

Companies Act, 71 of 2008

Solvency and Liquidity Test

Section 4 of the Companies Act of 2008 (the "Act") contains particulars in respect of the solvency and liquidity test that must be applied.

As an aside, companies must also be aware of the provisions of section 22(2) of the Act which provides that the Companies and Intellectual Property Commission may, if it has reasonable grounds to believe that a company is unable to pay its debts in the ordinary course of business and after the Commission has taken the necessary steps, issue a notice to the company requiring it to cease carrying on its business or trading.

What you should do:

Before making payments or the distribution of assets, a company must satisfy the solvency and liquidity test in terms of the Act.

"Distribution" means a direct or indirect:

- transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one more holders of any of the shares, or to the holder of a beneficial interest in any such shares, of that company or of another company within the same group of companies, whether:
 - in the form of a dividend;
 - as a payment in lieu of a capitalisation share, as contemplated in section 47;
 - as consideration for the acquisition: by the company of any of its shares, as contemplated in section 48; or by any company within the same group of companies, of any shares of a company within that group of companies; or
 - otherwise in respect of any of the shares of that company or of another company within the same group of companies, subject to section 164 (19);
- incurrence of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that

company or of another company within the same group of companies; or

- forgiveness or waiver by a company of a debt or other obligation owed to the company by one or more holders of any of the shares of that company or of another company within the same group of companies;

but does not include any such action taken upon the final liquidation of the company;

In performing a solvency and liquidity test, a director will satisfy the test when considering all reasonably foreseeable financial circumstances of the company at the time, that after the transaction that is being considered:

- the fairly valued assets of the company or the fairly valued consolidated assets in the case of a holding company will be equal to or exceed the fairly valued liabilities of a company, or in the case of a holding company, its fairly valued consolidated liabilities, and that
- the company will be able to pay its debts in the ordinary course of business as they become due for a period of 12 (twelve) months after the date on which the test is considered or the distribution is made.

What you should know:

In terms of section 46(6) a director is personally liable for loss, damage or costs sustained by the company as a direct or indirect consequence of the director's actions if the director:

- *was present at the meeting where the board approved a distribution; and*
- *failed to vote against the distribution, despite knowing that the distribution was contrary to the requirements of the Act by not satisfying the solvency and liquidity test.*

The solvency and liquidity test requires that assets and liabilities are to be fairly valued and that reasonably foreseeable contingent assets and liabilities are taken into account. This necessitates that a more detailed exercise than a simple review of the balance sheet be undertaken. In terms of sections 28 and 29 a high standard must be met by a company in respect of the keeping of accounting records and financial statements. A high standard must be met by a company in respect of the keeping of accounting records and financial statements. It is also important, in view of

the possible need for solvency and liquidity tests to be done on a regular basis, that the adequacy and integrity of financial information is ensured.

The solvency and liquidity test requires the development of a 12-month cash flow forecast that takes into account all financial issues consequent to a company's day to day trading.

These provisions of the Act also create duties on directors which, if not discharged in the appropriate manner, can result in personal liability exposure for the directors.

Section 46(1) specifically prescribes that a company must not make any proposed distribution unless it reasonably appears that the company will satisfy the solvency and liquidity test immediately after completing the proposed distribution and the board of the company has **by resolution** acknowledged that it has applied the test and reasonably concluded that the company will satisfy the test after completing the proposed distribution. The proposed distribution must be fully carried out **within 120 business days** after the test was satisfied, otherwise the test must be reconsidered in respect of the remaining distribution and the board must adopt a further resolution. Where a proposed distribution must be made pursuant to a court order, and after applying the test it appears that the company does not satisfy the test, the company may apply to the court for an order varying the original order.

The solvency and liquidity test has to be performed in any of the following events:

- the provision of financial assistance to third parties for the acquisition of the company's own shares (section 44);
- loans or other financial assistance to related parties, including subsidiary companies, holding companies and directors (section 45);
- dividends or other "distributions" (as defined in section 1) to shareholders (section 46);
- the issuing of capitalisation shares on terms whereby the recipient can choose whether to take the shares or to take cash (section 47);
- share buy-backs - in other words, where the company buys back its own shares (section 48);
- an amalgamation or merger with another company (section 113).

NEED ASSISTANCE WITH THE IMPLICATIONS OF THIS ACT?**CONTACT:**

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