The Solvency Regime – A Critical Evaluation of the Legal Framework in Sri Lanka

Ms. W. Indira Nanayakkara
Dept. of Commercial Law

Abstract

Introduction

The new Companies Act No. 7 of 2007 brought into existence the solvency test into the legal framework of Sri Lanka. This is to be met in a variety of corporate procedures and requires companies to satisfy two tests to be classed as being solvent; the first is the "cash flow" test or trading solvency. The second test is ‘assets test’ or balance sheet solvency, namely that the assets of a company must be greater than its liabilities. The test plays an important role in the management of companies and presents challenges to the board of directors of a company as to how a company enhances its solvency position. During last three decades, Sri Lanka witnessed number of cases of corporate failures, especially in finance companies. Such failures can have huge impact on the economy which can set a country several years back in its path to development. Because today a company cannot stand in isolation, its actions and behaviour affects society, the lives of people it transact with and the nation at large.

The recent plight of the Golden Key Credit Card Company and the major corporate scandals such as Sakvithi created a severe umbrage amongst the investors in Sri Lanka. The mismanagement of the corporate sector, the lack of a proper regulatory/legal regime to monitor the internal management and administration of companies, the manipulation of financial reporting standards to promote unethical practises by the directors, auditors and senior officials of the companies and oversight and the lack of timely action by the Central Bank of Sri Lanka to prevent such collapses in relation to financial institutions have been some of the main attributes for the financial instability created in the recent past in Sri Lanka.

Sri Lanka until the 2007 Act, like most other jurisdictions through a capital maintenance approach protected the creditors of a company. The intention was to prevent companies returning funds to shareholders by way of distribution or providing financial assistance for the purchase of its own shares or reducing its capital etc. in order to ensure that there was a pool of money on which creditors could rely. However it was questionable as to the extent the capital maintenance rule provided the protection to the creditors.

The paper identifies deficiencies in the previous framework which proved very detrimental for creditors, reviewing the evolution in shareholder and creditor protection that has taken place in Sri Lanka under the 2007 Act. Also explores and evaluates the practical impact, importance and the drawbacks of the solvency test as a mechanism to provide effective protection to stakeholders of a company with special reference to the position of the creditors of a company. The paper is based on the hypothesis that the solvency regime is a major step in ensuring the integrity of the corporate sector and it provides a better protection to stakeholders of a company, as opposed to the protection afforded by capital maintenance rules. The effectivness of the test is analysed with a comparision of New Zealand and UK jurisdictions.

Methodology

This essay is solely based on literature review on the said topic. Reference is made to large collection of publications on the subject, journal and newspaper articles, and the worldwide web to assess the practical situations.

Results

The provisions relating to solvency regime has paved way for companies to contemplate action that were previously prohibited or allowed only subject to stringent requirements. Thus, a company now has more freedom and to distribute its money or property as it wishes subject to one important obligation. The obligation is that the directors of the company must be satisfied that immediately after making certain transactions the company will satisfy the solvency test. The capital maintenance has been removed and the stated capital has now been introduced.

In addition it minimizes the concerns of the creditors as the safeguards built in by the solvency regime focuses on the net assets of the company and on its ability to pay its debts and also require the company to act in a more transparent manner. Solvency test plays an important role in the management of companies and while it gives directors more freedom similarly presents challenges to them where it gives greater responsibility and potentially greater liability of directors. The law makes the directors vigilant in exercising their powers and discretion, which could otherwise stultify the stability of the company. They need to ensure is that the company has sufficient financial resources at all times, so that there is no significant risk that the company cannot meet its obligations when they fall due.

Thus the solvency test introduced by the Act strives to achieve its goal in two ways; firstly, it act as a warning sign to the management, the board of directors of a company, so that they are well informed of the company's financial stability and can make sure that the company is financially healthy. Secondly, if the company has already become insolvent, the plight of the company, its officers and the penalties are also laid down under the test.

Conclusion

As opposed to the doctrine of capital maintenance which failed in its sole objective of protection of creditors, the solvency regime provides increased flexibility in return of capital to shareholders while ensuring such activities would not impair the going concern of the company which is in the interests of creditors as well as other stakeholders. The solvency regime enhances the flexibility by which a company can return money to its investors from two perspectives. Firstly, the definition of distribution is wide and it includes share redemptions, buy backs and financial assistance in repurchase of own shares and secondly, circumstances have changed from a position where profits only were distributable to a position where companies have the freedom to distribute earnings as well as capital.

However as there are pros and cons in every legal theory, similarly solvency test too has shortcomings. If it can be brought to a better shape than it is now, it will definitely achieve the objectives for which it was introduced. Therefore, one objective of the paper is to determine whether further safeguards are needed for those dealing with corporate groups. The writer searches the answers and makes future recommendations in the proposed paper and a comparative assessment will be made with reference to the laws of other jurisdictions.