The British Virgin Islands (BVI) is a British dependent overseas territory in the eastern Caribbean. A leading jurisdiction for the incorporation of joint venture and private equity vehicles, the BVI is also an increasingly popular choice for establishment of investment funds. A bedrock principle of flexibility underpins the current BVI corporate statute, the BVI Business Companies Act (the “Act”).

**SOLVENCY TEST AND SOURCE OF FUNDS**

BVI law applies a single unified test to all distributions. The Act provides that the directors may, by resolution, authorise a distribution if they are satisfied, on reasonable grounds, that the company will, immediately after the distribution, satisfy the statutory solvency test. A distribution includes cash and in specie dividends (but not stock dividends), share redemptions and repurchases of shares, capital reductions, and the direct or indirect transfer of an asset or the incurring of a debt for the benefit of a shareholder.

The solvency test combines two parts: balance sheet (net assets) and liquidity (cash flow). It requires that the value of the company’s assets will not exceed its liabilities and the company will be able to pay its debts as they fall due. This aligns with the BVI’s test for insolvency for general purposes; there is no separate earnings or profits based test.

There is no requirement to demonstrate surplus or any other form of distributable reserves and no restrictions on the use of share subscription proceeds. Consideration for the issue of shares simply forms part of the assets of the company which can (assuming solvency) be applied as the directors see fit. Concepts of capital, share premium and surplus accounts have thus been abandoned. The only exception relates to companies incorporated under the previous statute, which may only pay dividends out of surplus unless they have opted to apply the rules under the Act.

Although Delaware is frequently cited as the inspiration behind the Act, the BVI distributions rules most closely resemble the ABA’s Revised Model Business Corporation Act. They also have much in common with New Zealand and Canada. The BVI approach has since been adopted in Guernsey.

**VALUATION OF NET ASSETS**

Despite the simplicity of the balance sheet part of the test, it still requires a valuation of the company’s net assets. BVI companies are not required by BVI law to conduct an annual audit or to follow any particular accounting principles although many opt to do so. It is thus unsurprising that the BVI follows the prevailing U.S. approach that no single objective valuation standard for distributions is necessary. Adherence to formal accounting principles in applying a balance sheet test for distributions can be problematic, especially if a company’s assets have a market value exceeding book value (common with start-ups). Directors will typically look to accounting and finance teams for support in all but the most clear cut cases, but the BVI follows Delaware’s example and allows the board to determine the appropriate reference data.

**AUTHORISATION**

Absent any additional substantive or procedural requirements in the company’s articles of association, the board is free to declare and pay a dividend at any time. The authorising board resolution must confirm that the directors are satisfied on reasonable grounds that the company will, immediately after the dividend, satisfy the solvency test. It is common for the articles of association to require that notice of the dividend be given to each shareholder. Other types of distributions must follow the relevant statutory process and any provisions in the articles of association.

Significant distributions may require shareholder approval. The Act requires shareholder consent for certain...
dispositions exceeding 50% in value of the company’s assets outside its usual course of business. Distributions are not carved out of the scope of the rule even though shareholders in companies with a single class of shares arguably do not typically need such protection. The rule can be disapplied in the company’s articles of association, but otherwise a distribution representing more than half of a company’s net assets may require a shareholder resolution.

UNLAWFUL AND IMPROPER DIVIDENDS
Distributions made in breach of the solvency test may be subject to reversal and “claw back” from the shareholder under the Act. This does not apply if the shareholder received it in good faith and without notice of the breach, it altered its position in reliance on the distribution’s validity, and it would be unfair to require repayment. In that situation, the directors are personally liable to make good the shortfall if, before the dividend was paid, the directors ceased to be satisfied that the company would satisfy the solvency test but failed to take reasonable steps to prevent its being made. If the company could have satisfied the solvency test by paying a lower amount, the courts may limit shareholder or director claw-back to the extent of the difference.

Directors may later incur liability for insolvent trading under insolvency laws even if a distribution was made lawfully at the time. A distribution may also amount to a voidable preference under insolvency laws. In BTI 2014 LLC v Sequana SA & others [2016] EWHC 1686, the English High Court held that a dividend was a transaction entered into at an undervalue within the relevant statutory definition, there being nothing in the wording to exclude the payment of a dividend from its scope. The BVI has a virtually identical definition of a transaction at an undervalue for insolvency purposes so it is likely that the BVI courts would take the same approach.

Compliance with the minimum requirements in the Act does not absolve the directors from liability to liquidators or shareholders if the making of a distribution amounts to a breach of their fiduciary duties. Generally, directors acting in good faith may be able to protect themselves to some extent by seeking shareholder approval of discretionary decisions (although the outer limits to this doctrine are unclear). The Act contains an unusual provision, allowing companies to modify the general rule that directors’ duties are owed to the shareholders of a solvent company, taken as a whole. A company can permit its directors to act in the interests of the shareholder(s), even if this is not in the best interests of the company of which (s)he acts as director. This is limited to wholly or partly owned subsidiaries and “joint ventures” (although the latter term is not defined for these purposes).

TAXATION
The BVI does not levy income or other tax (either by deduction or withholding) on distributions made by BVI companies. Appropriate advice should however be taken in any jurisdiction where a shareholder is liable to tax. This is particularly important where payments are made from sources other than profits, as they may be taxable in the hands of overseas shareholders as a return of capital rather than income. In First Nationwide v The Commissioners for HMRC [2012] EWCA 278 the English High Court ruled that it is the legal machinery under applicable company law - and not the source of the funds - that is determinative of their nature for tax purposes. This provides some welcome certainty for UK shareholders but not all jurisdictions will adopt the same approach.

CONCLUSION
Regulation of the ability to distribute assets to shareholders protects creditors and preferred shareholders, but critics of more rigid rules argue that over reliance on accounting principles can artificially preclude financially sound companies from making distributions. The BVI is in the global vanguard of flexible distribution policy, giving directors the latitude to apply sustainable capital management principles best suited to the company’s particular circumstances. This reflects a wider trend towards abandoning many aspects of traditional capital maintenance doctrine in favour of a focus on solvency and emphasising compliance by directors with their fiduciary duties.