper amount and it is also in the company's interest that the transfer of funds to customers does not endanger the activity of the company.

The balance sheet test and the solvency test are connected to each other. Before distribution of company assets e.g. the distribution of dividends and the reserve of unrestricted equity, it is necessary to test whether distribution is, in fact legally possible.[22] Based on the solvency test, one must verify whether it is necessary to decrease the amount distributed. It is illegal to distribute assets in contravention to the solvency test. Such a violation results in a refund obligation.[23]

> The balance sheet test makes a distinction between the company law concepts of restricted and unrestricted equity and liabilities. The FLLCA defines equity and divides it into two types: restricted and unrestricted[24]. Restricted equity consists of share capital, as well as of the fair value reserve and revaluation reserves under the Accounting Act. Unrestricted equity consists of other reserves, as well as of profit from the current and the previous financial periods.

[19] The provision can be interpreted based on the traditional duty of care. The provision refers in particular to a decline in the financial situation of the company after the conclusion of the financial statement. Decreases in the reserve of unrestricted equity after the preparation of the financial statement must be taken into account in the distribution of dividends and in the estimation of the unrestricted equity available for distribution. Similar increases in unrestricted equity cannot be taken into account without the adoption of the new financial statement because distribution must always be based on an adopted (and audited) financial statement.

[20] Under the Limited Liability Companies Act, chapter 13, section 6, subsection 4, unrestricted equity may, on the consent of all shareholders, also be distributed in a manner other than referred to in section 1, subsection 1 above, unless otherwise provided in the articles of association.

[21] Pursuant to the Limited Liability Companies Act, liabilities take precedence over equity in the distribution of funds. It is a question of collocation between equity and liabilities or different financial instruments. The order is based on the idea that returns paid on liabilities or other related expenses are dealt with in the company's profit and loss account as deductible expenses and they always decrease the company's distributable assets. See *Mähönen, Jukka & Villa, Seppo*: Osakeyhtiö II. Pääomarakenne ja rahoitus. WSOYpro Helsinki 2006. Mähönen & Villa 2006 II), p. 21.

[22] For further information on distributable unrestricted equity, see Mähönen & Villa 2006 II, p. 322.

[23] Chapter 13, section 4 of the FLLCA.

[24] Chapter 8, section 1, subsection 1.

> The revaluation and fair value reserves refer to reserves of the same name in the chapter 5 of the Accounting Act. The company law concept of a fair value reserve covers also the part of equity that consists of changes in value credited directly to equity based on the International Accounting Standard (IAS) 39. According to IAS 16 and IAS 38, the changes should be credited directly to equity under a revaluation reserve, if the carrying amount of a tangible or intangible asset is increased or decreased as a result of revaluation. According to IAS 39, investment real estate and agricultural goods credited to the fair value are not provided for in the FLLCA. Consequently, the profit indicated in the profit and loss account for the financial period may include unrealised increases in value.
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> In terms of company legislation, the profit for a financial period can in total be considered unrestricted equity regardless of whether it includes realised profits or not. The Finnish Parliament's Commerce Committee has considered it necessary that provisions on the distribution of unrealised value increases are prepared separately in cooperation with the Ministry of Justice and the Ministry of Finance and that a separate government proposal be issued thereon.[25]

Hence, the test is twofold. Only the sum indicated by the balance sheet test may be distributed, and the distribution is possible only within the frames set by the solvency test. In consequence, the solvency test sets the limits for distributing assets with the aim of ensuring that the distribution is not carried out in contravention to the collocation of those having invested capital in the company in different forms and ways.

In this connection, I wish to point out that the solvency test concerns the distribution of both restricted and unrestricted equity equally. This provision shall be applied irrespective of whether creditor protection under chapter 14 of the FLLCA has been applied to the distribution.

III.B. New Zealand – the NZ CA

Creditor protection in the New Zealand has been arranged with a solvency test similar to the solvency and the balance sheet tests of the FLLCA. Pursuant to NZ CA section 4, subsection 1: distribution depends on the company's ability to pay its debts (*the Liquidity Limb of the Solvency Test*) and the company's assets being greater than its liabilities after distribution (*the Balance Sheet Limb of the Solvency Test*). Management is obligated to assess the amount of the company's assets and liabilities, their nature and proportion based on the latest financial statement, which has been prepared in accordance with the Financial Reporting Act of 1993. Under NZ CA, section 4, subsection 1, a company passes the solvency test if:

[25] See the memorandum of the Commerce Committee TaVM 7/2006 vp and Government Proposal HE 109/2005 vp. p. 5. The Government Proposal has not yet been issued to the parliament.

> The company is able to pay its debts as they become due in the normal course of business; and
>
> The value of the company's assets is greater than the value of its liabilities, including contingent liabilities.

One of the characteristics of the NZ CA is that the company directors may, without special authorization,[26] distribute the company's assets as they see fit, provided that they can, on reasonable grounds, be sure that the company fulfils both requirements of the solvency test based on an assessment carried out immediately after the distribution.[27] Pursuant to NZ CA, section 52, subsection 1:

> The board of a company that is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the solvency test may, subject to section 53 of this Act and the constitution of the company, authorise a distribution by the company at a time, and of an amount, and to any shareholders it thinks fit. [28]

As the quote above demonstrates the NZ CA gives directors extensive rights to distribute the company's assets as they see fit without the disposition of shareholders. For the protection of both passive shareholders and creditors, it is understandable that passing the solvency test must be essentially connected to the preparation of a *directors' certificate* immediately after the distribution of assets.[29] In the certificate, directors must affirm that the statutory solvency test has been satisfied and explain in minute detail the information on which they base their statement.[30] Failure to provide such a certificate has also been sanctioned.[31]

> Under the Companies Act 1955, which preceded the Companies Act 1993, the traditional approach to the permanence of a company's capital did not allow the distribution of dividends from the capital invested in the company. Only the company's cumulative income could be distributed. The system was based on the idea that

[26] See *Christopher I. Haynes*: The Solvency Test: A New Era in Directorial Responsibility. Auckland University Law Review 1996, (pp. 126-141), p. 126. (Haynes).

[27] According to the preparatory work on the New Zealand Companies Act, the solvency test is an essential provision aiming to protect creditors and passive shareholders and may be used to limit the distribution of a company's funds to shareholders. Its purpose is to act as a counterforce to the directors' right to distribute the company's funds as they see fit. See New Zealand Law Commission, Report 9, 1989, p. 78.

[28] The contents of the provision resembles chapter 13, section 6, subsection 4 of the Finnish Limited Liability Companies Act, under which shareholders may unanimously distribute the company's assets as they see fit. NZ CA section 52, subsection 1 and the Limited Liability Companies Act, chapter 13, section 6, subsection 4 are an accurate description of the systematic differences between shareholders and directors in the two company law systems.

[29] See NZ CA section 52, subsection 2.

[30] See Haynes 135-137.

[31] See NZ CA section 373, subsections 1 and 4.

> companies should have a capital buffer to protect creditors.[32] Hence the distribution of dividends was completely prohibited if the net assets of the company were smaller than the amount of capital invested in the company by shareholders.[33]

The structure of the 1955 NZ Companies Act and its doctrine on the permanence of capital, led to a nearly similar result as the Finnish Limited Liability Companies Act of 1978 and its provisions on the permanence of equity invested in a company. The permanence of capital invested into a company in the form of a subscription price was protected in order to protect the receivables of creditors, and in practice, only unrestricted equity from profit could be distributed.[34] The permanence of capital was de-emphasised in the NZ CA of 1993 by highlighting instead the importance of the solvency test.

As *Grantham & Rickett* state, the enactment of the NZ CA significantly streamlined the distribution of assets and the requirements for permanence of capital, by allowing the company directors to distribute assets, such as dividends, as they see fit, provided that the company is solvent and remains so after the distribution.[35] In addition, the distribution of assets is naturally limited by NZ CA, which requires that the value of a company's assets must be greater than the value of its liabilities.[36]

III C. Comparison

The Finnish solvency test applies to all distribution of assets, not only the distribution of dividends or capital from the company's reserve of unrestricted equity. It must be applied e.g. when a company acquires or redeems its own shares or reduces its share capital. However, it is not applied when a company's assets are distributed in connection with its dissolution.[37] One should also note that the application on the solvency test is not limited to situations referred to

[32] If shareholders paid a premium exceeding the nominal value in the share subscription, the premium was dealt with similarly to the nominal value in terms of permanence. See also Ross, p. 178: "Where shareholders paid a premium over par, the share premium was treated as if it were nominal capital."

[33] See Grantham & Rickett, p. 855.

[34] The obligation under the Finnish Companies Act, chapter 13, section 2 to liquidate the company and prevent the continuance of its activity at the risk of the creditors based on the low ratio between the equity and share capital should be considered as a special characteristic of creditor protection in Swedish and Finnish limited liability company legislation.

[35] See Grantham & Rickett, p. 855.

[36] NZ CA Section 4, subsection 1, paragraph b.

[37] In the dissolution of a company, creditor protection is based on the repayment of debts and distribution of assets provided in chapter 20, section 15 of the Limited Liability Companies Act. In accordance with the first sentence of the section, once the due date of the public summons to the creditors of a company has passed and all known debts have been repaid, the liquidators shall distribute the assets of the company. Pursuant to the third sentence of the section, shareholders shall have the right to a share in the distribution of the net assets of the company in proportion to their shareholding, unless it is otherwise provided in the articles of association.

in chapter 13, section 1, subsection 1 of the FLLCA[38], but it may also be extended to the distribution of assets of companies with a purpose other than producing profit to company shareholders, as well as to so-called continuous distribution of companies operating on the absorption principle.[39]

The scope of the solvency test under the NZ CA corresponds to the solvency and the balance sheet tests in the FLLCA, which are applied to all distribution of assets within a company, not only dividends.[40] The NZ CA solvency test also concerns all distributions. It is also applied when company assets are used to provide financial assistance for purchasing company shares.[41] The NZ CA defines distribution as the direct or indirect transfer of money or property to, or for the benefit of the shareholder, or the incurring of a debt to or for the benefit of the shareholder.[42] This division requires that assets be distributed to shareholders in proportion to the shares they hold.

> Haynes has interpreted the wording "in relation to shares held by that shareholder" rather loosely because channelling assets or financial profit to controlling shareholders based on other than shares held, may be prejudicial to minority shareholders or creditors. Haynes has also discussed whether the payment of wages in closely held companies should be interpreted as distribution and thus a measure requiring a solvency test. He concludes that the solvency test should also be applied to the payment of wages, if the company's result is made negative by paying wages to shareholders in the company, especially if the wages differ from market-based wages. [43]

The most important creditor protection provision in the NZ CA[44] is also structurally very similar to the solvency and balance sheet tests of the FLLCA. Both legal systems measure the distribution of assets by the assets indicated in the balance sheet and by the company's solvency, which measures the financial status at a more general level. One of the essential differences involves the content of the capital system relating to the permanence of assets. According to the FLLCA share capital credited to restricted equity, and legal and share premium reserves

[38] In accordance with chapter 13, section 1, subsection 2 of the Limited Liability Companies Act, company funds may be distributed to shareholders only as provided in the act on: 1) the distribution of profit (dividends) and funds from the reserve of unrestricted equity; 2) the decrease in share capital referred to in chapter 14 of the Limited Liability Companies Act; 3) the acquisition and redemption of the company's own shares, referred to in chapters 3 and 15 of the Limited Liability Companies Act; and 4) the dissolution and deregistration of the company in chapter 20 of the Limited Liability Companies Act.

[39] See Government proposal HE 109/2005 vp. p. 124.

[40] See New Zealand Law Commission, Report 9, 1989, p. 79: "The solvency test is applied in the draft Act to all distributions, including share repurchase as well as dividends." See also Ross, p. 177.

[41] NZ CA section 77, subsection 1. Financial assistance granted by a company for buying its own shares is not considered as the company's assets (receivables) in assessing whether the company passes the solvency test.

[42] NZ CA section 2, subsection 1, paragraphs a) and b).

[43] See Haynes, p. 127.

[44] Section 4, subsection 1.

pursuant to the Finnish Limited Liability Companies Act of 1978 may be distributed only by observing a special creditor protection procedure. Other items of equity (the valuation reserve, fair value reserve and revaluation reserve) are absolutely undistributable. The NZ CA does not divide equity into restricted and unrestricted, but defines company financing in terms of capital invested in the company, assets and liabilities.

The application of the solvency test pursuant to the NZ CA has caused problems similar to those that must be solved in the application of the solvency and the balance sheet tests in the FLLCA. According to *Ross*, practical problems are encountered with cash flow timing, the valuation of assets and liabilities, and basing the assessment of solvency on a statutory or other financial statement. The meaning that can be assigned to the opinion of accountants and other professionals on the solvency of the company has also proven problematic.[45]

IV. The Practical Significance of the Solvency Test

One of the purposes of the solvency test is to ensure that a company does not distribute its assets in a way that endangers its solvency when it according to the solvency test is possible due to unrealised increases in the value of unrestricted equity. The solvency test limits the abuse of management power and protects creditors.[46] The solvency test also avoids the unreliable aspects of the balance sheet test, in relation to e.g. intangible assets, or other goods[47] with valuation problems. In New Zealand, one of the strongest arguments for adopting the solvency test and abandoning the sole use of the balance sheet test was the difficulty in valuating and representing balance sheet items.[48]

One incentive to carrying out the solvency test is connecting it to the directors' potential liability in damages to creditors. If acting in violation of the test is damaging to a creditor, a

[45] See Ross, p. 180.

[46] "The Solvency test -- is pivotal to the scheme of the Act. It applies to all transactions which transfer wealth from the company to the prejudice of creditors and, where some shareholders only receive benefit, to the prejudice of non-participating shareholders. The test is designed to be a substantial constraint in such circumstances because they are those in which limited liability and management power are most open to abuse." New Zealand Law Commission, Report 9, 1989, p. 78.

[47] The preparatory work of the Limited Liability Companies Act mentions company acquisitions as an example, where the valuation of balance sheet items may be affected by the commercial value of the company acquired as well as by other possible benefits, such as synergy and economies of scale. See Government proposal HE 109/2005 vp. pp. 125-126. See also *Airaksinen, Manne & Pulkkinen, Pekka & Rasinaho, Vesa*: Osakeyhtiölaki II. Talentum. Helsinki 2007 (Airaksinen & Pulkkinen & Rasinaho II) p. 20.

[48] See Ross, pp. 190-191. Ross states that in New Zealand, company directors may, within the frames of the Financial Reporting Act 1993 and the Securities Regulations 1993, somewhat freely decide which items should be presented as assets or liabilities in the balance sheet, and which of them may be left out.

board member or the managing director may be liable in damages for losses.[49] Shareholders may also be held responsible for any loss that they, contributing to a violation of the act or the articles of association, have deliberately or negligently caused to the company, another shareholder or a third party.[50] Assets received from the company in contravention of the act or the articles of association are refunded, if the recipient knew or should have known of the violation.[51]

> A member of the board of directors or the supervisory board and the managing director shall likewise be liable in damages for a loss that he or she, in violation of other provisions of the act or the articles of association, has in office deliberately or negligently caused to the company, a shareholder or a third party.[52] A key point is that in such cases, a *presumption of fault* is applied, unless the liable person does not prove that he or she has acted with due care.[53] Such a situation may be at hand when the distribution of assets has led to insolvency, based on which the company is declared bankrupt and the creditors cannot be fully paid.

An essential factor in determining liability, and thus in the application of the solvency test, is what was or should have been known when making the decision to distribute assets. Information available for the test based on the course of subsequent events is irrelevant. According to the preparatory work for the FLLCA, the fact that a company becomes insolvent within a relatively short period of the distribution of assets does not yet indicate that the solvency test was violated.[54] The formulation "should have known" contained in the provision should be interpreted similarly to presumption provisions in general. *Airaksinen, Rasinaho and Pulkkinen* maintain that this expression brings a certain objectivity to the assessment of the situation. If the actor did not know of the insolvency, he or she is not discharged from liability solely on those grounds. Instead, what the person in his or her position should have known is also assessed.[55] The connection to the duty of care posed in Chapter 1, section 8 of the FLLCA, and the importance of the business judgement-rule seems obvious.[56]

[49] In accordance with chapter 22, section 1, subsection 2 of the FLLCA.

[50] According to chapter 22, section 2, subsection 1 of the FLLCA.

[51] Under chapter 13, section 4 of the FLLCA.

[52] According to chapter 22, section 1, subsection 2 of the FLLCA.

[53] Under chapter 22, section 1, subsection 3 of the FLLCA.

[54] See Government proposal HE 109/2005 vp. p. 125. For further information on the definition of the concept of insolvency, see e.g. Airaksinen, Pulkkinen & Rasinaho II, p. 21 and *Erkki K. Laine*: Maksukyky uuden osakeyhtiölain mukaan. Tilintarkastus 5/2006, (Laine 2006) p. 9-14.

[55] See Airaksinen & Pulkkinen & Rasinaho II, p. 22.

[56] For more details on the so-called fiduciary duties of management, see *Mähönen, Jukka & Villa, Seppo*: Osakeyhtiö I. WSOYpro Helsinki 2006 (Mähönen & Villa I) p. 107.

A similar system is in use in New Zealand. According to the NZ CA, a distribution made to a shareholder at a time when the company did not, immediately after the distribution, satisfy the solvency test may be recovered by the company from the shareholder.[57] However, the shareholder's refund obligation is limited. Distributed assets cannot be recovered if

a) the shareholder received the distribution in good faith and without knowledge of the company's failure to satisfy the solvency test,
b) the shareholder has altered his or her position in reliance on the validity of the distribution, and if
c) it would be unfair to require repayment in full or at all.[58]

Pursuant to the NZ CA, a director of a company is personally liable to repay the company so much of the distribution as is not able to be recovered from shareholders.[59] In addition to the supplementation obligation and liability in damages, company directors may also be sanctioned for violating the solvency test.[60] Directors in favour of a distribution are liable to a fine not exceeding 5 000 New Zealand dollars if they have failed to sign the certificate concerning the solvency test[61] or have neglected to state the grounds on which, in their opinion, the company would satisfy the solvency test after the distribution. If a director has signed the certificate fully aware of it being fraudulent or misleading, he or she may be sentenced to a fine of up to 200 000 New Zealand dollars or five years of imprisonment.

V. How Is Solvency Assessed?

V.A. Solvency or Insolvency?

There are at least four key questions related to defining the contents of a solvency test. One must establish,

1) whether it is a question of assessing insolvency or solvency,
2) when the test must be conducted,
3) which information serves as the basis for the solvency assessment, and
4) how far into the future the solvency test must extend.

[57] NZ CA section 56, subsection 1.

[58] Haynes considers it difficult to fulfil the refund criteria because fulfilment of paragraph b) requires active measures from the shareholder. See Haynes, p. 139. In comparing the national provisions, an interesting observation is that the refund obligation is assessed also on grounds of equity.

[59] NZ CA section 56, subsection 2.

[60] NZ CA section 56.2, subsection 2. See also Haynes, pp. 126 and 139.

[61] In accordance with NZ CA section 52, subsection 5: "[T]he directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test and the grounds for that opinion".

Even though these questions are seemingly separate and independent of each other, they are nevertheless connected to investigating one and the same matter. Therefore, they should also be considered as overlapping and intertwined.

In Finland, solvency tests must be based on the latest adopted financial statement, which must be evaluated along with other information affecting solvency, taking also into account the business forecasts of the company. The preparatory work on the FLLCA recognises the difficulty of determining insolvency, and it does not aim for an exhaustive explanation concerning insolvency or the contents of the insolvency test.[62] In fact, the questions above cannot be answered unequivocally; they always depend on the context and actors involved. Therefore, the ambiguity of the concept of solvency and the open-endedness of the solvency test are susceptible to criticism. Interpretative guidance can only be obtained from subsequent legal practice.

Pursuant to NZ CA[63], a company is solvent, if it is able to pay its debts as they become due in the normal course of business,[64] if the value of its assets is greater than the value of its liabilities. In New Zealand, there has been discussion especially concerning the meaning of the phrase "*ability to pay debts as they become due*" and how company solvency is measured.

Haynes has analysed legal cases, and based on them, listed five points which may be of assistance in interpretation. First, it is imperative to assess solvency based on the date of payment and to some extent also on the recent past and near future. Second, attention should be paid to the total amount of debts. Third, the date of payment refers to liabilities becoming legally due. Fourth, assets must be assessed base on their liquidity, and lastly, the solvency test must be carried out objectively. However, *Mike Ross* maintains that the test focuses on estimating future cash flows. Nonetheless, there are no guidelines on how far into the future the directors should gaze, but the directors make the decision based on their ability to evaluate the company's business activities and solvency in a professional manner.[65]

Insolvency in the FLLCA is not the same kind of insolvency that is referred to in, for instance, the Finnish Act on Recovery to an Estate in Bankruptcy.[66] Nonetheless, interpretation of the

[62] See Government proposal HE 109/2005 vp. pp. 125-126.

[63] NZ CA section 4, subsection 1, paragraph a and b.

[64] The sentence has been interpreted as meaning that the company must be able to pay its debts as they become due from the viewpoint of normal business activities. The payment of debts that are not expected to fall due does not need to be taken into account in the test. See Haynes, p. 130.

[65] As the assessment period for cash flows, Ross recommends the business cycle following the date of comparison, which most likely means the planning period for the following financial period. See Ross, p. 182. Naturally, the planning may focus on a period other than the financial period.

[66] Finnish Act on Recovery to an Estate in Bankruptcy (758/1991).

concept may be aided by other provisions which contain the concept of insolvency.[67] One should, however, bear in mind in the interpretation that the FLLCA refers not only to the assessment of insolvency, but also that of future solvency. The concept of insolvency adopted in the act on recovery to an estate in bankruptcy should therefore not be applied as such to company law and in particular to the distribution of assets, because the FLLCA constitutes special legislation in relation to the act on recovery to an estate in bankruptcy.[68] The interpretative rule of *lex specialis* thus governs; a general law can only be used to the extent the specialized law is silent.

V.B. When Should Solvency Be Assessed?

Insolvency should be assessed at the moment assets are distributed, or at least as close to it as possible.[69]

> "Assets shall not be distributed, if it is known or should be known at the time of the distribution decision that the company is insolvent or that the distribution will cause the insolvency of the company."

The chosen wording supports the interpretation that the test should be carried out as close as possible to the actual distribution decision. It is common company practice that the directors carry out the test in connection with proposing a distribution to the general meeting.

On the other hand, it is the duty of the board of directors to implement the decisions of the general meeting, and the directors may not comply with a decision by the general meeting or the board of directors which is contrary to the FLLCA or the articles of association. Such decisions are inherently void, and thus the board of directors must always verify that any decision it makes on the distribution of assets is, in fact, in accordance with the FLLCA even at the time of implementation.[70] If the board of directors observes that the solvency of the

[67] The concept of insolvency can be found at least in the Bankruptcy Act (120/2004), the Penal Code (39/1889), the Restructuring of Enterprises Act (47/1993), the execution act (37/1895), the Pay Security Act (866/1998) and the act on financial supervision (587/2003). *Erkki K. Laine* has analysed the contents of the concept of insolvency based on legislation. See *Erkki K. Laine*: Maksukyky uuden osakeyhtiölain mukaan. Tilintarkastus 5/2006 pp. 8-17 (Laine).

[68] See Airaksinen, Pulkkinen & Rasinaho II, p. 23 and especially *Ahti Kaarenoja & Seppo Suontaus*: Maksukyvyttömyys ja osakeyhtiön varojenjako. Defensor Legis 2007, pp. 239-256 (especially pp. 246-248). (Kaarenoja & Suontaus 2007).

[69] See Government proposal HE 109/2005 vp. pp. 125-126.

[70] The prohibitive provision in the Limited Liability Companies Act, chapter 6, section 2, subsection 2 concerns all decisions made by the company's organs that require implementation measures. Before implementation, the board of directors or its individual members have the duty to examine whether the decision is legal in both form and content. If the decision to be implemented is in violation of the Limited Liability Companies Act or the articles of association, and thus invalid, the board of directors shall not comply with it.

company has decreased to the extent that there is a risk of insolvency, if the decision is implemented, the board of directors[71] is obligated not comply with the decision.[72]

The duties of the board of directors are not affected by whether the company was solvent at the time of the distribution decision but insolvent at the time of implementation, or whether the board knew or should have known that a distribution would lead to insolvency. The board of directors is considered to have a constant obligation to update and examine the solvency test as it implements the general meeting decision.[73] Similarly, the director is always responsible for performing the solvency test and it applies to all distribution of assets in New Zealand. The directors must also prepare a certificate regarding solvency[74] when it distributes the company's assets.[75]

V.C. What Information Serves As the Basis for the Assessment?

The assessment of solvency should be based on all available information on the company's financial status. Thus, it is not merely a question of the latest adopted and audited financial statement, but of all information produced in connection with the company's business-related information flows, describing and measuring the company's financial status. Therefore, it is a question of a constantly augmenting information flow. The latest adopted (and audited) financial statement does, however, play a pivotal role. Firstly, it indicates the amount of unrestricted equity which may be distributed.[76] Secondly, it lists the items related to a company's solvency, such as the amount, form and type of assets, the liquidity of assets, the amount of liabilities and its division into short-term and long-term liabilities.

[71] Pursuant to chapter 6, section 19, subsection 1 of the Limited Liability Companies Act, the same applies to the managing director as to members of the board of directors under chapter 6, section 2, subsection 2 of the same act with regard to invalid decisions.

[72] If the solvency of a company is in critical condition and it is not certain at the time of deciding on the distribution of dividends that the company would remain solvent after the distribution, a recommendable measure would be for the general meeting to authorise the board of directors to decide on the distribution of dividends. The board may then schedule the distribution for a time when the solvency test, which is under its responsibility, will indicate that the solvency of the company is sufficient.

[73] The same is required if the board of directors distributes assets based on an authorisation from the general meeting. The board must be sure as it distributes assets that the distribution is not in violation of the solvency test pursuant to chapter 13, section 2 of the Limited Liability Companies Act.

[74] NZ CA section 52, subsection 2: "The directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test and the grounds for that opinion".

[75] This is natural since under NZ CA section 52, subsection 1, the board of directors is entitled to decide on distributions as it sees fit: "[T]he board of a company that is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the solvency test may, subject to section 53 of this Act and the constitution of the company, authorise a distribution by the company at a time, and of an amount, and to any shareholders it thinks fit".

[76] In accordance with chapter 11, section 1 and chapter 13, section 5 of the FLLCA.

> The solvency ratio may be characterised as a concept describing the financial standing of the company, which cannot be measured with individual parameters. It is described by analysing a combination of several parameters, the nature and conditions of fund-raising, the focus and contentual quality of the use of funds. Based on this overall analysis, a company can be declared solvent, or certain financial measures involving the company, such as selling shares or changing short-term debts to long-term or lowest priority debts, may be stated to strengthen the company's solvency.[77]

Solvency assessments based on balance sheets are connected with a company's *static* solvency. They assess the relation of the company's short-term liabilities and liquid assets.[78] Static solvency simply measures whether a company has sufficient liquid assets to repay its liabilities according to its financial obligations timely and in the proper amount as they fall due.[79] If the payments cannot be made, the company must be considered insolvent.[80] The assessment of solvency based on the company financial statement is tied to the financial status at a specific point in time, when the company's assets and liabilities are compared according to the conditions at that time.[81] The point-wise measurement of financial statement information provides information on the recent history, but not necessarily on whether the company is solvent at them moment of measurement or will be in the near future.

Founding the company's solvency assessment on static solvency alone is not sufficient. A balance sheet assessment is an examination of a single point in time and therefore does not provide a comprehensive picture on the company's ability to repay its liabilities. In addition, the assessment should include *dynamic* solvency. Dynamic solvency means that the company has

[77] See *Seppo Villa*: Pääomalaina. A study on company legislation and obligations involving equity loans in Finland, Jyväskylä 1997, pp. 67-69, which states e.g. that assessments of a company's solvency should be understood as tools provided by business studies that investigate financial operation. These tools provide further grounds for decisions concerning a company's financial, investment or other decisions.

[78] Traditional solvency parameters include the quick ratio (liquid assets/short-term debts), the current ratio (current and liquid assets/short-term debts) and the amount of liquid assets. Comparing the proposed distribution of dividends to liquid assets is one way of documenting the maintenance of solvency after the distribution. However, all of the above-mentioned parameters are static, balance sheet based parameters tied to a specific point in time. As Mike Ross states: "Financial ratios are of limited benefit in assessing future solvency because they are based on historical data. -- Nevertheless, they are widely used by financial institutions and security analysts, in the absence of any alternative. They reflect a company's ability to pay debts as they fall due in the normal course of business out of working capital". Ross, p. 184.

[79] *Erkki K. Laitinen* considers that a company's insolvency means the company's inability to repay its financial obligations as they become due. *Erkki K. Laitinen*: Yrityksen maksukyvyttömyyden arvioiminen taloustieteen näkökulmasta, Lakimies 1996, p. 1169. See also *Yrjö Tuokko*: Maksukyvyttömyydestä ja pysyvästä maksukyvyttömyydestä. Defensor Legis 1995, p. 290.

[80] For further information on the contents of the concept of insolvency, see Kaarenoja & Suontaus 2007, pp. 239-256.

[81] See e.g. *Risto Koulu*: Yrityssaneerausmenettelyn aloittaminen. Vammalla 1994, p. 239.

sufficient revenue to pay its current expenses. In the words of *Ross*: "there must be sufficient cash available to meet the company's existing commitments."[82]

The going concern in a company is based on positive cash flow, which may consist of both the capital investments received by the company and funds generated from operations. Solvency should be at a level that allows the company to repay its financial obligations in both the short and the long term. A key criterion in assessing a company's solvency and maintaining it regardless of distributions, is the company's cash flow forecasts, which take into account future revenue and payments that are based on both cash flow and capital financing.[83] In carrying out the assessment, one should, however, bear in mind that the assessment is connected to future events, which are liable to change.

Since the solvency test under the FLLCA has an element focused on the future, it is somewhat difficult to assess how and to what extent the company management should be able to assess future solvency. The third sentence of chapter 13, section 3 of the FLLCA requires that essential changes in the financial position of the company after the completion of the financial statement shall be taken into account in the distribution. Naturally, these changes will not be indicated in the latest financial statement, which means that other tools must be used. As the company's profitability affects both solvency and cash flow; low profitability is a strong indicator that the company's solvency at the moment of distribution and in the future must be determined using other tools. In their publication on insolvency and the distribution of assets in a limited liability company, *Kaarenoja* and *Suontausta* come to the conclusion that a distribution proposal should be based consistently on reports on the current status and future forecasts.[84]

Dividends that have not been distributed, but have fallen due according to a decision by the general meeting can be credited as the company's debt to shareholders. However, the financial nature of the dividends will not take on the financial nature of debt, which could be paid without regard to the solvency test. However, this kind of situation has its problems. The normal financing of a company entails that the distribution of dividends can also be financed by new debt. In such cases, of course, cash flow forecasts must be updated to include the repayment and interest on the new loan in order to show that the company has maintained its solvency despite the additional debt. Accordingly, the board of directors must, make sure that they do not compromise the solvency of the company, because the company must remain

[82] Ross, p. 183.

[83] Kaarenoja and Suontaus conclude that the essential going concern and solvency assessment criterion are the company's cash flow forecasts. See Kaarenoja & Suontaus 2007, p. 256.

[84] See Kaarenoja & Suontausta, p. 255. In an uncertain situation, the board of directors should carefully examine the current status of the company: assess the static and dynamic solvency. In addition to the current state, the directors should sufficiently forecast future trends.

solvent both when a decision to distribute dividends is made and when dividends-based liabilities are repaid.[85]

Obviously, the FLLCA does not specify how the company management should determine that the company is and will remain solvent after a distribution decided on by the management.[86] It is up to the company management to decide how it carries out the solvency test related to the distribution of assets. The key point is that management is aware of its responsibility to conduct the test and understands that neglecting to perform it, or performing it without due care, may lead to personal liability for damages.

> The FLLCA, chapter 1, section 8, lays down a duty of care and loyalty.[87] Management is required to act with due care in performing the solvency test, which may in practice be assessed to the extent required by the business judgement rule[88]. The way how the solvency test is carried out is also affected by the presumption of fault in the FLLCA.[89] A loss shall be deemed to have been caused negligently, insofar as the person liable does not prove that he or she has acted with due care.[90]

Similarly, the company management must base the solvency test on the company's most recent financial statements in New Zealand and they may rely on valuations of assets or estimates of liabilities therein. In addition to the information in the balance sheet, the directors must take into account all other circumstances that they ought to know of[91] and that affect or may affect the amount of the company's assets or liabilities. The liabilities also include contingent liabilities.[92]

In the assessment of balance sheet-based information, the completion of the NZ CA solvency test does not differ from the solvency and balance sheet tests under the FLLCA. The assessment must take into account the operation of the company:

[85] In accordance with chapter 1, section 8 of the FLLCA.

[86] See also Airaksinen & Pulkkinen & Rasinaho 2007, p. 23, which states that the provision lays down no requirements that the board of directors or the general meeting should prepare e.g. a statement on the sources and uses of funds to support the distribution unless there are special grounds for it. Special grounds might include low profitability, or a poor financial standing or result, or the management knowing that the company may have difficulties in repaying liabilities due in the near future in the proper amount and time.

[87] For further information, see e.g. Mähönen & Villa 2006 I, p. 107.

[88] See Mähönen & Villa 2006 I, pp. 112-115, and in this connection especially Kaarenoja & Suontausta, pp. 254-255.

[89] Under chapter 22, section 1, subsection 3 of the FLLCA.

[90] For further information on the presumption of fault, see e.g. *Mähönen, Jukka & Villa, Seppo*: Osakeyhtiö III. Corporate Governance. WSOYpro. Helsinki 2006, p. 290. (Mähönen & Villa 2006 III).

[91] In accordance with NZ CA section 4, subsection 2, paragraph a, subparagraph I, and with section 4, subsection 2, paragraph b. Similar to the formulation of chapter 13, section 2 of the Limited Liability Companies Act: "is known or should be known at the time of the distribution decision". The provision requires careful consideration and a "professional" approach to the assessment of the company's financial status.

[92] NZ CA section 4, subsection 2, paragraph a, subparagraph ii.

1) whether the assessment is carried out with an eye on the "going concern"-situation or the dissolution of the company,
2) whether the cash flow of the company consists of the employees' work contribution when the balance is low, and
3) whether balance sheet items have special financial characteristics.[93]

Especially the financial characteristics may be connected with e.g. the valuation of subordinated loans and taking into account contingent liabilities. The NZ CA specifically requires that the solvency test must take into account, not only items in the most recent financial statement, but also contingent liabilities on the company's financial status.

The assessment of the value and liquidity of assets and due debts is obviously difficult and tied to each assessor's subjective views. In conducting the solvency test, the management may use financial material produced by the company itself. In addition they may use assessments on the company's solvency at the time of distribution, and in the future, from financial advisers and persons responsible for budgeting and reporting. NZ CA section 138 specifically secures the right of the management to rely on financial data and statements supplied by outside financial advisers, such as:

a) An *employee* of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned:
b) A *professional adviser or expert* in relation to matters, which the director believes on reasonable grounds to be within the person's professional or expert competence.

This kind of information is acceptable for the purposes of conducting the solvency test on the condition that the directors act in good faith, make proper inquiry where the need for inquiry is indicated by the circumstances, and have no knowledge that such reliance is unwarranted. In addition, the directors' general duty of care in handling company affairs is applicable.[94] A director may avoid personal liability if he or she has; taking the conditions into consideration, relied on information supplied by a reputable adviser and has had no reason to suspect that the information is fraudulent. The use of an outside adviser does not, however, absolve the management from responsibility, but it does have weight in evaluating whether a director has acted with due care.

[93] See Haynes, pp. 131-132.

[94] NZ CA section 137, subsection 1 provides the general duty of care of management. The provision states the following: [A] director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation a) the nature of the company; b) and the nature of the decision; and c) the position of the director and the nature of the responsibilities undertaken by him or her. This is similar to the Limited Liability Companies Act, chapter 1, section 8, under which the company management shall act with due care and promote the interests of the company.

VI. Certificate on Satisfying the Solvency Test

The NZ CA is dispositive, and it provides management with an extensive authority to, for instance, distribute company assets. Thus, it is understandable that special attention has been paid to the lawful distribution of assets. One such feature, with no equivalent in the FLLCA, is the obligation of directors, who vote in favour of a distribution, to provide a certificate concerning the solvency test.[95] The certificate must state that, in the opinion of the undersigned, the company will, immediately after the distribution, satisfy the solvency test in terms of amount of net assets available and liquidity.[96] In addition, the certificate must state the grounds for the opinion of the undersigned. Failure to provide such a certificate is sanctioned.[97]

According to *Haynes*, the fulfilment of the balance sheet and liquidity tests required for the solvency test must be presented separately. He also maintains that the certificate should indicate that the conclusions were drawn on reasonable grounds after detailed consideration.

In Haynes' opinion, the certificate should include at least the directors'

1) estimation on by how much the company's assets exceed its liabilities,
2) statement that nothing has occurred after the latest financial statement that would obligate changing the financial status indicated in the financial statement,
3) report that the financial statement was analysed with care, taking into account all of the known valuation questions involving the assets and liabilities in the balance sheet,
4) report on adviser statements on ambiguous valuation questions,
5) account on the essential risks involved in the company's activity and financial status,
6) account on the reasonable grounds for the directors' assessment,
7) account on whether the company is able to repay its liabilities as they fall due in the normal course of business, and
8) account on the company's contingent liabilities and their assessment methods. [98]

VII. Conclusions

After comparing the solvency and balance sheet tests of the FLLCA to the solvency test under the NZ CA, it can be concluded that they are very similar, despite minor substantive differences. In comparing the two, it is especially notable that the capital systems pursuant to

[95] The directors may sign the same certificate or separate ones in the same terms (NZ CA section 394).

[96] In accordance with NZ CA section 52, subsection 2.

[97] See NZ CA section 52.5, subsection 2.

[98] See Haynes, pp. 135-136.

the NZ CA and the FLLCA have some structural differences. No minimum amount is set for share capital, nor are assets divided into restricted and unrestricted equity in the NZ CA, as they are in the FLLCA. A significant difference between the systems is that the board of directors is authorised to distribute company assets to shareholders as it sees fit and to the extent it considers appropriate in New Zealand.

In both systems, the tests apply to all distribution of assets – that is, the distribution of profit or repayment of capital invested in the company. As a condition for the distribution of assets, the systems specify that the latest adopted financial statement must indicate that the company does, in fact, have assets that it can distribute to shareholders. The NZ CA specifically requires that distributions must be based on the latest financial statement, which has been drawn up in accordance with legislation in force concerning financial statements.[99] According to the FLLCA[100], distributions must be based on the latest adopted financial statement, and the company must select an auditor and the financial statement must be audited.[101] The NZ CA, the distribution of assets presupposes that the company's assets exceed its liabilities, and the FLLCA presupposes that the company has unrestricted equity for the distribution without resorting to the creditor protection procedure.

The rather modern solutions in the NZ CA of 1993, which largely resemble the American Model Business Corporations Act (MBCA), aim to ensure, firstly, that only assets that exceed the amount of liabilities are distributed, and secondly, that the company maintains its solvency despite the distribution.[102] In the measurement or assessment of company solvency, there are no significant differences. Satisfying the tests presupposes that the company is, despite the distribution, able to repay its liabilities in the proper amount as they fall due.

In both systems, conducting the test is the management's responsibility. Fulfilling the requirements of the tests includes that the management must assess not only the solvency at the

[99] In accordance with the Financial Reporting Act, section 10 (Obligation to prepare financial statements): (1)The directors of every reporting entity must ensure that, within 5 months after the balance date of the entity or, where the entity is required by any other Act to prepare financial statements or accounts within a shorter period after the end of its financial year or balance date, within that period, financial statements that comply with section 11 of this Act are: (a) Completed in relation to the entity and that balance date; and (b) Dated and signed on behalf of the directors by 2 directors of the entity, or, if the entity has only 1 director, by that director. (2) The directors of every exempt company must ensure that within 5 months after the balance date of the company or, if all the members or shareholders of the company agree, within 9 months after the balance date of the company, financial statements that comply with section 12 of this Act are: (a) Completed in relation to the company and that balance date; and (b) Dated and signed on behalf of the directors by 2 directors of the company, or, if the company has only 1 director, by that director.

[100] Chapter 13, section 3 of the Limited Liability Companies Act enters into force in this form on 1 July 2007 (see 461/2007).

[101] If so provided in the FLLCA or the articles of association.

[102] In this respect, the solvency test also satisfies the requirement under article 15, paragraph 1, subparagraph a of the Second Company Law Directive that only net assets may be distributed.

moment of distribution, but the effect of the distribution on the company's financial status in the near future, by taking into account the repayment of liabilities to interest groups. The NZ CA requires that the solvency test be applied also to the company's obligation to distribute dividends to holders of preferred shares.

The systems differ especially in that the directors are required to sign a certificate stating that the company has satisfied the solvency test under the NZ CA. The certificate is the directors' assurance to interest groups on the fact that the company is and will remain solvent despite the distribution. The certificate must also state the grounds on which the directors consider the solvency test satisfied. The FLLCA solvency test may be criticised of an ambiguous content and of providing insufficient information on how solvency should be assessed. In addition, interest groups do not, in the absence of specific provisions obligating the company thereto, receive information on whether the test has been carried out, how, and based on what information.

Requiring a certificate or assurance similar to the one under NZ CA, would undoubtedly improve the position of interest groups and their possibilities to consider their own risks in relation to those involving the company. The adoption of this kind of a provision must be considered recommendable *de lege ferenda* as a factor that strengthens legal certainty. *Haynes* aptly comments on the connection between the liberalisation of company legislation and the solvency test:

> ”While directorial freedom is expanded under the regime, the solvency test operates as a significant restriction, enhancing scrutiny of directors' activities and providing greater transparency of company distributions”.[103]

However, the importance of the solvency test should not be overemphasised. The provision in chapter 13, section 2 of the FLLCA is to be applied similarly to other provisions in the act. For instance, if a company becomes insolvent relatively shortly after a distribution, it does not necessarily mean that the test was not carried out with due care or was neglected completely, since it is common knowledge that business involves both known and hidden risks. Thus, the management is not expected to foresee "a bolt out of the blue", and the provision should not be applied as an afterthought. Although "reasonable grounds" should, in principle, be interpreted objectively, it involves a subjective element that concerns each actor, according to which a director is not responsible for what he or she did not or was not expected to know.[104]

[103] Haynes, p. 141.

[104] See Haynes, p. 138.