SOLVENCY - WHY IS THIS AN IMPORTANT ISSUE FOR ME? WHAT SHOULD I DO?

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Policy of the Companies Act 1997

The shareholders of a company enjoy limited liability. Once they have paid the amount due on their shares, they have no further obligation. They cannot, except in special cases, be required to contribute to debts owed by the company to third parties or to creditors of the company.

So creditors of the company must have some reasonable protection; some expectation that they will be paid. Company law in all countries has provision to give confidence to creditors and investors. It is common practice that controllers of companies who know, or should have known, that the company could not pay the debts they were allowing the company to incur, should be made personally liable for those debts.

In the past there were other measures, such as those designed to maintain capital. But they were restrictive, and sometimes worked against good commercial practice. So instead, the Companies Act 1997 has given company directors much, much more freedom of action, but in return has imposed obligations on them - and penalties if they fail those obligations.

The principle now is: “Let the managers manage, but make them accountable”.

They are not made accountable when decisions which have been carefully considered prove to be errors of human judgment, because making a profit always involves some risks - managers are expected to take carefully considered risks in pursuit of profits.

But directors are made personally accountable - made to repay out of their own personal money if the company cannot - when they are careless, reckless, negligent or indifferent to the proper claims of others.

Directors now have more freedom - and more obligations.

Why solvency is a particular concern for directors in PNG

If a company or organisation becomes insolvent, or may possibly become insolvent, there are major issues for the directors, board members or controllers - in whatever country or jurisdiction the organisation may be.

The particular concern in PNG is that there are *two* tests of solvency. Many countries or jurisdictions have only one test of solvency - one which deals with the capacity of the organisation to pay its debts as they fall due. This is sometimes called a "flow" test or 'trading solvency'. In PNG however, there is a second test - what is sometimes called a "position" test or 'balance sheet solvency', namely the assets of the company must be greater than its liabilities.

To be solvent, a PNG company must satisfy *both* tests. As a result, there are more opportunities for it to be classed as insolvent; there are more things to which a director must pay particular attention.

Whose problem is it?

Surely this is an issue for the company's accountants? This is about figures, so surely it can be left to the accountants?

No. Not so.

The law makes each director responsible.

The consequences and the penalties apply to directors; possibly to some senior officers of the company also, but certainly to directors.

It is the directors who are sued; the directors who may go to gaol; the directors who may lose their house and assets.

Directors may delegate the work of compiling the accounts to officers or accountants, but it is the responsibility of the directors to understand them.

Directors are expected by law to consider the accounts of the organisation and be able to understand them. Ignorance is no excuse.

> In particular, the stage has been reached when a director is expected to be capable of understanding his company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity. Moreover, he is under a statutory obligation to express such an opinion annually.
>
> I think it follows that he is required by law to be capable of keeping abreast of the company's affairs, and sufficiently abreast of them to act appropriately if there are reasonable grounds to expect that the company will not be able to pay all its debts in due course and he has reasonable cause to expect it."
>
> Tadgell J., re National Safety Council of Australia (Victorian Division) 1991.

The consequences for me as a director or board member

If a company or organisation attempts to carry on after failing one or other of the solvency tests, or if the directors fail to comply with the requirements of the Companies Act in relation to solvency, there may be - depending on the particular circumstances - any of these consequences:

- penalties imposed under the Companies Act. For example, penalties of K5,000 for failure to comply with section 50 (regarding distributions) or section 234 (regarding amalgamations), penalty of K10,000 for failure to lodge the annual return;

- civil liability to repay money to the company from the private assets of the director. For example under section 348 (failure to prevent insolvent trading) or section 54 (a distribution deemed not to be validly made);

- criminal consequences where fraud or other criminal act may arise from the continuation of company activities with reckless indifference, reckless carelessness, obtaining an improper benefit, or while knowing that the company would be unable to pay the liabilities it incurs.

Examples

There do not seem to be any examples in PNG case law reports.

However a well-known Australian example concerns the National Safety Council of Australia (Victorian Division). The CEO, John Friedrich, committed fraud and, in doing so, duped not only the creditors of the company but also the other directors.

A major creditor, the Commonwealth Bank of Australia, sued the Chairman Max Eise, a part-time, non-executive, honorary Chairman with a long history of community work for small reward. The bank obtained judgment against him for an amount between A$96 and A$97 million! All applications to the Victorian Supreme Court by Eise were rejected. He had signed the Director's Statement and Director's Report presented to him without really understanding them, and thus had falsely represented the company.

He lost his house and everything he owned.

As another indication, on 18 December 2002 the Australian Securities and Investment Commission released the stage one results of its most recent survey project of companies listed on the Australian Stock Exchange. Seventeen percent of listed Australian companies face solvency issues, the enquiry found. It found that 166 out of 1,000 companies listed on the exchange had solvency issues, and another 31 companies remained in question!

The tests of solvency

Section 4 of the Companies Act provides that a company satisfies the solvency test where:

(a) the company is able to pay its debts as they become due in the ordinary course of business; and

(b) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities.

In relation to the second of these tests, the directors:

- should have regard to the most recent financial statements;
- should have regard to all other circumstances that the directors know or ought to know;
- may rely on reasonable valuations of assets and estimates of liabilities; and
- in considering contingent liabilities, may take account of the likelihood of the contingency occurring and any reasonable counter-claim.

In section 50, which deals with distributions, there is further amplification of the terms "debts" and "liabilities".

Specific provisions of the Companies Act 1997

Specific references to solvency in the Companies Act are:

Section	
50	Distributions may be made only if the company remains solvent afterwards. "Distribution" is defined very widely in section 2. It includes dividend, return of capital, redemption or acquisition of shares, purchase of property from a shareholder, incurring a debt to a shareholder, transfer of property to a shareholder.
53(3),(5)	Shareholder discounts.
54(1),(2),(3),(5)	Recovery of distributions which make the company insolvent. If they cannot be recovered from the recipient, they may be recovered from directors.
58(1),(2)	Contract by the company to purchase its own shares.
63	Giving financial assistance to acquire shares in itself.
89(3),(4),(5),(6)	Transactions by unanimous agreement of shareholders which result in insolvency.
96(1),(2)	Exemption from minority buy-out rights if it would result in insolvency.
234, 235	Amalgamation
348	Recovery where directors fail to prevent insolvent trading of the company.
349	Recovery where directors fail to prevent insolvent trading of a subsidiary.
Schedule 6, Item (t) Annual Return Item 29	Declaration of solvency as part of the annual return.

When is a Certificate or Declaration of Solvency required?

(1) Distributions - section 50. The directors who vote in favour of the distribution must sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test.

The penalty for failure to sign the certificate - K5,000.

A suggested form of certificate appears below.

(2) Amalgamations - section 234 and 235.

A certificate is to be signed that the directors are satisfied, on reasonable grounds, that the amalgamated company will, immediately after the amalgamation becomes effective, satisfy the solvency test.

(3) Annual Return, Item 29 - Schedule 6, Item T of the Companies Act.

The annual return contains a declaration, pursuant to a resolution of the board, that the company satisfies the solvency test.

Operation of the Solvency Test

The specific provisions fall into three categories:

(1) An embargo on certain activities if they would result in the company failing the solvency test.

For example sections 50, 53, 58, 63, 89, 96.

In some cases this is accompanied by a requirement for a certificate by directors which both focuses their minds and has an element of "holding out" the continued viability of the company.

In three cases, failure to complete the certificate is an offence resulting in a penalty. The offence is failing to complete the certificate. Nothing flows immediately if the certificate is signed, but wrong.

(2) Enabling a recovery of funds for the benefit of the company and its creditors;

Section 54 - Recovery of distribution;

Sections 348, 349 - Recovery following a failure to prevent insolvent trading.

(3) A holding-out by the board of the viability of the company - annual return Item 29.

Recovery of money for the benefit of the company and creditors

Section 54 deals with recovery of distributions which result in insolvency. The transaction is deemed cancelled; the company can recover from recipients or, if not, from directors.

Section 348, dealing with insolvent trading, addresses situations in which directors may be made personally liable - liable to repay from their own assets - for allowing the company to trade while it is insolvent. This is a big concern for directors.

But it is rather limited in scope. Sub-section (2) makes it a pre-condition of any order by the Court for repayment that the company has been liquidated. Thus the section can only come into effect, and liability for insolvent trading will only arise, where the company has been placed in liquidation. The grounds for putting a company in liquidation are in section 291(3) and expanded in section 335. These grounds do *not* include that the company is insolvent or has failed the solvency test. Instead, the first ground for liquidation (and doubtless the most common) is that the company "is unable to pay its debts as they fall due in the ordinary course of business". This is the first of the two tests of solvency - the flow test - but only the first test! The second test - the "position" test - is apparently irrelevant for the purposes of sections 348 and 349 except

to the extent that it may be an element in one of the other grounds of section 291(3) and this is rather unlikely.

The conclusion is that, as far as it affects personal liability of directors for insolvent trading, the second limb of the solvency test is a "toothless tiger". However it is still relevant for the recovery of distributions (section 54) and for the consequences at common law of the holding-out by the directors of the viability of the company.

Implications of the Solvency Test for accounting methodology

Reporting companies which meet their accounting obligations will have accruals-based accounts and, if these are up to date, their directors should have available to them information to satisfy themselves of company solvency.

Exempt companies are not required - for compliance purposes - to prepare cash flow statements, so their directors are disadvantaged when considering company solvency. They may find it prudent to insist upon cash flow statements.

Directors or board members of organisations which prepare accounts on a cash basis rather than on an accruals basis are considerably disadvantaged when considering the organisation's solvency. This applies commonly to incorporated associations and also to government instrumentalities and statutory authorities.

Solvency and statutory authorities

Statutory bodies are established under their own constituent legislation. Such statutes may, but rarely do, make provisions in relation to insolvency and the consequences thereof.

These statutes may adopt parts of or principles from other statutes. The Public Finances (Management) Act 1995 Part VIII applies to those public bodies which adopt its provisions in their statutes. An officer of the authority who is deemed by the constituent statute to be a "Department Head" has very wide powers to impose a "surcharge" (as it is there called) and each of the subject events constitutes an offence and gives rise to a penalty.

Whether or not the constituent statute adopts those provisions, there is again the common law and criminal law applying to board members. The conduct of activities of the authority with reckless indifference, reckless carelessness, by obtaining a secret commission, by obtaining an improper benefit or by knowingly permitting the organisation to incur liabilities it is unable to meet may be fraud or other criminal act.

The Leadership Code of Papua New Guinea is relevant also.

Solvency issues and incorporated associations

Neither the Associations Incorporation Act nor Regulations nor the Model Rules contain express provisions regarding solvency.

But board members are still subject to the common law and the criminal law. As noted above in the case of statutory authorities, the conduct of activities by the association with reckless indifference, reckless carelessness or by knowingly permitting the association to incur liabilities it is unable to meet may be fraud or other criminal act.

I am a Director, what should I do?

(1) Recognise that it is ***my*** problem.

I cannot "leave it to the accountants".
As a director I am responsible, not the accountant or employees.

I can delegate the work and compiling of accounts, but I cannot delegate the responsibility.

It is me who will be sued; me who will go to gaol; my assets which will be taken.

(2) Make sure that I know how to make *at least* these basic checks of solvency in my organisation

(a) Liquidity or 'flow' tests
- current ratio; and
- quick and acid test.

(b) Asset-to-debts or 'position' test
- assets greater than liabilities, including contingent liabilities

If I do not know how, I must find someone to teach me.

(3) Consider the adequacy of the accounting figures provided to me;

(a) for *every* board meeting, insist that I am provided with a set of accounts from which I can make *at least* the calculations mentioned above;

(b) are the accounting figures up to date? Why not? What am I, as a director or board member, doing about it?

(c) am I provided with a cash flow statement, which I need for management purposes, even if not for compliance purposes?

(d) are the accounting figures proper accruals-based figures?

(e) are the figures given to me in sufficient time before the meeting so that I have enough time to consider them?

(4) Having received these figures, take time to consider them. Do *at least*:

(a) the checks of solvency mentioned above; and

(b) Do them for the past 2, 3 or 4 periods to find the trend.

(5) Be alert to well-known "danger signs". See below.

(6) Identify about three or four key indicators or 'success factors' of my business and monitor them carefully. The choice of key indicators will depend on the type of business. For example, if the company gives credit, a key indicator might be the average number of days that amounts owing are outstanding.

How to recognise potential insolvency - warning signals

These are just some. None are conclusive. Nor are they the only symptoms. But if a number of these occur, directors should be alert! They are not in any special order. A more complete list appears on this site also.

- A generally poor financial position, plus:
  - trend is to a weaker financial position; or
  - high level of borrowings in relation to assets.

- Difficulty in obtaining from staff complete and up-to-date financial information.

- Information available to directors for meetings is neither adequate nor timely.

- The reputation of the company within its industry is deteriorating - there is gossip about the company.

- Suppliers to the company are being asked to extend the time for payment.

- The length of time it takes to pay creditors (the 'day's creditors' ratio) is increasing significantly. This applies particularly to payments of VAT, superannuation payments to NASFUND and payments to the Government of PAYE tax deductions from salaries.

- Management neglects or omits important tasks, this often being related to inexperience or attitude or inadequate procedures.

- Inattention to risk management policies and their implementation resulting in forseeable catastrophes for which there was no planning

- There is an increasing number of court judgements being obtained against the company by creditors.

- From the statement of cash flows

  - Are receipts from customers lower than payments to suppliers and employees? Or is the excess of receipts very small?
  - Is the net cash flow from operating activities negative or relatively small?
  - Is the net cash flow from operating activities lower than the operating profit for the year?
  - Have the auditors qualified their report in any way?

- Financial ratios

  - Are the current ratio and acid test ratios declining while the days creditors are outstanding is increasing?
  - Are the current ratio and acid test ratios low?

I am concerned about insolvency of my organisation - What action can or should I take?

Appropriate action may depend on which of the two limbs of the solvency test is at risk.

(1) If the company is close to being unable to pay its debts as they become due in the ordinary course of business.

Some possible actions include:

- Get independent advice promptly; advice that is both financial advice and advice about your legal position.

- If you have a parent organisation, ask for more funding.

- Seek to negotiate extended terms for payment, so that amounts are not yet "due". This however may be only delaying the problem.

- Improve the "income" side of activities;
  get in amounts owing from debtors;
  examine the pricing structure;
  examine ways to improve profit margin;
  seek or approach a funding body;
  appeals to public or business

- Reduce the expenses. Stop some activities. **Reducing costs is the initial urgent measure**.

- Seek a personal release from creditors. This may not be a complete answer.

- Consider carefully - and seek advice on - what is "ordinary course of business".

- If I am still not satisfied, I must resign.

(2) If the value of the company's assets may not be greater than the value of its liabilities, including contingent liabilities.

Possible action includes:

- Get independent advice, both financial advice and advice about my legal position.

- Reduce the liability.
  Note that borrowing does not help.
  Note that selling an asset at or below book value does not help.
  Note that you cannot write off a liability - you can negotiate with the person to whom the money is owed, and possibly *he* may agree to write it off!

- Get in more equity. Raise money from shareholders; levy the members.

- If cash flow is good, possibly sell assets and lease them back again.

- Improve the assets. They may be revalued but only up to the market value. Consider value of intangibles and goodwill - but be careful as there are special provisions in accounting standards.

- If I am still not satisfied, I must resign.

Sample Certificate of Solvency

See following pages.

Last updated 17.02,2003
This is not a substitute for legal advice. Users should obtain professional advice.

XXXXX Company Limited

CERTIFICATE OF DIRECTORS REGARDING SOLVENCY

Companies Act 1997   Section 50(2)

NOTING that at the meeting of the Board of Directors of the company held on .... at .... at .... am/pm it was resolved:

> "The Board being satisfied that the company will, immediately after the transaction, satisfy the solvency test, and in accordance with the constitution, IT WAS RESOLVED THAT a distribution be made in the following terms:
> *(set out the words of the resolution, giving date, amount and to whom; or modify as appropriate)*

AND NOTING that the directors listed below, constituting a majority of those present, voted in favour of the resolution,

WE, the directors whose names and signatures appear below, certify that:

1. in our opinion, the company will, immediately after the distribution, satisfy the solvency test; and
2. the grounds for that opinion are:

   (set out the grounds for that opinion.
   For example: On the basis of accounts as at .....(date).....presented to this meeting the company will, after the distribution, satisfy both the current ratio and the 'quick & acid' test of liquidity and its 'asset-to-liabilities (including contingent liabilities) ratio will be greater than one)

Dated this .... day of .... in the year ....

Director: ....
....
Name (printed)   Signature

Director: ....
....
Name (printed)   Signature

Director: ....
....
Name (printed)   Signature

(Repeat as often as required)

NOTE: This certificate must be retained with company records for 7 years (section 164)