ACRN Journal of Finance and Risk Perspectives
Vol. 2, Issue 1, p. 1 - 8, Nov. 2013
ISSN 2305-7394

SOLVENCY-TESTS – AN ALTERNATIVE TO THE RULES FOR CAPITAL-MAINTENANCE WITHIN THE BALANCE SHEET IN THE EUROPEAN UNION

Josef Arminger[1]
[1]Professor of International Financial Accounting,
University of Applied Sciences Upper Austria; School of Management, Steyr

Abstract. *Creditor protection in the European Union (EU) is based on the principle of capital maintenance within the balance sheet in accordance with the Second Company Law Directive issued in 1976. Developments in financial reporting, especially the trends towards internationalization in connection with the adoption of International Financial Reporting Standards (IFRS), have a major impact on the current principles of capital maintenance. Accounting law in the EU is based on the Fourth Council Directive which allows a wide range of accounting options leading to a different basis for distributions to shareholders. As a consequence creditor protection may be endangered. As a consequence the European Commission has initiated projects with the aim to modernize company law. Solvency tests are seen as a possible alternative to the existing principles of capital maintenance.*

This contribution provides an overview of the current rules within the EU to limit distributions to shareholders. On the other hand, a critical analysis of both systems, as well as an overview of current developments, shows a need for political action.

Keywords: Solvency-test, Capital-maintenance, Creditor Protection

Introduction

Planned reforms of company law in Europe initiated a discussion in connection with the elimination of creditor protection in the form of capital maintenance within the balance sheet based on the Second Council Directive (the " Capital Directive") (Council of the European Communities, 1976) dated from 1976 (Brandt, Jödicke, & Richard, 2007. p. 367-371).

Limitations of distributions to shareholders based on article 15 of the Capital Directive especially became the focus of considerations. US-based capital protection regulations are often mentioned as possible alternatives. This contribution should provide an overview over the current rules of the European Union to limit distributions to shareholders. On the other hand, existing alternatives in the United States of America are presented. In summary a critical analysis of both systems as well as an outlook on potential developments will be given (Pellens, Brandt, & Richard, 2006, p. 2021).

Capital-Maintenance Rules in the European Union

In the European Union, creditor protection is determined on the concept of capital-maintenance within the balance sheet, based on the Capital Directive dated from 1976. Member states have to enforce regulations that comply with this Directive (Council of the European Communities, 1976, Article 43).

The aforementioned Capital Directive provides regulations concerning capital-maintenance, among others. In the Articles 15 till 24 you can find rules concerning:

- Limitations for the payments of dividends,
- Claims for return of unlawfully received dividends,
- Call of a general meeting in the case of a serious loss,
- Limitations for the acquisition of own shares,
- Prohibition of financial support with a view to the acquisition of shares by a third party,
- Acceptance of own shares as security.

Article 15 of the Capital Directive provides rules in connection with distribution of dividends:

> *"1 (a) 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.*
>
> *[...]*
>
> *(c) The amount of a distribution to shareholders may not exceed the amount of the 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."*

The so called „balance-sheet test" according to Art. 15 (1) a) restricts the distribution to shareholders, provided that the nominal capital and restricted reserves – based on law or statute – would be diminished.

The so called „profit and loss account test" according to Art. 15 Sec. 1 (c) takes into consideration the financial situation of the company. Profits (gains and losses) of prior periods are taken into account for the measurement of the ceiling for distributions.

Limitations for Distributions according to US Company Law

US company law is not familiar with distribution rules of European style. In the US, so called "solvency tests" should ensure the future solvability of the company (Krapf & Schürmann, 2008, p. 119).

In this connection, it should be mentioned that US corporations are organized under state laws, so that there are fifty different corporation statutes. The formation of a US corporation is independent from the location where it does business. Management can choose the state of incorporation and therefore the governing law for the corporation. The most important State of incorporation is Delaware, where more than 50 per cent of the publicly listed companies are incorporated, followed by the State of California (KPMG, 2008, p. 155).

Efforts to harmonize the different corporation laws in the 1940s led to the development of the Model Business Corporation Act (MBCA)(Committee on Corporate Laws of the Section of Business Law of the American Bar Association, 2010). This model corporation statute is applied by the majority of the States (Krapf & Schürmann, 2008, p. 274).

ACRN Journal of Finance and Risk Perspectives
Vol. 2, Issue 1, p. 1 - 8, Nov. 2013
ISSN 2305-7394

Hereinafter, the basis for distributions to shareholders based on the MBCA, the rules of the state of California (based on the California Corporation Code) (State of California, 2012) and Delaware (according the Delaware General Corporation Law) (State of Delaware, 2013), will be presented.

Rules for the measurement of dividends on the basis of the MBCA

The MBCA initially presented in the 1940s, was subject to a comprehensive revision in 1984, which led to a simplification and modernization of the rules in connection with distributions to shareholders (Committee on Corporate Laws of the Section of Business Law of the American Bar Association, 2010; Krapf & Schürmann, 2008, p. 274).

According to § 1.40 (6), dividends "are direct or indirect transfers of money or other property (except for the own shares of the company) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect to any of its shares. "Distributions to shareholders can – besides possible limitation in the articles of incorporation – only be authorized if the provisions of the equity insolvency test and the balance sheet test (§ 6.40(c) (1) and (2) MBCA) are fulfilled.

Main clauses in detail are:

No distribution may be made if, after giving it effect:

(1) the corporation would not be able to pay its debts as they become due in the usual course of business; or

(2) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

Pursuant to these rules, a company will be able to meet its obligations from the ordinary business, considering the impact of a planned distribution (equity insolvency test). Furthermore, the corporation's total assets must not exceed the sum of its total liabilities plus the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders (balance sheet test).

The equity solvency test takes into account the interests of creditors. The MBCO does not provide detailed guidance in connection with both tests. According to KPMG (KPMG, 2008, p. 158) there are strong indications that a significant shareholder's equity, operations under normal conditions, regularly audited financial statements without qualification in its most recent auditor's opinion concerning the corporation's status as a "going concern" would lead to a positive judgement. When there are any doubts concerning the solvency, detailed plans for the development of liquidity are necessary. This calculation should include the possibility for raising additional funds to fulfill obligations in the near future as well as contingent liabilities. The MBCO does not define a time horizon.

When considering the balance sheet test after distributions, there must be assets that, at a minimum are equal or exceed debts of the company plus any amount that would be needed to satisfy the shareholders' superior preferential rights upon liquidation if the corporation were to be dissolved at the time of the distribution.

In reference to accounting practices § 6.40 (d) MBCA financial statements are required to be compiled in accordance with current accounting principles or on the basis of fair value measurement or other methods that are reasonable for the circumstances. An obligation to prepare financial statements according to the US-GAAP does not exist (Krapf & Schürmann, 2008, p. 122).

Rules for the measurement of dividends on the basis of the California Corporations Code

As early as 1977, the concept of legal capital was removed by the California Corporation Code (Cal.Corp.Code) (Pellens et al., 2006, p. 2022). The foundation of a company does not require a minimum legal capital. According to § 409 (a)(1) Cal.Corp.Code considerations of shareholders may be in the form of money, services rendered, as well as tangible or intangible property. Equity will be divided into contributed capital (considerations by shareholders) and retained earnings.

Basis for contributions to shareholders are the financial statements prepared in accordance with US-GAAP of the current version (§ 114 Cal.Corp.Code). In the case of a corporation with subsidiaries, consolidated financial statements of the corporation are required as a basis for distributions.

Paragraph 500 et seq. of the Cal.Corp.Code provide guidance concerning limitations for distributions to shareholders, whereby distributions are defined as transfers of cash or property by a corporation to its shareholders without consideration (§ 166 Cal.Corp.Code). Distributions are principally prohibited, if the corporation in general or as a consequence of distribution is unable to meet its liabilities as they mature (§ 501 Cal. Corp.Code). This rule is referred to as the "*equity solvency test*".
Par. 501 Cal. Corp.Code states:

> *" Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders [...] if the corporation or the subsidiary making the distribution is, or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature."*

If these conditions are satisfied according to § 500 (a), distributions are only allowed, if the amount does not exceed the retained earnings. In the course of the liquidity test, it must be analyzed if the current assets exceed current liabilities, taking into consideration the planned distribution.

Rules for the measurement of dividends on the basis of the Delaware General Corporation Law (DGCL)

The State of Delaware does not stipulate minimum capital requirements for corporations. According to § 151 DGCL, the issuance of stock, with or without par value is permitted.

At the discretion of the board of directors, considerations received for the issuance of shares are split into capital and surplus. In addition, corporation law does not specify particular accounting methods. Corporations do not have to adhere to any specific accounting method (KPMG, 2008, p. 168). An appreciation of assets beyond cost is permitted, if directors act in good faith.

Distributions to shareholders are primarily based on regulations in the certificate of incorporation. According to § 170 DGCL, payment of dividends may not exceed the surplus (surplus test). If there is no surplus, dividends can be paid out of the net profits for the fiscal year in which the dividend is declared and/or from the preceding fiscal year (net profit test). Capital cannot be diminished by the way of distribution beyond the amount attributable to issued and outstanding shares with preferential rights. Distributions are allowed if this limit is exceeded.

A solvency test, comparable to the regulations of the MBCA and those of the State of California, has not been provided for. However, distributions in the case of imminent insolvency lead to a breach of fiduciary duty towards creditors and as a consequence to the risk of personal liability of the board of directors (Krapf & Schürmann, 2008, p. 167).

Criticism of the limitations on distributions within the European Union and Reform Efforts

A limitation of distributions to owner and connections to creditor protection seems to be necessary if no personal liability exists for liabilities of a corporation falling due in the future. Distributions shall only be allowed up to the amount that future payments to creditors (principle and interest) can be made (Grottke, 2009, p. 262).The realistic objective of limitations of distributions cannot be to totally prevent insolvency; rather it is intended to avoid such forms of insolvency that are based on conscious excessive payments to shareholders to the detriment of creditors (Fuchs & Stibi, 2007, p. 20).

The European Union tries to achieve this objective by using the rules of Art. 15 of the Capital Directive. Distributions are only allowed if the minimum level of capital is observed and on the other hand, only retained earnings can be distributed. This limitation of the distribution is only effective, if accounting rules are also based on the principles of creditor protection. Recognition and measurement principles should support this rationale.

Insofar as accounting rules are not defined in the Capital Directive, the Fourth Council Directive (Council of the European Communities, 1978) should provide the basis. This directive provides many accounting choices, which lead to all kinds of possibilities abroad for national law makers (Lanfermann, 2008, p. 1925). Additionally creditor protection cannot be achieved by this Directive.

The so called IAS-Directive (European Parliament and the Council of the European Union, 2002) led to an extension of accounting rules insofar as the member states can prepare individual financial statements in accordance with International Financial Reporting Standards (IFRSs). Creditor protection is not the core principle within these accounting principles.

On 29 June 2013 this Directive was repealed by the Directive 2013/34/EU(European Parliament and the Council of the European Union, 2013). Member States of the European Union shall bring into force laws, regulations and administrative provisions necessary to comply with this Directive by 20 July 2015. The new rules have to be applied in financial statements for financial years beginning on 1 January 2016 or during the calendar year 2016. The new Directive reduces some accounting choices, nevertheless “true and fair view” is the dominant principle when preparing financial statements and not the prudence principle.

Par. 9 of the introduction of Directive 2013/34/EU states:

> *“Annual financial statements should be prepared on a prudent basis and should give a true and fair view of an undertaking's assets and liabilities, financial position and profit or loss. It is possible that, in exceptional cases, a financial statement does not give such a true and fair view where provisions of this Directive are applied. In such cases, the undertaking should depart from such provisions in order to give a true and fair view.”*

Accounting in compliance with the prudence principle also provides protection only in years of profit. If hidden reserves are released unnoticed in years of losses, this procedure opposes the intention of creditor protection (Pellens, Jödicke, & Richard, 2005, p. 1394).

An essential point of criticism in connection with the current concept of capital maintenance within the balance sheet and the consequential restriction of distribution is seen in the retrospective view, instead of the orientation on forward looking cash-flows (Pellens et al., 2005, p. 263). In this respect future liquidity situations and investment decisions are mainly ignored (Pellens et al., 2006, p. 2027).

The fundamental reform of capital protection rules within the European Union was initiated by the report of the High Level Group in 2002 concerning a “modern regulatory framework for company law in Europe” (High Level Group of Company Law Experts, 2002).

In connection with rules for distributions to shareholders, the following recommendations were proposed (High Level Group of Company Law Experts, 2002, p. 92):

“In the alternative regime to be considered at a later stage, a proper solvency test should be required for any payment of dividend or other distribution. The solvency test should be based on at least two tests to be performed before making the distribution: a balance sheet test and a liquidity test.

Directors of the company should issue a solvency certificate, in which they explicitly confirm that the proposed distribution meets the solvency test. Directors are responsible for the correctness of the solvency certificate and Member States should impose proper sanctions, which could be extended to “shadow” directors (High Level Group of Company Law Experts, 2002, p. 100).

The report also provides indication towards the direction to solvency tests in accordance with US-rules (High Level Group of Company Law Experts, 2002, p. 84).

Criticism of the Limitations on Distributions according US Corporate Law

Chapter three describes the three forms of limitations for distributions according to the Model Business Corporation Act (MBCA) as well as those of the States of California and Delaware. They show different forms of limitations of distributions. In the MBCA and statutory regulations in the State of California, you can find the so called “equity solvency test” which allows distribution insofar as the company stays solvent after distribution. Both regulations do not define the time frame for the planning nor a concrete method of the calculation of solvency of the corporation. A wide field of discretion and corresponding uncertainties remains (Lienau, 2008, p. 90; Pellens et al., 2005, p. 1396).

In the state of Delaware, solvency tests preceding distributions are resulting de facto on the fiduciary duty of the board of managers. Provisions for liabilities for unlawful distributions support this principle.

A critical point, however, is that all mentioned statutory regulation do not issue precise guidance for the calculation of the solvency test. Insofar a lack of legal certainty exists, as in many cases, courts assess the admissibility of distributions ex post (Brandt et al., 2007, p. 358).

In addition to the solvency test, you can find in all mentioned state-laws as well as in the MBCA, further tests that allow or forbid distributions if certain ratios are reached or exceeded. Barring the legal rules in the State of California, which only allow accounting according to the current version of US-GAAP (§ 114 Cal.Corp.Code), accounting rules are not explicitly defined. Hence recognition and measurement of assets and liabilities can be different and lead to different results. As a consequence, this cannot assure reliable measures for the limitation of distributions with respect to creditor protection.

Summary and Outlook

Distributions to owners of corporations without personal liabilities for future obligations of the corporation may endanger creditor protection. Current limitations of distributions within the European Union to protect creditors are based on the Capital Directive of 1976 and the concept of capital maintenance within the balance sheet.

The Fourth Council Directive provides many accounting options and the application of different accounting principles, which may pursue different objectives besides creditor protection. The application of IFRSs in the individual financial statements may especially lead to the recognition of - unrealized - profits that may be distributed to shareholders. Accounting Directive 2013/34/EU strengthens the "true and fair view" principle in comparison to "prudence principle". Insofar as accounting rules follow the prudence principle as a core standard, such rules should continue to apply. For accounting principles that primarily serve the information needs of the readers of financial statements, solvency tests should be obligatory as an alternative (Krapf & Schürmann, 2008, p. 211).

Reform efforts within the European Union urge a modernization of company law and adjusted rules for the limitations of distributions to shareholders.

In the course of the reform plans, rules concerning the limitations of distributions in the US are mentioned. These jurisdictions do not rely on the principle of capital maintenance. Solvency tests – sometimes supplemented by so called balance sheet tests – provide the basis for the payment of dividends. Such payments to shareholders in the aforementioned States are forbidden, if the company cannot settle its debts after distribution. Detailed guidance concerning the design of the solvency test as well as underlying accounting principles are predominantly lacking (Krapf & Schürmann, 2008, p. 140).

The implementation of the US-rules (solvency tests) as an instrument for the limitation for the distributions of corporations within the European Union without detailed guidance for the design of the test would not achieve the objectives. Discretionary decisions in the process of achieving the data basis prevent an effective creditor protection.

Along with the introduction of a solvency test, changes in liability provisions for the board members should be introduced to better assure satisfaction of claims of creditors (Lienau, 2008, p. 87).

Finally, the trend to Internationalization in the accounting is an ongoing process that cannot be stopped. There is a need for action for European lawmakers to prepare a modern framework for creditor protection. Insofar as different accounting principles – comprising different recognition and measurement principles – in individual financial statements are permitted, limitations for distributions cannot be based on items from financial statements.

Calculations based on future cash flows should provide a more secure and reasonable basis for payments of dividends to shareholders. Accompanying documentation and possible audit requirements for such calculations should be reconsidered. Liability provisions for board members should be revised in this context. Reform concepts should also consider distinctions based on the size of the corporation.

References

Brandt, E., Jödicke, D., & Richard, M. (2007). Solvenztest [Solvency tests].. Die Betriebswirtschaft, *(67), 357–361.*

Committee on Corporate Laws of the Section of Business Law of the American Bar Association (2010). MODEL BUSINESS CORPORATION ACT, *revised through 2010.*

Council of the European Communities (1976). Second Council Directive on coordination of safeguards which, for the protection of the interests of members and others; are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent: 77/91/EEC.

Council of the European Communities (1978). Fourth Council Directive based on Article 54 (3) of the Treaty on the annual accounts of certain types of companies: 78/660/EEC.

European Parliament and the Council of the European Union (2002). Regulation (EC) No 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards: (EC) No. 1606/2002.

European Parliament and the Council of the European Union (2013). DIRECTIVE 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.

Fuchs, M., & Stibi, B. (2007). Solvenztests als Grundlage der Ausschüttungsbemessung - Anforderungen und betriebswirtschaftliche Gestaltungsmöglichkeiten [Solvency tests as a basis for distributions – requirements and economic opportunities]. Betriebs-Berater Special, 19-24.

Grottke, M. (2009). Kritik an der Kapitalerhaltung und synoptische Darstellung des aktuellen Stands der Reformvorschläge:[Criticism of the capital-maintenance and synoptic depiction of the current status of current proposals for reforms]. KoR - Zeitschrift für kapitalmarktorientierte Rechnungslegung, 9(5), 261–266.

High Level Group of Company Law Experts (2002). Report of the High Level Group of Company Law Experts on a modern Regulatory Framework for Company Law in Europe, from http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf.

KPMG (2008). Deutsche Treuhand-Gesellschaft Aktiengesellschaft: *Contract ETD/2006/IM/F2/71:* Feasibility study on an alternative to the capital maintenance regime established by the Second Company Law Directive 77/91/EEC of 13 December 1976 and an examination of the impact on profit distribution of the new EU-accounting regime Main Report.

Krapf, J., & Schürmann, J. (2008). Solvenztest: Ausschüttungsbemessung und Gläubigerschutz.[Solvency tests: basis for distributions and creditor protection], Berlin.

Lanfermann, G. (2008). Ausschüttungen auf Basis von IFRS: Bleibt die deutsche Bundesregierung zu zögerlich? .[Distributions based on IFRS – remains the German government too reluctant?], Der Betrieb, (36), 1925–1932.

Lienau, A. (2008). Gläubigerschutz durch Solvency Tests auf der Basis eines IFRS-Abschlusses.[Creditor protection by means of solvency tests based on IFRS financial statements]. KoR - Zeitschrift für kapitalmarktorientierte Rechnungslegung, (2), 79–88.

Pellens, B., Brandt, E., & Richard, M. (2006). Kapitalschutz in Kalifornien - Vorbild für die europäische Gesellschaftsrechtsreform? .[Capital protection in California – an example for European company-law reforms?], Der Betrieb, (38), 2021–2027.

Pellens, B., Jödicke, D., & Richard, M. (2005). Solvenztests als Alternative zur bilanziellen Kapitalerhaltung? .[Solvency-tests as an alternative to the capital protection within the balance-sheet?], Der Betrieb, (26/27), 1393–1401.

State of California (2012). The California Corporations Code: Cal.Corp.Code, Edition 2012.

State of Delaware (2013). Delaware General Corporation Law, Edition 2013.