

**Results of the external study
on the feasibility of an alternative to the Capital Maintenance Regime
of the Second Company Law Directive and
the impact of the adoption of IFRS on profit distribution**

The Second Company Law Directive 77/91/EEC establishes a series of requirements for the incorporation of a public company limited by shares, notably that such a company should have a minimum legal capital, or share capital, of 25.000 Euros. This "cushion" is intended to help ensure that creditors are paid, even if the company suffers substantial losses. In this connection, the Directive also sets rules on capital maintenance which limit the ability of (the controlling) shareholders to distribute dividends (or repurchase shares) through a balance sheet test¹. The objective of this set of rules on capital formation and maintenance is mainly to protect creditors.

The Second Directive has recently been simplified (see Directive 2006/68 of 6 September 2006).² However, this simplification did not address the question of an alternative to the current legal capital system in the form for instance of a solvency test in order to give more flexibility in the field of distributions to shareholders. To this end, as announced in its May 2003 Action Plan on Company Law and Corporate Governance³, the Commission launched an external study. This study has now been delivered and is available on the Commission website⁴

The main findings of the study are the following:

1. The current minimum legal capital requirements and rules on capital maintenance do not constitute a major obstacle to dividend distribution

Member States are currently at liberty either to introduce higher capital requirements or to comply strictly with the 2nd Directive, which only requires a minimum legal capital of 25.000 Euros, which nowadays does not represent a significant amount. This does not prevent companies from adopting a higher share capital if they consider this necessary to guarantee their creditworthiness.

As to dividend distribution, the only constraint is that this is prohibited if the so-called balance sheet test is negative. This has prompted the question whether it would not be more appropriate to replace this test by a solvency one or at least to permit the application of a solvency test as an alternative. In this regard, the study shows that:

- a "balance-sheet" test is also required by those non-EU States (except Australia) which impose a solvency test (for more details, see Table 1 below);
- EU Member States are presently at liberty to introduce an additional solvency test, if they so wish;

¹ Dividends can only be paid out of assets in excess of liabilities plus the minimum legal capital (25.000 Euros)

² http://ec.europa.eu/internal_market/company/capital/index_en.htm

³ Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, available at:
http://ec.europa.eu/internal_market/company/modern/index_en.htm#communication

⁴ The document is available at the following webpage:
http://ec.europa.eu/internal_market/company/capital/index_en.htm

- Most existing academic proposals to amend the 2nd Directive refer to the necessity to add a solvency test to a balance-sheet test (see Annex).

2. Impact of IFRS on dividend distribution: several Member States have required or permitted the application of IFRS for individual accounts without any apparent difficulty for the distribution of dividends.

It has been argued that the balance sheet test (based on historical cost accounting in accordance with the 4th Accounting Directive) has become an inadequate yardstick for deciding whether the company has sufficient reserves for it to make distributions to shareholders, following the adoption of International Financial Reporting Standards (IFRS).

According to the external study and additional information gathered by the Commission, at present, 19 of the 27 EU Member States already apply IFRS to individual company accounts, which means that in such Member States dividends must be determined with reference to IFRS. In 8 of these 17 Member States, whilst individual accounts prepared under IFRS accounting are used as the basis for distribution purposes, Member States have introduced limitations to the distribution of unrealised profits.

From the results of the study it emerges that the 2nd Company Law Directive is a flexible instrument insofar as it requires a limited (almost symbolic) amount of legal capital and allows Member States to impose higher capital requirements if they so wish. Moreover, under the Second Company Law Directive, Member States remain free to require or allow companies to prepare individual IFRS-based accounts for dividend distributions purposes. Moreover, the Second Company Law Directive already allows Member States to adopt some of the solvency-based systems existing outside the EU as well as some of the alternative proposals for reform, except the possibility to distribute profits in the presence of a negative balance sheet. Finally, it appears from the study that the compliance costs of the 2nd Directive are rather limited, and not higher than those required by the alternative regimes outside the EU.

In the light of the conclusions of the external study, the view of DG Internal Market and Services is that the current capital maintenance regime under the Second Company Law Directive does not seem to cause significant operational problems for companies. Therefore no follow-up measures or changes to the Second Company law Directive are foreseen in the immediate future.

Table 1. Alternative distribution regimes outside the EU

The table illustrates the main features of existing solvency test regimes around the world compared to the legal capital regime established by the Second Company Law Directive. Annex 1 illustrates such regimes in detail.

	Balance sheet test	Solvency test	Both tests required	Other tests
2nd Directive	assets=liabilities plus 25.000 eur. Possible to distribute capital in excess of 25.000 eur.	No, but EU MS are at liberty to introduce it.	No (Yes if decided by MS)	
RMBCA (US)	assets=liabilities. Directors may use valuation methods that are reasonable in the circumstances.(*)	The corporation should be able to pay its debts as they become due in the usual course of business.	yes	
Delaware	Assets=liabilities in case of no par-value shares. In case of par value shares assets=liabilities plus company equity. Possible to distribute dividends with negative balance sheet as long as net profit realised in the current or previous year. Directors may use valuation methods that are reasonable in the circumstances.(*)		No	
California	Assets=liabilities plus stated capital and reserves. To distribute capital and reserves (i) total assets 1.25 times total liabilities; (ii) current assets=current liabilities		NA	
Canada	Assets=liabilities plus stated capital and reserves. Directors may use valuation methods that are reasonable in the circumstances.(*)	The corporation should be able to pay its debts as they become due in the usual course of business.	Yes	
New Zealand	assets=liabilities. Directors may use valuation methods that are reasonable in the circumstances.(*)	The corporation should be able to pay its debts as they become due in the usual course of business.	Yes	
Australia				Surplus of income over expenses in any specific year. However, to avoid liability risks, directors often carry out solvency test

				and/or balance-sheet test.
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(*) Directors are free to assess the economic value of net assets and are not bound by statutory balance sheet test in considering the balance of assets and liabilities.

Table 2. Four proposals for an alternative dividend distribution

The following table illustrates the main features of the four proposed regimes for dividend distributions to be established by the Second Directive. For a more detailed illustration see Annex 2.

Proposed alternative regimes

	Balance sheet test	Solvency test	Both tests required	Compatible with the 2nd Directive
Rickford proposal	Assets=liabilities plus preferential obligations and any stated capital by reference to statutory accounts; but comply or explain obligation only.	The company must satisfy a one year liquidity test and a cash flow test of indefinite duration (the foreseeable future).	Solvency test mandatory; Balance Sheet Test: comply or explain obligation only	An alternative system required.
Lutter proposal	Assets=liabilities plus capital plus reserves, applying GAAP	The company must be able to meet its immediate liabilities and the liabilities due within one or two following years.	No, the solvency test to be applied in case of recourse to IFRS	Already applicable by MS without amendments to the 2 nd Dir.
Dutch proposal	Assets=liabilities plus the amount paid for the company shares.	Liquidity test	yes	Necessary to delete the requirement to reduce stated capital by extraord. General meeting of shareholders.
High Level Group	Assets=liabilities	The company must be able to meet its immediate liabilities and the liabilities due within the following year.	yes	Already applicable by MS without amendments to the 2 nd Dir.

Comparing the proposals for a new dividend distribution regime in the EU with the present regime established by the Second Directive, the proposals from both the Lutter group and the High Level Group could already be applied by Member States who wish to do so, without requiring any amendment to the Directive. On the other hand, the Dutch and, more importantly, the Rickford proposals would require the amendment of the Directive. In particular, in order to allow Member States to comply with the Dutch proposal in full, it would be necessary to delete from the Directive the provision which requires a special majority at the shareholders' meeting to reduce the company's legal capital, together with the special publicity requirements and the rights for creditors to refer such a decision to a court. As for the Rickford proposal, it would require allowing applying to the balance-sheet test valuation methods which do not necessarily

follow those methods required under national GAAPs or IFRS, provided directors explain why they opted for valuation methods different from those standards ("comply or explain").

Table 3. Profit distribution based on IFRS in the EU⁵

Country	Profit distribution based on IFRS-financial statements mandatory/possible?	Modifications if IFRS-profit required?
Austria	No	N/A
Belgium	No	N/A
Bulgaria	Yes	No modification required.
Cyprus	Yes	No modification required
Czech Republic	Yes	No modification required
Denmark	Yes	Some form of “modification” required.
Estonia	Yes	No modification required
Finland	Yes	No modification required
France	No	N/A
Germany	No	N/A
Greece	Yes	Some form of “modification” required.
Hungary	No	N/A
Ireland	Yes	Some form of “modification” required.
Italy	Yes (listed companies only)	Some form of “modification” required.
Latvia	Yes	No modifications required.
Lithuania	Yes	No Modifications required.
Luxembourg	No	N/A
Malta	Yes	Some form of “modification” required.
Netherlands	Yes	Some form of “modification” required.
Poland	Yes	Some form of “modification” required.
Portugal	Yes	No modifications required.
Romania	No	N/A
Slovakia	Yes	No modification required.
Slovenia	Yes	No modification required.
Spain	Yes, (only financial institutions until 31 December 2007. Thereafter all companies).	N/A
Sweden	No	N/A
United Kingdom	Yes.	Some form of “modification” required.

⁵ Sources: KPMG 2007 and European Commission.

Annex 1. Alternative distribution regimes outside the EU

Revised Model Business Corporation Act (RMBCA)⁶

Under the Revised Model Business Corporation Act (RMBCA) all kinds of distributions are regulated under a unified solvency test.⁷ This test has two parts, which must both be satisfied to allow any kind of distribution to shareholders. The first part is the simple balance-sheet test (also called bare net assets test); under this a corporation's total assets should not be less than the sum of its total liabilities.⁸ The second part is the equity insolvency test; the corporation should be able to pay its debts as they become due in the usual course of business. Finally, companies are allowed to apply to the balance-sheet test valuation methods which do not correspond to national GAAPs but are reasonable in the circumstances.

Delaware⁹

The distribution regime in Delaware has two alternative parts; the bare net assets test (or enhanced net assets test if a company has issued par value shares) and the nimble dividends test. The bare net asset test corresponds to the test in the MBCA; the corporation's board of directors is authorised to make a distribution as long as there is a surplus. A surplus corresponds to the company's net assets (assets minus liabilities).¹⁰ This test applies when a company has issued no par value shares. If a company has issued par value shares (shares with a nominal value), the value of its net assets has to be greater than the amount of its share capital. Therefore, in order for a dividend distribution to be allowed it is not sufficient that the company's equity is positive. The company's equity must also be greater than its share capital. Finally, companies may depart from the valuation rules set under their national GAAPs when applying a balance sheet test, provided that these rules are reasonable in the given circumstances.

According to the nimble dividends test, the corporation's Board is authorised to make a distribution, even in the absence of a surplus, to the extent that the company has realised a net profit in the financial year in which the dividend is distributed or in the prior financial year. This means that, even when the company's balance sheet shows a net deficit because of losses incurred in previous years, nonetheless 'earnings have become positive for two years, the future looks brighter, and the directors would like the shareholders to participate in the new prosperity before the net deficit in the retained earnings account can be wiped out.'¹¹

California¹²

The California approach to distributions provides rules which are aimed at replicating what sophisticated creditors normally require in their loan agreements. The regime is based on

⁶ §6.40 RMBCA (1979) by the American Bar Association.

⁷ See *R.C. Clark: Corporate Law*, 1986; *J. Rickford et al.*, 'Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance' in *European Business Law Review*, Vol. 15, 2004.

⁸ Plus, unless the articles of association permit otherwise, if the corporation were to be dissolved at the time of the distribution, the amount that would be needed to satisfy the rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution (in such a case it is an enhanced net assets test).

⁹ §170(a) Delaware General Corporation Law (DGCL).

¹⁰ However, in Delaware special rights upon dissolution are not disciplined.

¹¹ *R.C. Clark: Corporate Law*, 1986 p. 617.

¹² §500 California Corporation Act.

financial ratios. The California statute allows dividends to be paid out of retained earnings (retained earnings test). If dividends are paid out of other distributable reserves, then after payment of the dividend, (i) the corporation's total assets must be at least 1.25 times its total liabilities (enhanced net asset test), and (ii) its current assets must be at least equal to its current liabilities (solvency test).¹³

Under a retained earnings test (also called earned surplus test),¹⁴ dividends may only be declared and paid out of the unreserved and unrestricted earned surplus of the corporation. This means that a company with a net deficit cannot distribute dividends. It also means that the retained earnings test does not allow distributions to be made out of a reduction of the stated capital or the capital surplus. However, dividend distribution is possible by reducing the stated capital and the capital surplus, as long as the abovementioned ratios are maintained.¹⁵

Canada¹⁶

The decision to distribute dividends is a matter for the board of directors. In order to declare a dividend, both of the following tests must be satisfied: a) there must be no reasonable grounds to believe that after payment of the dividend the corporation would be 'unable to pay its liabilities as they become due' (solvency test); b) there must be no reasonable grounds to believe that 'the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes' (balance-sheet test). The board can choose a more suitable way to assess the balance sheet. Companies may depart from the valuation rules set under their national GAAPs when applying a balance sheet test, provided that these rules are reasonable in the given circumstances.

New Zealand¹⁷

In order to make a lawful distribution, the board must satisfy a two-fold cumulative test: the company must remain able to pay its debts as they fall due (solvency test); and the value of the company's assets must exceed the value of its liabilities (balance-sheet test), including contingent liabilities. The directors who authorise the payment of a dividend must sign a certificate (solvency certificate)¹⁸ to this effect, stating their grounds. It is expressly stated that, subject to contrary provisions in the company's articles of association, 'debts' include any fixed preferential

¹³ *R.C. Clark: Corporate Law*, 1986 p. 623. According to *J. Rickford et al.*, 'Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance', in *European Business Law Review*, Vol. 15, 2004 p. 104, 'distributions may be made out of retained earnings or if, (1) the net assets (excluding goodwill, capitalised R&D, and deferred charges) are not less than 1.25 times liabilities (excluding deferred tax, income, and credits); and (2) current assets are not less than current liabilities, or if earnings before tax for the preceding two fiscal years were less than average interest expense, not less than 1.25 times current liabilities ... California thus has an earned surplus combined with an alternative more elaborate balance-sheet test regime. However, the balance-sheet test attempts to reflect in some proportionate way the company's financial condition.'

¹⁴ *R.C. Clark: Corporate Law*, 1986 pp. 612-613.

¹⁵ However, according to *B. Mannin & J. Hanks: Legal Capital*, 3rd ed., New York, 1990 p. 177 (quoted by *J. Rickford et al.* in 'Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance', in *European Business Law Review*, Vol. 15, 2004), while the test appears to be cumulative, it is in fact alternative.

¹⁶ §42 Canada Business Corporations Act 1985 (CBCA).

¹⁷ §4 New Zealand Companies Act 1993.

¹⁸ §52(2) New Zealand Companies Act 1993. Such certification must take into account either test (§4(1)(a) – *Solvency Test* and (b) – *Balance Sheet Test*).

return on prior ranking shares, 'liabilities' include contingent liabilities, and 'fixed preferential' (presumably capital) includes claims in a winding up or on earlier redemption. There is a criminal sanction for non-compliance and an obligation on directors to pay any sum not recovered from shareholders.¹⁹

Directors must refer to the most recent company financial statements and to all other circumstances which they know about or ought to know about which affect, or may affect, the value of the assets and liabilities.²⁰ As for contingent liabilities, the directors may take account of the likelihood of any contingency and any claim reasonably expected to reduce it. Unlawfully paid dividends are recoverable unless they have been received in good faith, or received by a shareholder who has altered their financial position, and it would be unfair to require repayment. Finally, Companies may depart from the valuation rules set under their national GAAPs when applying a balance sheet test, provided that these rules are 'reasonable'²¹ in the given circumstances.

Australia²²

A dividend may only be paid out of company profits.²³ The term 'profits' implies that a comparison is made between the state of business on two specific dates, usually separated by an interval of a year. It is sufficient for the calculation of profits to establish that there was a surplus of income over expenditure in a particular financial year. No account has to be taken of an expected future reduction in the value of certain assets. Furthermore, no distinction is made between increases in the values of fixed and current assets in a financial year.

A company is not bound to refund losses from previous years. Dividends may be paid out of the current year's profits even if the company has incurred losses in previous years (nimble dividend test).²⁴ However, a company which pays a dividend must take into consideration the fact that such a transaction could entail incurring a debt within the meaning of the insolvent trading provisions. To avoid such a risk, directors usually only pay dividends if the solvency test²⁵ is satisfied.

Dividend distribution according to the Second Company Law Directive

The dividend distribution regime provided by the Second Directive can be defined as consisting of a simple balance-sheet test (which can be developed as an enhanced net assets test by the Member States) plus a partial earned surplus test (also called retained earnings test). The Second

¹⁹ If directors fail to comply with §52(2) they are liable to criminal sanctions (§52(5)) and compelled to repay the company such part of the distribution as cannot be recovered from the shareholders (§56).

²⁰ Compare §4(2) New Zealand Companies Act 1993 with §6.40(d) RMBCA. See also *J. Rickford et al.*, 'Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance', in *European Business Law Review*, Vol. 15, 2004 p. 58.

²¹ §56(1) New Zealand Companies Act 1993.

²² Australian Corporations Act 2001.

²³ §254T Australian Corporations Act 2001. However, 'profits' are not defined in the law, and courts have never been inclined to define the term precisely. See *H.E. Boshma, M.L. Lennarts & J.N. Schutte-Veenstra*: *Alternative Systems for Capital Protection*, Institute for Company Law, 2005 p. 28.

²⁴ *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch. 266, referred to in *H.E. Boshma, M.L. Lennarts & J.N. Schutte-Veenstra*: *Alternative Systems for Capital Protection*, Institute for Company Law, 2005 p. 29.

²⁵ Such solvency test is not limited to a cash flow test, the company's overall financial situation is taken into consideration (assets, liabilities, cash, money from asset sales or loans, the company's creditworthiness). Hence, in certain circumstances, both a cash flow test and a balance sheet test may be carried out: see *Quick v Stoland* [1998] 29 ACSR 130, per Emmett J.

Directive does not expressly require non-distributable legal or statutory reserves.²⁶ Thus, according to Article 15(1)(a), in the national system of a Member State in which such reserves are not provided for, only subscribed capital should be taken into account for dividend distribution purposes. Moreover, the Second Directive has a minimum capital requirement of EUR 25,000 (Article 6(1)), which means that a company could also distribute its subscribed capital up to this very low limit. However, such a distribution would involve a capital reduction which, according to Article 30 of the Directive, would require a special majority for the decision at a general meeting, as well as a special form of publicity. Moreover, according to Article 32, the decision could be referred to a court by creditors invoking the right to obtain security for their claims, even though, as seen above in section 9, the Amending Directive has recently reversed the burden of proof for creditors in this area.

²⁶ With a few exceptions, in the first place one concerning a company's acquisition of its own shares: Article 22, Second Directive. We remind that legal reserves are reserves required by Member State's law, while statutory reserves are those determined by the articles of association.

The Rickford proposal: the ‘two-part solvency test’²⁷

The Rickford report proposes the introduction of a new instrument for regulating distributions to ensure the maintenance of solvency. The ‘two-part solvency test’ has two requirements: a) from the management’s point of view, the company must be able to meet its liabilities immediately following a distribution ‘In their [management's] opinion, after full enquiry into the position and prospects of the company, there will immediately after the distribution be no ground on which the company could be found unable to pay its debts’. The first part of the test also requires the board to reach the long term view i.e. that "for the reasonably foreseeable future, taking account of the company's expected prospects in the ordinary course of business it can be reasonably be expected to meet its liabilities"; b) on a going concern basis, the company must be able to pay its liabilities as they become due over the course of the following business year. In both cases contingent and prospective liabilities as well as contingent assets should be considered.

According to the Rickford proposal, the balance-sheet test would not be mandatory, but would provide a guide for the management in assessing the distributable amount. Indeed, if a legitimate distribution under the *two-part solvency test* contravenes the statutory balance sheet net assets test, the management must indicate this and explain why the distribution is nonetheless legitimate.

The Rickford proposal includes a provision for directors’ liability based on fault. Its extent ‘should be the normal one under the directors’ duty of care, skill, and diligence’ under the UK law. In particular ‘it should require that directors should certify that they have made enquiry into the affairs and prospects of the company which is proper for the purpose.’ Such an enquiry ‘cannot be expected to provide any absolute guarantee of an ongoing solvency’. In the end, the Rickford proposal advises that ‘a final definition of the two-part solvency test should ideally be settled after thorough consultation with representatives of those concerned, particularly company directors, and careful exploration of the range of prospects to be taken into account, illustrated with practical examples and should reflect the conditions in different Member States’. The Rickford group also proposed an extensive range of sanctions including directors' civil and criminal liabilities for distributions in excess of the solvency standard (either part).

Finally, the management should be required to issue and disclose a ‘solvency certificate’ which attests that the company has satisfied the solvency test. Where annual accounts of a company are audited, the audit report must consider the legality of the distribution and the directors' "going concern assurances". In cases in which there are doubts as to the lawfulness of distributions, the members of the board are furthermore required to consult an auditor prior to the distribution. Shareholders would be required to refund illegitimate distributions culpably received. The Rickford Group proposes a comprehensive system

²⁷ J. Rickford et al., ‘Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance’, in *European Business Law Review*, Vol. 15, 2004.

of sanctions, emphasising that the alternative system depends in part on the existence of the availability of effective sanctions. Shareholders would be required to refund illegitimate distributions.

The Lutter proposal: Enhanced balance-sheet (net assets) test plus solvency test²⁸

The Lutter group proposes a dual solution for a capital maintenance regime:

- either companies should produce a balance sheet according to commercial accounting principles (or GAAP), which is reviewed, certified and then used in connection with distributions (enhanced balance-sheet/net assets test);
- or companies should draw up a balance sheet according to the IFRS, which is reviewed and certified. However, such a balance sheet would not suffice for distributions because, under the IFRS, not only would realised profits be distributable, but mere book profits (unrealised profits) as well. To tackle this problem an additional solvency test is required. Instead of adjusting the IFRS balance sheet according to the principles of realisation and imparity (see the Fourth Company Law Directive), planned distributions would have to comply with a solvency test, looking at one to two years as a maximum.

The Lutter group proposes an enhanced balance-sheet test which requires that 'a sufficient amount of shareholders' equity must exist in the firm's IFRS account'. The proposal also provides 'a solvency test based on current information summarised in a financial budget and on a longer term capital budget should document that the intended distribution will highly likely leave the firm with sufficient funds to meet liabilities as they become due for the next two years.' In particular, the financial budget 'should focus on making the solvency testing procedure reliable by standardising it to the greatest extent possible, for example by referring to existing accounting and auditing standards' This solvency test would only be applicable to companies adopting the IFRS for their individual accounts, making such a regime optional for companies.

The Dutch proposal: Liquidity test and simple balance-sheet test²⁹

According to the Dutch group the basic principle of creditor protection should be that creditors have a reasonable prospect that the company will meet its obligations to them in a timely fashion.

Hence, given that the special responsibility of directors for making distributions to shareholders is one of the key features of the proposed regime, there should be a requirement for them to publish an explicit statement that the distribution will not negatively affect creditors. Such a statement would be added to the shareholders' resolution on distributions at the general meeting, clarifying the relationship between the general meeting and the board of directors. It would have slight administrative costs if it were not required to be certified by an auditor. Moreover, the Dutch group proposes that the requirements which should be met for a lawful distribution are a (simple) balance-sheet test combined with a liquidity test.

In the proposed (simple) balance-sheet test, the criterion is whether, after making a distribution, the assets of the company are at least equal to its debts and provisions. Only a surplus may be distributed. Such a test should be modelled on the Delaware or the

²⁸ M. Lutter et al., 'Legal Capital in Europe', in *European Company and Financial Law Review*, Special Volume 1, 2006.

²⁹ H.E. Boshma, M.L. Lennarts & J.N. Schutte-Veenstra: *Alternative Systems for Capital Protection*, Institute for Company Law, 2005

RMBCA examples. The Dutch group recommends the rejection of the current enhanced net asset test provided by Article 15(1)(a) of the Second Company Law Directive.

In the proposed liquidity test, the criterion is whether the company, assuming it continues operations, has sufficient cash available after making the distribution to be able to meet its financial obligations as they fall due in the coming period (for instance 12 months) in the course of its ordinary business operations. Such a test should be modelled on the Australia solvency test. Nevertheless, the Dutch group points out that ‘the liquidity test, certainly, contains uncertain elements: while many hard figures are available, certain forecasts have to be taken into consideration. And these are never 100 % hard.’ Directors will have to prepare a liquidity estimate for the coming 12 month period. The specific requirements for such an estimate can be established in consultation with accounting organisations.

To sum up, the Dutch group proposes the adoption of a combination of a (simple) balance-sheet test and a liquidity test. The liquidity test is provided to get round the disadvantages (evaluation problems and uncertainties) of prescribing only the balance-sheet test, and to give additional protection to creditors. On the other hand, the simple balance-sheet test is provided to get round the disadvantages of the liquidity test which only considers liabilities in the relatively short term.

The High Level Group proposal

The High Level Group’s perspective was to verify whether the legal capital regime established by the Second Directive ensured effective creditor protection.³⁰ The Group proposed a solvency test made up of two cumulative parts:

The first part consists of a balance-sheet test (a more rigorous version of Article 15 of the Second Directive). The second part of the solvency test proposed by the High Level Group consists of a liquidity test (also called a current assets/current liabilities test) According to this, the company must have sufficient liquid assets to pay its liabilities as they fall due in the following period, for instance 12 months.

In practice the Group recommended taking the MBCA model as a starting point, saying that further study should establish the opportunity to reinforce the two tests by requiring a certain solvency margin, *de facto* applying the California model.

³⁰ High Level Group of Company Law Experts: Report on a Modern Regulatory Framework for the Company Law in Europe, Brussels, 2002 p. 87. See: http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf;

for the *Consultative Document* see:

http://ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf: ‘In a legal capital regime, it is possible that a solvent company is unable to make distributions, or, conversely, that an insolvent company is able to make distributions.’