CAREY OLSEN

Payment of dividends and distributions by a Guernsey company

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This briefing note explains the distinction between the concepts of dividends and distributions before setting out the main steps involved in paying out dividends and distributions under The Companies (Guernsey) Law, 2008 as amended (the "Companies Law").

Guernsey's reliance on a "solvency test" in board authorisations of distributions or payments of dividends offers a considerable degree of flexibility for a company seeking to return capital or earnings to its investors. The wide definition of "distributions" to cover transactions which in other jurisdictions may be subject to creditor protection mechanisms brings a greater number of transactions under the remit of the solvency regime, putting the onus on directors to take responsibility for determining the viability of the proposed transaction in light of the financial status of the company.

The meaning and application of Guernsey's solvency test is more fully examined below.

The distinction between distributions and dividends

A company makes a distribution to its members whenever, in respect of a member's interest in that company, it transfers money or property (excluding the company's own shares) to or for the benefit of a member (directly or indirectly) or whenever the company incurs a debt to or for the benefit of a member. This is the case whether the distribution is by means of a purchase of property, the redemption or other acquisition of shares, a distribution of indebtedness or by some other means.

A dividend is every distribution of a company's assets to its members and may be in the form of money or other property. Dividends can be of such amount and may be paid at such time and to such members as the board thinks fit.

All dividends are distributions under the Companies Law, but not all distributions are necessarily dividends. Whilst the Companies Law sets out the procedures for approving dividends and distributions in separate sections, substantively the procedures for each are essentially the same, save for two particular differences for dividends. When a company declares dividends, all the shares constituting a share class must be treated uniformly (unless the dividend amount is by reference to the amount paid up on the share by the relevant member) and a member may waive his entitlement to receive a dividend in writing to the company.

In particular the following transactions do not constitute dividends and therefore must be authorised under the provisions of the Companies Law relating to distributions:

- an issue of shares as fully or partly paid bonus shares;
- a redemption or acquisition of any of a company's own shares, or financial assistance for the acquisition of a company's own shares;
- a reduction of share capital;
- a distribution of assets to members during and for the purposes of (i) winding up, (ii) an administration order or (iii) a receivership order; or
- a distribution of assets to members of a cell of a protected cell company during and for the purposes of the termination of the cell.

Procedures for approving distributions and dividends

In order to effect a distribution or pay a dividend, a board of directors ("Board") must approve a certificate signed by one of them that in the Board's opinion, the company will, immediately after payment of the distribution, satisfy the solvency test and the grounds for that opinion (a "Solvency Certificate"). A director who fails to comply with this requirement or signs a Solvency Certificate without having reasonable grounds to do so will be guilty of an offence.

Satisfying the solvency test

A company's Board may authorise a distribution or pay a dividend if:

- it is satisfied on reasonable grounds that the company will, immediately after the distribution or payment, satisfy the solvency test prescribed by the Companies Law; and it satisfies any other requirement in its Memorandum and Articles of Incorporation.

For the purposes of the Companies Law, a company satisfies the solvency test if:

- it is able to pay its debts as they become due; and
- the value of its assets is greater than the value of its liabilities, and
- in the case of a company supervised by the GFSC, the company satisfies any other requirements as to solvency imposed in relation to it by the relevant legislation under which it is supervised.

Aside from any regulatory solvency requirements, essentially, the test constitutes a cash flow test and a net assets test.

In analysing the cash flow test, a Board should consider all the company's debts for which a legal obligation exists or which the company is otherwise obligated to fulfil. The definition of "debts" includes fixed preferential returns on shares ranking ahead of those in respect of which the distribution is made or dividend is paid (as appropriate) (except where that fixed preferential return is expressed in the Memorandum or Articles as being subject to the power of the directors to make distributions or dividends (as appropriate)). This does not include debts arising by reason of the authorisation.

There is no definition of what is meant by the phrase "as they become due". Decisions of the English courts can be persuasive authority in the Royal Court of Guernsey. In the matter of Cheyne Finance Plc (in receivership) [2007] EWHC 2402 (Ch) judgment was given in respect of the meaning and interpretation of "unable to pay its debts as they fall due" in section 123(1)(e) of the UK Insolvency Act 1986. In particular, the court held that the phrase "as they become due" encompassed some consideration of the future debts of a company. It also incorporates contingent liabilities, and these will need to be considered by the Board and determined by forming reasonable judgments as to the likelihood, amount and time of recovery against the company. Boards should also consider those contingent liabilities of the company which may not necessarily be recognised on the balance sheets by applicable accounting standards.

In considering the net assets test, "liabilities" include the amounts that would be required, if the company were to be dissolved after the distribution or payment of the dividend (as appropriate), to repay all fixed preferential amounts payable by the company to members, at that time or on earlier redemption (except where such fixed preferential amounts are expressed in the Memorandum or Articles as being subject to the power of directors to make distributions or pay dividends (as appropriate)). Subject to the definition of "debts" in the Companies Law as set out above, "liabilities" do not include dividends payable in the future.

Information before the Board and directors' knowledge

As for the level of information which should be tabled before the Board, the Companies Law states that in determining whether the value of a company's assets is greater than the value of its liabilities, the directors:

- must have regard to:
    i. the most recent accounts of the company; and
    ii. all other circumstances that the directors know or ought to know affect or may affect the value of the company's assets and the value of the company's liabilities; and
- may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

Given that a company can no longer rely on the fact that it has created a distributable reserve, constituting profits available for the purpose which could be used to make distributions or pay dividends, Boards need to consider up-to-date financial data, preferably using management accounts which draw down from the date of the last full accounts.

The directors must also have regard to what they actually know and what they should have known about the company's financial position. All directors should conduct sufficient due diligence to ensure that they are aware of the financial status of the company before voting in respect of the distribution or dividend payment.

Continuing obligation of the board

If, after a distribution or dividend payment is authorised at Board level and before it is made, the Board ceases to be satisfied on reasonable grounds that the company will, immediately after the distribution or dividend payment is made, satisfy the solvency test, any distribution or dividend payment made by the company is deemed not to have been authorised and is therefore unlawful. Therefore the Board should continue to monitor the solvency position of the company after the authorisation to ensure the solvency test will still be met immediately after the distribution or dividend payment is made.

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Unravelling distributions or payments of dividends for failure to satisfy the solvency test

If the solvency test was not satisfied at the relevant time, the Companies Law essentially provides for claw-back provisions and puts the common law position on a statutory footing with regard to directors' liabilities in effecting unauthorised distributions.

Thus a payment made to a shareholder at a time when the company did not immediately after the distribution or dividend payment satisfy the solvency test may be recovered by the company from the shareholder unless (i) the shareholder received the payment in good faith and without knowledge of the company's failure to satisfy the solvency test, (ii) the shareholder has altered its position in reliance on the validity of the receipt and (iii) it would be unfair to require repayment in full or at all.

So, if legal procedures for gaining shareholder approval of the distribution or dividend payment were not followed or if there were no reasonable grounds for believing that the company would pass the solvency test at the time the certificate was signed, a director who failed to take reasonable steps to ensure the legal procedure was followed or who nonetheless voted to approve the certificate is personally liable to the company to repay any shortfall in the amounts not recoverable from the shareholders.

FIND US

Carey Olsen (Guernsey) LLP
PO Box 98
Carey House
Les Banques
St Peter Port
Guernsey GY1 4BZ
Channel Islands

T +44 (0)1481 727272
E guernsey@careyolsen.com

FOLLOW US

Visit our corporate team at careyolsen.com

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