RESEARCH ARTICLE

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AN APPRAISAL OF THE APPLICATION AND SOUNDNESS OF THE SOLVENCY AND LIQUIDITY TEST IN THE IMPLEMENTATION OF STATUTORY MERGERS

SUMMARY

The integration of the solvency and liquidity test into the South African company law has the effect of, among others, rendering the capital maintenance principle obsolete. The pertinent statutory provisions of statutory mergers require that both limbs of the test must be satisfied: solvency in the form of a forecast that the merging companies' assets are equal to and/or exceed their liabilities and liquidity in the form of a forecast that the merging companies' debts would be paid when due. The solvency and liquidity test is valid within 12 months after the test was considered, a set period which, we argue, is inadequate to protect the interests of long-term creditors and shareholders. According to reports, the largest leveraged buyout (LBO) in South Africa, the acquisition of Edcon by Bain in 2007, resulted in post-merger trade losses and high borrowing rates for Edcon. The post-mortem of the Edcon LBO reveals that the merged entity failed to honour creditors' repayment obligations, resulting in the shareholders losing proprietary interests to the creditors, heightening the need for having effective solvency and liquidity test. In addition, most of the recent corporate scandals emanating from deceptive accounting practices have exposed the inadequacy of the solvency and liquidity test, considering the heavy reliance on the solvency and liquidity test on financial records. To bolster creditor and shareholder protection, the article makes some suggestions that include making it mandatory that financial statements used in the forecasting be independently audited by external auditors and that the merging companies can only pass the solvency and liquidity test when their assets are greater than their liabilities, rather than simply being

equal to the liabilities, as is currently the case. The suggested yardstick for passing the solvency and liquidity test only when their assets are greater than their liabilities must be adopted in all capital reduction/altering transactions, including statutory mergers, and during the pay-outs of fair value to dissenting shareholders in the context of appraisal remedy.

1. INTRODUCTION*

The *Companies Act* 71 of 2008 ("the *Companies Act*" or "the *Act*") requires that two or more profit companies that are contemplating an amalgamation or merger (statutory merger) must project that both companies will satisfy the solvency and liquidity test upon implementing such a transaction.[1] The solvency and liquidity test is generally regulated by sec. 4, read together with sec. 1 of the *Companies Act*.[2] The overarching objective of the solvency and liquidity test is to protect creditors and shareholders in the context of distributions, financial assistance, and fundamental transactions. Scholarly work has explored the utility of the test in the context of distributions and financial assistance.[3] However, there is a dearth of literature specifically on the utility and efficacy of the test as a protective measure for creditors and shareholders in the context of statutory mergers.[4] This article seeks to address this gap.

We argue that, despite the soundness of the underlying policy rationales of the solvency and liquidity test, the implementation of the test has several shortcomings, as identified and addressed in this article.[5] One issue is that guaranteeing the success of the solvency and liquidity test by predicting the liquidity of the company for up to 12 months appears not to adequately protect long-term creditors and shareholders in the long run. The Bain-Edcon merger failed and we argue that, if the merger was implemented in terms of the new *Companies Act* and had the merging company invoked the solvency and liquidity test upon the implementation of the merger, the merged company was likely to succeed post-merger. As will be shown later, the merged company

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1 The *South African Companies Act* 71/2008:secs. 113(1) and (4), and 116(7), read together with *Companies Act*:sec 4.

2 *Companies Act*:sec.4, read together with *Companies Act*:sec 1.

3 Some of the articles that deal with the solvency test broadly or in the context identified above, save for mergers, include Cassim FHI 2005:283-293; Van der Linde 2009b:224-240; Van der Linde 2009a:481-501; Yeats & Jooste 2009:566-589; Bradstreet 2012:736-757; Bradstreet 2015:121-149; Bidie 2018:1-30; Bidie 2019:59-102.

4 The following papers focus on the solvency and liquidity test in statutory mergers to a limited extent: Cassim MF 2008:1-32; Cassim FHI *et al*. 2021:346-361; Cassim FHI *et al*. 2022:210-237; Cassim MF & FHI Cassim 2022:209-272; Davids *et al.* 2010:337-371.

5 Bradstreet 2015:133 suggested that, besides applying the text in distributions and other related capital reduction transactions, the solvency and liquidity test is of broad general relevance, because it is also a model that extends to the analysis of financial institutions and companies against systematic risks.

was debt-laden and failed to honour its obligations to creditors, with the result that the creditors took over its ownership.[6]

Notably, the solvency and liquidity test depends heavily on the correctness of the financial statements (statements of financial position and cash flow). However, the literature has revealed that, at the heart of several corporate scandals, is the crippling phenomenon of ‘creative accounting’, which is the inaccurate and arguably fraudulent representation of the company’s financial health. Creative accounting renders the solvency and liquidity test almost nugatory.[7] We also acknowledge that there are ways in which creditors and shareholders can protect themselves using the contractual and statutory means available under the *Companies Act* and the common law. However, a full discussion of the contractual remedies under common law falls outside the scope of this article.

This article comprises six parts. Immediately after the introduction, we deliberate on the definition and nature of an amalgamation or merger and then examine the pertinent procedure of statutory mergers. Thereafter, we critique the relevance and effectiveness of solvency and liquidity provisions in the *Companies Act*. We then reflect on the efficacy of the solvency and liquidity test in protecting the interests of creditors and shareholders in the context of statutory mergers. Finally, we make recommendations on how to bolster the test and provide some concluding remarks on its overall efficacy in statutory mergers.

2. DEFINITION AND NATURE OF AN AMALGAMATION OR MERGER

The definition of an amalgamation or merger appears in sec. 1 of the *Companies Act*. An amalgamation or merger is broadly described as a transaction, pursuant to an agreement, which results in two or more companies either forming one or more new companies, which together hold assets and liabilities that were previously held by the amalgamating or merging companies prior to the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies.[8]

Further, an amalgamation or merger is described as a transaction pursuant to an agreement between two companies, resulting in the survival of at least one of them with or without forming a new company that takes over the assets and liabilities that were previously held by the amalgamating or merging company immediately prior to the implementation of the agreement.[9]

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6 Kew “Bain exit leaves Edcon adrift in stormy seas”, https://www.iol.co.za/business-report/companies/bain-exit-leaves-edcon-adrift-in-stormy-seas-2072039 (accessed on 29 January 2022).

7 *Hlumisa Investment Holdings (RF) and Another v Kirkins and Others* (1423/2018) 2020 (ZASCA) 83; 2020 3 All SA 650 (SCA); 2020 5 SA 419 (SCA) (3 July 2020); *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and Others* (2833/2021) 2021 ZAWCHC 123 (2 July 2021):paras. 9 and 67.

8 *Companies Act*:sec.1.

9 *Companies Act*:sec.1.

A company that is a party to an amalgamation or merger agreement is called an amalgamating or merging company.[10]

The main implication of the implementation of a statutory merger transaction is that all (and not part of) the assets and liabilities combine by operation of law.[11] Such assets and liabilities vest either in a new company or a surviving company, as mentioned earlier. Importantly, before two or more companies amalgamate or merge, they must separately satisfy the solvency and liquidity test.[12] Since the assets and liabilities transfer automatically to the new or surviving company, the assumption is that, when the amalgamating or merging companies are able to satisfy the solvency and liquidity test separately, they will be able to satisfy the same when combined within the stipulated 12-month period.

Somewhat differently, in the United States (US) State of Delaware, a transaction that combines two or more companies through an agreement to form a single surviving company is referred to as a merger.[13] A transaction that results in the formation of a new company after an agreement is referred to as a consolidation.[14] Similarly, the *United Kingdom (UK) Companies Act* 2006 provides for a merger by absorption, namely, a transaction where the property and liabilities of one or more companies, including the company in respect of which a compromise or arrangement is proposed, are transferred to an existing company.[15] Further, sec. 904(1)(b) of the *UK Companies Act* 2006 provides for a merger by the formation of a new company where two or more public companies combine and transfer their property and liabilities to a new company (whether public or not).[16] It is interesting to note that clause 1 of the South African Companies Bill 2007 provided for a merger that was analogous to Delaware's merger or the UK's merger by absorption, whereas an amalgamation in the South African Companies Bill was equivalent to either a consolidation in Delaware or a merger by the formation of a new company in the UK.[17] Curiously, the drafters of the *South African Companies Act* chose to eventually define amalgamations and mergers as similar transactions, even though the transactions have different effects in practice.[18] A discussion of the rationale for the need to establish the technical differences between amalgamations and mergers is beyond the scope of this article. Notably, the consideration payable in statutory merger transactions includes securities and cash in South Africa, the UK, and Delaware.[19]

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10 *Companies Act*:sec.1.
11 *Companies Act*:sec.1.
12 *Companies Act*:sec.113(1) and (4).
13 *Title 8, Delaware General Corporation Law (DGCL):*sec. 251.
14 *Title 8, DGCL*:sec. 251.
15 The *United Kingdom (UK) Companies Act 2006*:sec.904(1)(a).
16 The *UK Companies Act 2006*:sec. 904(1)(b).
17 The *South African Companies Bill* 2007:clause.1.
18 The compound definition of an amalgamation or merger did not come without some criticisms; see also Cassim MF 2008: 2-3; Cassim FHI *et al*. 2022: 456-457, Cassim FHI *et al*. 2022:923-924, Mudzamiri 2023b: 817.
19 In South Africa, see *Companies Act*:sec. 113(2). See the *Companies (Cross-Border Mergers) Regulations* of 2007:reg. 2(2)(f) in the UK and *Title 8, DGCL*:sec. 251(b)(5).

3. THE PROCEDURE FOR IMPLEMENTING A STATUTORY MERGER

Secs. 113, 115, and 116 of the *Companies Act* provide for the procedure and steps that a statutory merger must follow for it to be successfully implemented. The first step in a merger procedure is for the parties to conclude a merger agreement, setting out the manner in which the merger will be effected.[20]

The second step is where the boards of directors in both merging companies consider whether each of the merging companies is able to satisfy the solvency and liquidity test.[21]

Notwithstanding the other contractual protections and the notice that creditors may have with the respective merging companies, we argue that the solvency and liquidity test together with the transfer of all assets and liabilities to the amalgamating company are the most meaningful creditor protections in the context of statutory mergers. This is because of the mandatory requirement that a merger cannot proceed unless it is predicted that, after the implementation of the merger, the merged company will still be able to pay its debts within the stipulated period.[22] Therefore, making the solvency and liquidity test a mandatory prerequisite for merger implementation seeks to grant creditors the assurance that the merged company will pay its debts. As third parties, creditors are not involved in the merger process, apart from being served with a notice (as discussed below). They are essentially protected from the consequences of the often 'insatiable appetite' of directors and shareholders to expand their businesses and seek a return on investment (ROI) by means of a merger, even when such a merger does not make business sense. [23]

The third step is the mandatory approval of the proposed amalgamation or merger transaction by a special resolution of shareholders in a meeting called for that purpose, as provided for in sec. 115(2) of the *Companies Act*.[24]

The fourth step entails the issuance of a notice to creditors in the prescribed manner, once all the applicable requirements are met, particularly shareholders' approval through a special resolution and the solvency and liquidity test.[25]

20 *Companies Act*:sec. 113(2).

21 *Companies Act*: subsec.113(1) and (4).

22 *Companies Act*:sec. 1 and subsec. 113(1) and (4).

23 Korman 2017:179.

24 This mandatory requirement of shareholder approval through a special resolution is a shareholder protection measure. A detailed discussion is presented below. As stated by Rudnicki & Ashe 2017:8, the shareholder(s) of every company involved in the merger or amalgamation must approve the merger. In addition, unless the merger is approved in the manner prescribed in *Companies Act*:sec. 115, it must not be implemented.

25 *Companies Act*:sec. 116(3).

The last step concerns the approval of the merger by the court in exceptional circumstances; in some instances, approval under the *Competition Act* may also be necessary.[26]

By implication, only shareholders and creditors of profit companies are statutorily directly protected by the five-step procedure and, in particular, by the application of the solvency and liquidity test, when implementing a statutory merger. The *Companies Act* defines a profit company as a company incorporated for the purpose of financial gain for its shareholders.[27] Thus, a profit company includes within its scope a public company, a personal liability company, a state-owned enterprise, and a private company.[28] The merits of including private companies within the ambit of Chapter 5 of the *Companies Act* that regulates fundamental transactions is debatable, mainly from a compliance and cost perspective.[29] Accordingly, regarding the discussion of the scope and application of the solvency and liquidity test in the context of statutory mergers, this article considers only regulated companies.

4. A CRITIQUE OF THE CURRENT FORMULATION OF THE SOLVENCY AND LIQUIDITY TEST UNDER SECTION 4 OF THE *COMPANIES ACT*

Sec. 4 of the *Companies Act* provides for the concept of the solvency and liquidity test. The liquidity test refers to the ability to satisfy the company's debts as they become due,[30] whereas the solvency test is a balance sheet test that reflects the net assets or liabilities at a specific time.[31] The solvency and liquidity test differs from the now-abolished capital maintenance principle which, as a general rule, prohibited, for example, the distribution of funds to shareholders other than distributable profits, except in a few cases where there was a court order.[32] According to Van der Linde, the new solvency and liquidity test cannot qualify as the capital maintenance rule but as

26 *Companies Act*:subsec. 115(2)(c) and (3)(a) and (b), read together with *Companies Act*:subec. 115(5) and (6); *Companies Act*:sec. 116(3) and (4). See also chapter 3 of the *Competition Act* 89/1998 and the *Competition Amendment Act* 2018:sec. 18A.

27 *Companies Act*:sec. 1.

28 *Companies Act*:sec. 1.

29 See Mashabane 2014:31-32. Phakeng 2018:431 argues that high compliance costs are associated with offers. Therefore, such inclusion of small private companies into merger regulation may, to a larger extent, overburden the said companies with costs of compliance than ensuring transparency and accountability. The legislature has identified the mischief of including private companies in the context and scope of affected transactions and proposes the amendment of the *Companies Act*:secs. 118 and 119(6) through the *Companies Amendment Bill* [B-27B -2023]:clause 16. It must be noted that the proposal is not yet in effect, since the *Bill* is not yet enacted into law.

30 Van der Linde 2009b:225.

31 Van der Linde 2009b:225-226.

32 Yeats & Jooste 2009:627.

an alternative.[33] It should be reiterated that, for a statutory merger to be successfully implemented, a projection must be done by the respective target and acquirer boards of directors that each of the two or more profit companies contemplating a merger will satisfy the solvency and liquidity test upon the implementation of the transaction.[34]

The *Companies Ac*t thus allows the directors to use the current financial information of the merging companies to make an 'educated guess' about the future performance of the merged company for the next 12 months. It is apparent that neither the solvency (particularly, due to the inclusion of unliquidated and contingent assets and liabilities in the test)[35] nor the liquidity aspects of the test are based on the actual solvency and liquidity position of the company, but on the prediction of the company's performance by the board of directors. This reliance on the projection by the board has potential pitfalls including, as shown in case law on many occasions, that the company directors may deliberately or negligently rely on misstatements and often manipulate the test,[36] particularly where a firm business decision to merge has already been made. Such a prediction may be even more difficult and unreliable in circumstances where a statutory merger results in the formation of a new company, since the prediction of the performance of a newly merged company after a 12-month period could be challenging, considering that such a company may be entering a new market and may not have amassed the requisite goodwill.

Further, the inaccuracy, uncertainty, and inherently flawed nature of predictions may be exacerbated by the fact that a 12-month period is a long period, especially in a dynamic business environment where, among others, exchange rates and inflation fluctuate. For example, predicting unforeseen performance is not always the best manner of conducting business, since different company management styles may bring different results. In addition, a *vis major*[37] such as riots, looting, and public health emergencies such as the COVID-19 pandemic and the accompanying national lockdown, with which South Africa grappled between 2020 and 2021, makes the solvency and liquidity test predictions rather faulty and unreliable.

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33 Van der Linde 2009b:224.

34 *Companies Act*:secs. 113(1) and (4) and 116(7), read together with *Companies Act*:sec. 4.

35 Cassim FHI *et al*. 2021:364 define contingent liability as liability that only becomes due and payable on the happening of an event that may not occur. Similarly, a contingent asset is a claim to an asset the vesting of which is conditional on the happening of an event that may or may not occur. The question must be the likelihood of the contingent event occurring and if it is likely to occur, the time it is likely to occur. See also Cassim FHI *et al*. 2021:949.

36 *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and others*:paras. 27 and 59. *De Bruyn v Steinhoff International Holdings NV and Others* [2020] JOL 47482 (GJ):par. 128.

37 Garner 2009:1587 defines *vis major* as a greater or superior force and/or irresistible force.

Sec. 1 of the *Companies Act* does not contain a definition of the solvency and liquidity test, save for indicating that it is a test contemplated under sec. 4(1) of the *Act*.[38] However, a closer look at the text of sec. 4(1) of the *Act* reveals that the provision only sets out the guidelines, by describing the broader elements of the solvency and liquidity test, and does not provide a concise definition *per se*.[39] In particular, sec. 4(1)(a) of the *Act* provides that the solvency limb of the test is established through an analysis of a company's statement of financial position (previously known as "the balance sheet test"), and passing such a test requires the company's fairly valued assets to be equal to or to exceed fairly valued liabilities after taking into consideration the "reasonably foreseeable financial circumstances of the company at that time".[40] Similarly, sec. 4(1)(b) of the *Act* regulates the liquidity limb, which relies on the company's cash-flow statement. To pass the liquidity test, each board must consider the financial circumstances of the company and predict whether the company will be able to pay its debts as they become due in the ordinary course of business within a 12-month period.[41] Put simply, the liquidity test is concerned with the available cash.[42]

In commenting on sec. 4 of the *Companies Act*, we affirm that Bradstreet correctly asserts that an evaluation of liquidity is likely to offer better protection to creditors whose accounts will be settled in the foreseeable future, that is, within a 12-month period.[43] He argues further that expecting accurate long-term predictions and the adequate protection of long-term creditors through a projection is unrealistic, given that business dynamics and exchange rates fluctuate over time.[44] Accordingly, the long-term creditors with claims that are due and payable after the 12-month period remain inadequately protected under the solvency and liquidity test.[45] Bradstreet goes on to suggest that a better approach to address the challenges created by the limited 12-month time frame is for the board of directors to consider long-term liabilities when applying the test.[46] However, it may be argued that, in the absence of a clear time frame, giving the board the discretion to decide how far into the future it may go in assessing the long-term liabilities would be undesirable.[47] Some of the directors may lose their jobs after a successful merger; accordingly, it may be difficult to hold them accountable for a prediction that they may have made, especially one that stretches beyond a 12-month period. Therefore, it was sensible for legislators to insert sec. 4 of the *Companies Act*, which requires "all reasonably foreseeable financial circumstances of a company"

38 *Companies Act*:sec. 1.
39 *Companies Act*:sec. 4(1).
40 *Companies Act*:sec. 4(1)(a).
41 *Companies Act*:sec. 4(1)(b).
42 *Companies Act*:sec. 4(1)(b).
43 Bradstreet 2012:750.
44 Bradstreet 2015:132. See Bradstreet 2012:750; Van der Linde 2009b:229 argues that the time frame is undesirable.
45 Bradstreet 2015:132.
46 Bradstreet 2015:132.
47 Bradstreet 2015:132. See Bradstreet 2012:750.

to be considered when determining whether the solvency and liquidity test is satisfied.[48] We argue that the phrasing of sec. 4(1) of the *Companies Act* to inclusively read "…considering all reasonably foreseeable…" (*the reasonableness requirement*) is unique to the South African *Companies Act*. Its inclusion is important because it delineates the extent to which the financial circumstances of the company, including its long-term liabilities, may be considered by the board. Cassim FHI *et al.* correctly assert that the reasonableness requirement in sec. 4 of the *Act* is an objective test, namely, whether a hypothetical reasonable board would have been satisfied with the solvency and liquidity test.[49] The policy rationale for measuring the reasonableness test by the objective test yardstick under sec. 4 of the *Companies Act* is to provide a benchmark for the board of directors to apply their minds and act in good faith in the context of the implementation of the solvency and liquidity test.[50] Notably, other progressive statutes in the US such as the *Delaware General Corporation Law* (*DGCL*) and the *Model Business Corporations Act* (*MBCA*) do not have a similar provision, making the South African position unique.[51]

Another issue surrounding the formulation of the solvency and liquidity test is that it is applied differently in varied transactions across the provisions of the *Companies Act*, for example, distributions and statutory mergers.[52] The formulation of paras. (b) and (c) of sec. 4(2) of the *Act* dealing with the solvency and liquidity procedure gives the impression that they apply only to distributions and not to statutory mergers.[53] This lack of harmony and inconsistency is undesirable, because the law must be harmonised, clear, and certain. However, if the observation that paras. (b) and (c) apply equally to statutory mergers is correct, then the prerogative inclusion of contingent assets and liabilities would be questionable. This is because it would complicate the solvency and liquidity procedure and contradict the applicable international accounting principles; for example, the said principles do not require the inclusion of contingent assets and liabilities in financial statements.[54] It is reiterated, in this instance, that a contingent asset is defined as a right or claim to an asset, with the vesting of such right being conditional on an uncertain

48 *Companies Act*:sec. 4(1). See Bradstreet 2012:750.
49 Cassim FHI *et al*. 2021:358.
50 Cassim FHI *et al*. 2021:360.
51 See *Model Business Corporations Act* (2016 Revision):sec. 6.40(c); *Title 8, DGCL*:sec. 154.
52 *Companies Act*:sec. 4(2)(b) and (c).
53 *Companies Act*:sec. 4(2)(b) and (c).
54 In April 2001, the International Accounting Standards Board adopted IAS 37 Provisions Contingent Liabilities and Contingent Assets, which the International Accounting Standards Committee had originally issued in September 1998. IAS 37 on clauses 27-30 and 31-35, specifically, requires entities not to recognise contingent liabilities and assets, respectively, even though entities need to disclose same. See *Companies Act*:sec. 4(2)(b) and (c); Van der Linde 2009b:231. For a further discussion on how the inclusion of contingent assets and liabilities is not desirable in the broader picture of interpreting the solvency and liquidity test, see Kadish 2020:47.

future event.[55] Similarly, we reinforce, in this instance, that a contingent liability is a debt that becomes due, owing and payable only upon the occurrence of an uncertain future event.[56]

Considering the above, Van der Linde correctly asserts that the inclusion of contingent assets and liabilities that will arise from distributions in the solvency and liquidity test is a curious requirement because it is unclear how the contingent assets and liabilities can be factored into distributions, and their inclusion also appears to contradict the premise that the test must be fulfilled immediately after the transaction is completed.[57] Similarly, it can be argued that the inclusion of contingent assets and liabilities in the solvency and liquidity inquiry in statutory mergers could raise similar questions raised by Van der Linde in the context of distributions.[58] Kadish also laments the inclusion of contingent assets and liabilities within the ambit of the solvency and liquidity test because it is more burdensome on the board of directors.[59]

In the South African context, both the solvency and liquidity legs of the test must be simultaneously satisfied, in order for a company to pass the test; therefore, satisfying one leg does not guarantee passing the solvency and liquidity test.[60] Similarly, other progressive comparative jurisdictions have adopted a similar approach of requiring both the solvency and liquidity test only in capital-reducing transactions. On the one hand, the countries that apply the solvency and liquidity test include Canada,[61] and some states in the US;[62] on the other hand, some jurisdictions such as the US State of Delaware,[63] Australia,[64] and the UK[65] require only the solvency test in capital reduction transactions. However, we reiterate that it must be noted that the above jurisdictions, save for South Africa, either apply the solvency and liquidity test or the solvency test to protect creditors in the context of capital-reducing

55 Kadish 2020:47.

56 Kadish 2020:47.

57 *Companies Act*:sec. 4(2)(b) and (c). See Van der Linde 2009b:231.

58 *Companies Act*:sec. 4(2)(b) and (c). See Van der Linde 2009b:231.

59 Kadish 2020:47.

60 Bidie 2019:225; Bradstreet 2015:134.

61 *Canadian Business Corporations Act* of 1985 (*CBCA*):secs. 34 and 42. Sec. 34 prohibits the company from repurchasing issued shares if it fails to satisfy the liquidity and solvency test, whereas sec. 42 places a negative duty on the company not to proceed with declaring dividends, if there is a reasonable belief that the company will not satisfy the liquidity and solvency test after such payment.

62 *MBCA*:sec. 6.40(c).

63 *Title 8, DGCL*:sec. 244(b).

64 *Australian Corporations Act* 2001, as amended by the *Corporations Amendment (Corporate Reporting Reform) Act* 66/2010 (the *Reform Act* 2010):sec. 254T, prohibits the company from paying dividends where it will not pass the solvency test after the dividend is paid.

65 See the *UK Companies Act* 2006:secs. 641, 642, 643, and 644, read together with sec. 832. Despite sec. 643 being titled solvency statement, the wording under a similar provision appears to have captured the meaning of the liquidity test *per se*.

transactions such as distributions and not in the context of mergers.[66] We submit that, when creditors are protected in the manner in which they are under the *Companies Act*, they are highly likely to extend credit to companies. This is an important source of finance for the growth and expansion of companies in South Africa. We further submit that, by considering the need for credit as espoused earlier, and by adopting the solvency and liquidity test in statutory mergers, the *Companies Act* is undoubtedly one of the progressive statutes that provide better creditor and shareholder protection in statutory mergers and offer valuable lessons to other jurisdictions.[67]

In general, and specifically in the context of statutory mergers, the adequacy of such protection is sometimes questionable because, for merging companies to pass the solvency and liquidity test, their assets and liabilities, fairly valued, must be at least *equal*, that is, where the businesses are *prima facie* not making any profits.[68] Such a position would probably have been different if the capital maintenance rule was still in place, where only companies that were making profits were allowed to engage in transactions that could potentially reduce a company's share capital. Furthermore, the South African solvency and liquidity test is deficient from the perspective of protecting creditors and shareholders when compared to other jurisdictions. For instance, in New Zealand, a company can satisfy the solvency and liquidity test only if its assets are *greater* than its liabilities, thus affording better creditor and shareholder protection.[69]

To sum up, the solvency test in South Africa provides inadequate protection to creditors and shareholders, because it allows a company to pass the solvency and liquidity test even when the assets and liabilities fairly valued are *equal*, that is, where the businesses are not *prima facie* making profits.[70] Further, the solvency and liquidity test is not flexible in adapting to an unfortunate *vis major* such as COVID-19 and the related national lockdown measures in South Africa, making the predictions in unforeseen circumstances even more faulty. Furthermore, the inclusion of contingent assets and liabilities in the solvency and liquidity test is questionable and complicates the test as shown earlier. Lastly, the inherent potential unreliability of financial statements and the creeping phenomenon of deliberate and negligent misrepresentations on financial statements by the boards of directors witnessed in some South African companies undermines the credibility of the solvency and liquidity test.

66 *Title 8, DGCL*:sec. 244(b). See the *UK Companies Act* 2006:secs. 641-644, read together with sec. 832, and the *Australian Corporations Act* 2001:sec. 254T, as amended by the *Reform Act* 2010.

67 *Companies Act*:secs. 113(1) and (4) and 116(7), read together with sec. 4.

68 *Companies Act*:sec. 4(1)(a).

69 *New Zealand Companies Act* 105/1993:sec. 4(1)(b).

70 *Companies Act*:sec. 4(1)(a).

5. A CRITIQUE OF THE SOLVENCY AND LIQUIDITY TEST IN STATUTORY MERGERS

The post-merger performance of Edcon, following its acquisition by Bain in 2007, is a noteworthy case study that exposes the inadequacies of statutory mergers and the need for bolstering the solvency and liquidity test in statutory mergers.

5.1 The aftermath of the Bain-Edcon Leveraged Buyout (LBO)

The target company in the Bain-Edcon LBO was Edgars Consolidated Stores Ltd (Edcon), a South African company that was acquired by an American investment firm, Bain Capital, for R25 billion in 2007.[71] The buyout was financed through equity worth R5 billion and debt worth R20 billion.[72] Typically, a merger or corporate takeover transaction financed by debt, where listed companies will be delisted on stock markets, is technically referred to as a Leveraged Buyout (LBO).[73] Edcon was delisted from the Johannesburg Stock Exchange (JSE) after its acquisition by Bain Capital, which utilised listed Eurobonds and notes in Ireland to finance approximately R18 billion of the merger. The acquisition was structured as a scheme of arrangement to access tax shields.[74] Notably, disposals, proposals for amalgamations or mergers, and schemes of arrangements form part of fundamental transactions,[75] which must now be preceded by the solvency and liquidity procedure.[76] This Bain-Edcon merger was implemented under secs. 311 to 321 of the old *Companies Act* and before the solvency and liquidity test requirement was effective in South African corporate law, in general, and statutory mergers, in particular.[77]

71 *Main Street 522 (Pty) Ltd and Edcon Consolidated Stores Ltd* case no 24/LM/Mar07.

72 According to Correia *et al*. 2018:17-1, the Edcon buyout by Bain through an LBO is one of the largest LBOs in South African history.

73 According to Correia *et al*. 2018:17-1.

74 *Main Street 522 (Pty) Ltd and Edcon Consolidated Stores Ltd* case no 24/LM/Mar07.

75 Chapter 5 of the *Companies Act* from secs.112-116 refers to the listed transactions as fundamental transactions and the definition of a fundamental transaction is not provided in the *Act*.

76 *Companies Act*:secs. 112-116.

77 Notably the Edcon and Bain merger was implemented under the *Companies Act* 61/1973:secs. 311-321. The solvency and liquidity test was not yet in operation, a position which was going to be different should it had been completed post the advent of the new *Companies Act*. A deeper discussion on the provisions of the old *Companies Act* is outside the scope of this article.

After the acquisition, Edcon was involved in a series of merger and corporate takeover deals.[78] After these takeovers, Edcon was left struggling with debt and huge interest commitments.[79] As a result, Edcon began to default on repayments to its suppliers and other creditors.[80] Trading profits fell from roughly R2.4 billion in 2007 to R2.2 billion in 2009, then to R1.9 billion in 2012, before falling even further to R1.3 billion in 2014.[81] After interest and fair value adjustments, Edcon's net income was R1.7 billion in 2007, but the group experienced losses of R1.3 billion in 2008, R640 million in 2009, R2.5 billion in 2012, and R2.4 billion in 2014.[82] The foregoing figures demonstrate the substantial underperformance of the merged company, which exposed creditors to the danger of not having their loans serviced on time, if at all. We argue that the position of the Bain-Edcon merger would have likely been different had it been implemented under the new *Companies Act* where the solvency and liquidity test is compulsory. In as much as we highlighted the potential flaws of the solvency and liquidity test, we argue that, if the solvency and liquidity test had been implemented, the potential of the merged company to struggle financially even within the 12 months after the implementation of the merger as was the case, was to a larger extent going to be averted. The fact that the merged company failed to pay its debts within a relatively short period of 12 months gives credence to the need for the solvency and liquidity test in statutory mergers.

Subsequently, Edcon sold its Edgars shareholding in Zimbabwe to a Mauritius investor, SSCG Africa Holdings, as a way of staying afloat in 2019.[83] Despite that move, the Edcon Group is currently under business rescue and has been selling some of its chain stores to rivals, for example, the sale of Jet stores to The Foschini Group (TFG) in 2020, which resulted in a substantial number of job losses.[84] The Edcon story has negative implications for different stakeholders, including low returns on investments and losses for

78 Some of the takeover deals that were subsequently completed by Edcon include a takeover in 2007 in *Edgars Consolidated Stores Limited v New Clicks (Pty) Ltd* case no 59 LM/JUN/07. See another example of a deal that was completed in 2015 in *Edcon Limited v Celrose (Proprietary) Limited and Eddels Shoes (Proprietary) Limited* case no. 020396. See also another takeover transaction effected in 2016 in *Parentco (Pty) Ltd v Edcon Limited* case no LM117Sep16.

79 Faku "Edcon taken by creditors", https://www.iol.co.za/business-report/companies/Edcon-taken-over-by-creditors-2070817 (accessed 20 January 2022). *Business Report* reported that the former CEO of Edcon (Bennie Brooks) said that, for Edcon to survive its financial crisis, the most feasible plan was to commence business rescue plan or a takeover by bondholders. See Correia *et al*. 2018:17-1.

80 Faku 2016.

81 Correia *et al*. 2018:17-1.

82 Correia *et al*. 2018:17-1.

83 Kuyedzwa "Edgars in Zimbabwe sold to investor from Mauritius", https://www.news24.com/fin24/Companies/edgars-in-zimbabwe-sold-to-investor-from-mauritius-20190910 (accessed on 30 January 2022).

84 Buthelezi "Foschini and Edcon agree on sale of parts of fashion retailer Jet", https://www.news24.com/fin24/Companies/Retail/just-in-foschini-and-edcon-agree-on-sale-offer-for-parts-of-fashion-retailer-jet-20200817 (accessed on 31 January 2022).

the shareholders, loan defaults and debt restructuring for creditors, loss of employment, and communities losing corporate social responsibility proceeds and community development opportunities, due to losses in corporate taxes.[85]

The Bain-Edcon merger exposes how the protection afforded to shareholders and creditors under the *Companies Act* is inextricably connected to the complexities of statutory merger implementation, namely the solvency and liquidity criteria that must be met before a statutory merger is implemented.[86] The Bain-Edcon takeover was effected through a scheme of arrangement, and we argue that, if it was implemented under the new *Companies Act*, it would have meant that the solvency and liquidity test was going to be effectively completed by the boards of the two or more merging companies. The solvency and liquidity test is a future projection of the company's performance after the merger, yet Edcon was already struggling financially within the very first 12 months after the merger. The statistics show that, immediately after the LBO, Edcon had a series of trading losses and high interest rates, meaning that both the short-term and the long-term creditors' debt repayments were affected. Accordingly, we argue that the solvency and liquidity test is a key protective measure, especially for creditors and shareholders in the context of statutory mergers; hence, it needs to be bolstered in the manner we suggested in our concluding remarks. The vexed question remains whether the inherent deficiencies of the test can be remedied by statutory amendment and/or in other ways to effectively provide adequate protection to creditors and shareholders in the context of statutory mergers.

5.2 Grey areas in the solvency and liquidity test procedure in statutory mergers

It is worth reiterating that, conceptually, the *Companies Act* provides better protection to shareholders and creditors, by requiring the two-step solvency and liquidity test when implementing statutory mergers, compared to Delaware, the UK, and Australia, which require the solvency limb only.[87] However, the adequacy of the protection offered by the *Act* is questionable since the merging companies can pass the solvency and liquidity test when the assets and liabilities fairly valued are equal, that is, where the company

85 See Mahlangu "22,000 Edcon employees get retrenchment notices", https://www.timeslive.co.za/news/south-africa/2020-06-17-22000-edcon-employees-get-retrenchment-notices/ (accessed 1 February 2022); Planting "The big shrink is over at Edcon", https://www.dailymaverick.co.za/article/2020-02-05-the-big-shrink-is-over-at-edcon/ (accessed on 2 February 2022); Claasen "Edcon's rescue deal gets thumbs up from competition watchdog", https://www.businesslive.co.za/bd/companies/retail-and-consumer/2019-05-02-edcons-rescue-deal-gets-thumbs-up-from-competition-watchdog/ (accessed on 1 February 2022).

86 Cassim FHI *et al*. 2022:459-665; Cassim MF 2008:6-8, 14-15.

87 Companies Act:secs. 113(1) and (4) and 116(7), read together with sec. 4(1)(a); *Title 8, DGCL*:sec. 244(b); UK *Companies Act* 2006:secs. 641-644, read together with sec. 832 of the *Australian Corporations Act* 2001, as amended by the *Reform Act* 2010:sec. 25T.

is effectively not making any profits.[88] Guaranteeing the maintenance of the equilibrium through a 12-month prediction of financial health in circumstances where there is at least a 50 per cent chance of success [this emanates from the language in sec. 4 of the *Companies Act*, "…*equal or exceed*…"] is somewhat risky. In as much as we lament the inadequacies of the solvency and liquidity test, we submit that, even in its current form, the solvency and liquidity test would have been useful to avert the unprecedented failure of the Bain-Edcon merger, should it have been incorporated into the implementation of same. We, further, submit that the policy rationales of the solvency and liquidity test are cogent and need to be strengthened as recommended in our concluding remarks, to ensure that creditors and shareholders are adequately protected in the context of statutory mergers.

In *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and Others* (the *Steinhoff* case),[89] the board of directors presented materially misleading financial statements with serious irregularities that nearly collapsed the company.[90] This shows that, in practice, financial statements may be materially misleading. Particularly, in this matter, the applicants argued that, since the expert relied on the financial statements with serious irregularities when implementing the solvency and liquidity test, the test was supposed to fall away.[91] However, the court applied the reasonableness test in determining whether the solvency and liquidity should stand.[92] The court held that a reasonable person could have concluded that the company was solvent and liquid should they have relied on the financial statements that were relied upon by the respondent's board of directors.[93] We submit that the conclusion of the court, in this instance, dwindles hope to complainants (either creditors or shareholders) who wish to reverse the fraudulent solvency and liquidity test which was completed based on gross financial irregularities. In this context, we submit that the cogency of the reasonableness test is thus questionable when assessing the solvency and liquidity test on a case-by-case basis.

It may be argued that, in order to mitigate the inadequacies of the solvency and liquidity procedure, particularly the possibility of relying on misleading financial statements, companies often rely on the services of external auditors. However, recently, some corporate scandals have shown that, in certain circumstances, internal auditors may collude with the board of directors. Such collusion has shown how reliance on financial statements potentially dents the efficacy of the solvency and liquidity test. In such circumstances,

88 *Companies Act*:sec. 4(1)(a).

89 *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and Others*.

90 *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and Others*:par. 56.

91 *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and Others*:paras. 63-65.

92 *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and Others*:paras. 71-72.

93 *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and Others*:paras. 71-72.

where the referee becomes a player, due diligence,[94] which includes the use of external auditors when applying solvency and liquidity tests, particularly in statutory mergers, is required to ensure that the financial statements are reliable and accurate in projecting the financial health of the merged company. Recently, the court grappled with the issue of collusion between the directors and auditors in *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkins and Others.*[95] In particular, one of the major contentions was that the directors and the auditors colluded, and relied on reckless financial practices, false statements, and prospectus with misleading information.[96] The courts concluded that indeed the auditors and directors had colluded to defraud the company by relying on false financial statements. However, both the court *a quo* and the SCA correctly held that directors and auditors do not owe fiduciary duties to individual shareholders. Hence, the reflective loss principle permits the company and not shareholders to claim for diminution of share value emanating from reliance on false financial statements and false audit reports.[97] The facts in *Hlumisa* substantiate the submission by Mahonen who correctly asserts that projections, including external financial projections, often lack accuracy and reliability.[98] Imperfect as they may be, they are still important in at least providing a glimpse of the broader implications of the post-merger financial position, which can be used by the company and creditors to design a comprehensive impact assessment. For this to happen, there must be a watertight compliance policy that ensures effective due diligence investigations to avoid pursuing a statutory merger that could disadvantage not only creditors but also the broad spectrum of stakeholders.[99]

94 According to Patel:2018:1, due diligence can be defined as the process adopted by the acquirer in the takeover transaction to investigate the target in order to reach an informed business decision on whether to proceed or abort the transaction. *Companies Act*:sec. 4, read together with secs. 113 and 115 requires the board of directors to conduct a solvency and liquidity test as part of due diligence.

95 *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkins and Others*.

96 *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkins and Others*:par. 5; Mudzamiri 2023a:164.

97 *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkins and Others*:paras. 71 and 76; Mudzamiri 2023a:164.

98 Mahonen 2020:23.

99 Patel 2018:1. For further discussions, see *United States v Hussein* 30 June 2018 case no 16-cr-00462-CRB (N.D.Cal. Jul. 30, 2018) United States District of California:par. 80. After a successful US$11.1 billion takeover of Autonomy, a UK software company, in 2011 by HP, a US computer and printer manufacturing firm, HP instituted litigation against the former CEO and the former CFO of Autonomy, Mike Lynch and Sushovan Hussain, respectively. The litigation-related events unfolded in the following manner. In 2012 (a year after the HP-Autonomy buyout), HP wrote down the value of Autonomy by US$8.8 billion, because HP allegedly uncovered accounting improprieties. The HP-Autonomy debacle shows how flawed the projections that the offeror or the merged company must make are if such forecasts are based on information that is untrue, because the target board of directors concealed and inflated essential financial information and/or provided financial documents tainted by fraud, during the takeover process.

Against the backdrop of the identified issues of misleading financial statements and collusion of the board of directors and auditors in the *Steinhoff* and *Hlumisa* cases, respectively, we argue that the efficacy of the solvency and liquidity test can be bolstered by adhering to strict due diligence, coupled with external auditing and that these must be compulsory for the impending statutory merger and that all profit companies must not opt out of these recommended measures. The underlying policy rationale for involving external auditors in determining the accuracy of the financial statements is that, as a general rule, external auditors have no relationship with the company's board of directors, which reduces the chances of collusion. It is accepted that audited financial statements are still prone to the so-called 'creative accounting' or 'accounting irregularities', as evidenced by the *Steinhoff* and *Hlumisa* cases. However, it can be argued that externally audited financial statements minimise the risk of 'cooked books', compared to internally prepared financial statements. There is also a regulatory risk for auditors who falsify financial statements in that they may be investigated, fined and/or imprisoned, and may lose their licences to operate as auditors. They are, therefore, likely to comply with the prescripts of the law and their profession when performing their auditing duties.[100]

Coupled with robust due diligence, directors who are involved in concealing the necessary financial information during the implementation of statutory mergers should be held liable for the breach of their fiduciary duties.[101] It is common cause that sound and proper due diligence includes allowing competing companies to exchange necessary financial information with each other.[102] Therefore, the *Companies Act* must seek to balance two important rights, namely, the right to access information and the right of companies to guard against having their competitors access sensitive financial records before making a firm offer. The balance can be struck by ensuring that the offeror can access the financial records of the target company to a certain extent.[103] However, in the context of mergers apart from the readily and

100 *Auditing Profession Act* 26/2005:Chs. V and VI.

101 *Companies Act*:secs. 76(3), 77, and 218. It is now established that directors and auditors cannot generally be held liable for breach of fiduciary duties by shareholders or any member of the company. See *Hlumisa Investment Holdings (RF) and Another v Kirkins and Others*. However, shareholders and/or creditors can access derivative actions on behalf of the company to hold directors liable for their breach of fiduciary duties owed to the company.

102 Cassim FHI *et al*. 2021:926.

103 *Loest v Gendac (Pty) Ltd and another* (17699/2016) 2017 ZAGPPHC 73; 2017 (4) SA 187 (GP) (3 March 2017):paras. 23 and 40. In this matter, the main question before the court was whether the applicant was entitled to information sought in terms of the provisions of the *Promotion of Access to Information Act* 2/2000 (*PAIA*), in order to protect or exercise his rights in terms of the *Companies Act*:sec. 164. The court held that the role of an appointed appraiser(s) would be to collate and process relevant information where the court deems available information insufficient and unreliable to determine. As an element of due diligence in merger procedure should information regarding the merged company be withheld, we submit that the court needs to compel the merging company to provide accurate and necessary information so that merging companies implement the statutory merger well-informed.

publicly available financial statements, all the confidential information of the merging profit companies (including private companies) must be accessible only to the external auditors who need to broadly assess the financial status of the merging companies.

The adequacy of the solvency and liquidity test can also be questioned, particularly in the context of statutory mergers in circumstances where the aggrieved dissenting shareholders seek the appraisal remedy.[104] Surprisingly, where a statutory merger resolution has been passed and adopted, and the dissenting shareholders seek to be paid the fair value of their shares, if the company believes that the payment of the agreed 'fair value' to the shareholder will render it incapable of satisfying the liquidity test, the company may apply to the court for a variation of its obligations.[105] The inclusion of the solvency and liquidity test, in this instance, is especially questionable since the triggering events in respect of the appraisal remedy include amalgamation or merger transactions, which may only be properly implemented by a company's management after satisfying the solvency and liquidity test.[106] Therefore, it is further submitted that, if the solvency and liquidity forecasts were reliable to the 'expected extent', the legislature would probably not have included sec. 164(17) in the *Act*. Further, the acknowledgment by the drafters of the *Act* that, even if the solvency and liquidity test was satisfied when the resolution to implement a merger was reached, the possibility of such a company failing to pay its debts as they become due in the context of the appraisal remedy makes it questionable whether the current threshold that triggers the solvency and liquidity test is effective in the first place.

Considering the above granting merged companies another chance to aver whether the payment of fair value will render it unable to satisfy the solvency and liquidity test is undesirable. We argue that it is conceivable that the prediction of solvency and liquidity would change if the company acquires new obligations to buy back shares in the context of the appraisal remedy. We, hence, submit that the minimum threshold of the solvency and liquidity test being reached when assets "… *equal or exceed* …" liabilities inadequately protects the merging company(ies) in that the moment there should be a pay-out of fair value if assets are equal to liabilities, the company immediately fails to satisfy the solvency and liquidity test. Perhaps, this is undesirable. We presume that the position would be different if the threshold was when assets exceed liabilities because the merging company(ies) would have the opportunity to pay out a certain percentage, if not all, of the fair value to dissenting shareholders in the context of the appraisal remedy, and thus, companies will not automatically be subjected to a second solvency and liquidity test unless they deem it necessary. Still, this raises questions as to whether the test was properly applied when implementing such a resolution in the first place.[107] Otherwise, sec. 164(17) of the *Act* may simply create an escape route for a company wishing to circumvent its obligation to pay the

104 *Companies Act*:sec. 164(17)(a); Mudzamiri & Osode 2020:403.

105 *Companies Act*:sec. 164(17)(a).

106 *Companies Act*:sec. 116(7), read together with sec. 113(1) and (4); Cassim FHI *et al*. 2021:1094 - 1125.

107 Mudzamiri & Osode 2020:403.

fair value of shares to the dissenting shareholders as they become due.[108] Upon receipt of such a company's application, the court may either make a just and equitable order in view of the company's financial position or request payment of the amount due to the shareholder by the company as soon as the company satisfies the liquidity test.[109] Therefore, deferring the payment of the fair value of dissenters' shares until the company regains its ability to satisfy the liquidity test is problematic, because it has the potential of needlessly prolonging the appraisal remedy procedure, thereby diminishing and diluting the rights of dissenting shareholders to the fair value of their shares as they may have to wait for an indefinite period of time.[110]

Likewise, one of the most important characteristics of creditors of a company is that they are owed money by a company and they have a legal right to payment of that amount at some point in time.[111] In addition, one of the risks that creditors normally incur after lending money is that the company will not be able to pay back the entire capital sum advanced.[112] Therefore, the liquidity element of the solvency and liquidity test addresses the fundamental expectation that the creditors will be paid on time.[113] Notably, the application to vary obligations in the payment of fair cash value for dissenting shareholders is beneficial to the creditors, since it will ensure that the company is liquid, and the creditors have a better chance of being paid on time.[114] The inclusion of sec. 164(17) in the *Companies Act* raises the possibility of overregulation, in that boards on different occasions with different circumstances and information would forecast the solvency and liquidity of the company; that is, when the proposal of a statutory merger was made, then should it be necessary when fair value is paid out to dissenting shareholders. Hence, the subsection appears to repeat the same procedure. On the other hand, allowing the company to 'second-guess' its liquidity position in contexts where appraisal remedy pay-outs are due may also function to reinforce the solvency and liquidity test in merger regulation. We submit, however, that the solvency and liquidity test in the context of appraisal remedy is unnecessary because all the triggering events of appraisal remedy are implemented pursuant to a solvency and liquidity test. Hence, providing for it under sec. 164(17) brings more harm than good.

108 Mudzamiri & Osode 2020:403.

109 *Companies Act*:sec. 164(17)(b).

110 As Cassim FHI *et al*. 2022:808 assert, the appraisal remedy is inherently associated with delays on the part of dissenting shareholders in accessing the remedy. For example, by simply sending a written demand to the company for the fair value of their shares, the dissenting shareholders would have relinquished all their rights in connection with their shares and would have to wait for the payment of the fair value of the said shares which is due at the end of the appraisal proceedings. Until then, the dissenting shareholders may be deprived of accessing their shares and/or participation in share-related proceedings. See Mudzamiri & Osode 2020:403.

111 Gullifer & Payne 2019:80.

112 Gullifer & Payne 2019:6.

113 Van der Linde 2009b:227.

114 It must be noted that such delay in the payment of fair value in the appraisal remedy procedure has a potential benefit not only for creditors, but also for the majority of non-dissenting shareholders, because there will be no reduction in the liquidity of the company until the appraisal remedy procedure has been finalised.

6. CONCLUSION

The overarching objective of incorporating the solvency and liquidity test into South African company law is the protection of company creditors and shareholders, and this is laudable.[115] Conceptually, South Africa has distinguished itself from other progressive jurisdictions by incorporating both the solvency and liquidity elements into the test, which arguably offers better protection to creditors and shareholders. However, the efficacy of the test in practice is questionable, particularly in statutory mergers. We have argued that predictions are inherently flawed, since they are not based on exact science. Other challenges posed include that the solvency and liquidity test may, in some instances, be based on not only unreliable financial statements that are possibly falsified, as evidenced by some case law discussed earlier. In addition, circumstances in the business environment may change, rendering the predictions unreliable. This may be exacerbated by emergencies such as the COVID-19 pandemic and the national lockdown. To address this, we have recommended the use of external auditors to bolster the effectiveness and reliability of financial statements. In addition, due diligence must be made compulsory when implementing statutory mergers. The bar for passing the solvency and liquidity test appears to be too low, because the directors of the merging companies simply need to establish that the merged company will have *equal* fairly valued assets and liabilities, which means that the businesses are not *prima facie* making profits. In addition, the current provision that governs the solvency and liquidity test appears to be ‘inflexible’ in adapting to a *vis major* such as the COVID-19 pandemic.

Another challenging issue in the interpretation of the solvency and liquidity test provisions is that the liquidity limb is satisfied through a 12-month forecast that each merging company will be able to pay its debts as they become due following the implementation of the statutory merger. We have argued that this is problematic for long-term creditors and shareholders, because their claims that are due and payable beyond the 12-month period are not directly accommodated in the test. To mitigate this challenge, long-term creditors could still access other proprietary and contractual remedies, but this will be at their cost.

The double application of the solvency and liquidity test, both in triggering events such as the statutory merger implementation and in the context of the appraisal remedy, appears to be evidence that the legislature anticipated that the test alone would not be an effective protection measure in statutory mergers. To address the limitations of the test in statutory mergers, it is recommended that the ‘overarching’ statutory provision that deals with solvency and liquidity should be amended in line with the solvency test provided in the New Zealand

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115 Davids *et al.* 2010:360; Yeats 2014:336; Cassim 2017:314-316.

statute, which may afford better creditor and shareholder protection. Such amendment will ensure that a company will satisfy the solvency and liquidity test only if the company's assets are greater than its liabilities.[116]

Lastly, as noted earlier, the so-called creative accounting weakens the efficacy of the solvency and liquidity test.[117] To address this challenge, we recommend the strengthening of the protection of creditors and shareholders through a solvency and liquidity test that is predicated on the mandatory external auditing of financial statements and the introduction of compulsory due diligence in the evaluation of financial statements.

116 *New Zealand Companies Act*:sec. 4(1)(b); Mudzamiri 2021:109.

117 *Hlumisa Investment Holdings (RF) and Another v Kirkins and Others*. *Trevo Capital Ltd and Others v Steinhoff International Holdings (Pty) Ltd and Others*:paras. 9 and 67.

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