McLEOD LAW LLP

PUBLICATION

When can a Mortgage Investment Corporation Distribute a Dividend?

Andrew Neil Hutton

June 6, 2014

When can a Mortgage Investment Corporation Distribute a Dividend?

Exempt Edge, Summer 2014

A Mortgage Investment Corporation (MIC) is a unique entity in the corporate world because the provisions of the Income Tax Act (Tax Act) permits a MIC to deduct from its income the amount of taxable dividends it pays to its shareholders. The Tax Act also permits a MIC to pay out substantially all of its net income and net realized capital gains every year as dividends. Thus, a MIC's profit flows to its shareholders by way of dividends, where it is taxed in their hands.

While this advantage is permissible under the Tax Act, MICs must still comply with the provisions of the Alberta Business Corporations Act (ABCA) prior to distributing a dividend. Section 43 of the ABCA outlines the statutory tests that a MIC's Board of Directors must ensure are satisfied before a MIC can issue a dividend to its shareholders. Although the corporate legislation in other provinces contains a similar provision, this article will only address the application of the statutory tests under Alberta law.

These statutory tests are comprised of two arms: (1) a Solvency Test; and (2) a Liquidity Test. The Solvency Test requires a Board to establish that "there are no reasonable grounds for believing that the corporation is, or would after payment be, unable to meet its liabilities as they come due." If such reasonable grounds exist, the MIC is effectively insolvent and a dividend should not be issued. One of the primary purposes of the Solvency Test is to ensure that shareholders are not given preference over a MIC's creditors. Debtor-creditor laws have established that shareholders' rights to receive assets from a corporation are subordinate to rights of its creditors.

The Liquidity Test requires a Board to establish that "there are no reasonable grounds for believing 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." If there is insufficient realizable value of the assets, the MIC is not liquid. This is a more difficult and less obvious test in its application than the Solvency Test. The rationale behind the Liquidity Test again addresses creditor protection by requiring a Board to factor in a MIC's liabilities, but it also requires a Board to consider a MIC's stated capital.

With a finite value to its assets, and creditors having first priority to them, if a MIC distributes a dividend without meeting the Liquidity Test it will be left with an asset value less than the value of its stated capital. Thus, the Liquidity Test also serves to protect the erosion of shareholders' capital. A shareholder receiving a dividend under these circumstances will be left in a less favourable situation, from a tax perspective, than if a MIC's Board had applied the tests and declined to issue a dividend. This is because the dividends are taxable but the return of capital upon redemption or dissolution is not.

Furthermore, a MIC's director(s) may be personally liable to the corporation's creditors and shareholders for any amount of monies paid out where the MIC was unable to satisfy these statutory tests. Given these critical requirements and consequences, where does a MIC Board begin with its analysis of whether it can distribute a dividend? Both the Solvency and Liquidity Test contain the phrase "no reasonable grounds." This wording provides a MIC Board with discretion on what is 'reasonable' when applying the tests. The Board must, however, act in the best interest of the MIC's stakeholders (i.e. creditors and shareholders). A consistent step-by-step approach is required in application of the tests. Although not intended as legal advice, the following offers guidance on the application of the Solvency Test and Liquidity Test:

1. The Solvency Test is generally straight forward. If the dividend payment will immediately result in a MIC being unable to pay its other liabilities as they come due the MIC is insolvent and a dividend should not be distributed.

The Courts have held that the test is to be applied at the time when the dividend is both declared and paid. Thus, a dividend should not be distributed unless it can meet these tests at the time of payment. The Courts have also established that this analysis must be based on the current financial position of a MIC and a Board should not rely on past financial statements.

2. If the Solvency Test is met, a Board must then apply the Liquidity Test. This test must also be based on the MIC's current financial information. The Liquidity Test has more elements to consider and requires an additional layer of analysis. The Liquidity Test requires a Board to establish the "realizable value of the corporation's assets." There is no statutory definition for this phrase but the Courts have adopted the position that "realizable value" means the fair market value of a corporation's assets based on either a liquidation basis or a going-concern basis.

A Board should first establish whether a MIC is a going concern or whether it is in a liquidation situation. Simply put, a going-concern is a business that carries on operations without the threat of liquidation for the foreseeable future, usually a period of at least 12 months. If a MIC cannot declare itself to be a going-concern then liquidation is reasonably foreseeable.

To assist with this determination, the Courts have confirmed that the going-concern valuation is appropriate when one or more of the following external circumstances are present:

- The corporation is growing
- There are increased royalty revenues
- The corporation has a definite business plan
- Purchasers continue to invest in the corporation
- Application of the liquidation approach essentially eliminates the corporation's value
- There is no reasonable possibility of liquidation
- There is no evidence that the corporation has sold assets with the intent of liquidating

If there are 'storm clouds on the horizon' which would lead the Board to believe that liquidation was a reasonable possibility, then a MIC's assets cannot be valued on a going-concern basis and should instead be valued on a distress basis. This result will prevent most dividends distributions.

3. If a going-concern valuation is reasonable, the Courts have supported the traditional approach to establishing

fair market value in the open marketplace. In other words, “what price a willing and knowledgeable vendor and purchaser, neither acting under compulsion, would agree to.” The Courts have confirmed that the assets should be valued on a going-concern basis if that would maximize the price. “Distress liquidation values would only come into play if the storm clouds were on the horizon.”

4. While the specific method of establishing fair market value is left to the discretion of a Board and its advisors, guidance can be taken from the Courts on using a going-concern approach that employs a reasonable method to maximize the value of the assets. For a MIC, it may be possible to maximize the value of the mortgage contracts based on what willing third party is prepared to pay to assume the contract and the related interest income stream, rather than valuing the mortgage contract based strictly on its book value (i.e. the outstanding principal).

5. The Liquidity Test is satisfied if the realizable value of a MIC’s assets exceeds the aggregate of the liabilities and the value of the MIC’s stated capital, and, if the Solvency Test has also been satisfied, then a dividend can be distributed.

It is imperative for a Board to recognize that if a dividend is distributed when one or both of these tests cannot be met, the Courts will find there to be a misrepresentation by the directors which may give rise to legal action against such directors. If a director voted for, or consented to, the payment of dividends when a MIC was unable to satisfy these statutory tests, that director may be liable for the amount paid out and the directors are exposed to personal civil and criminal risk.

It is also important to note that a Board is obligated to reach a reasonable assessment of the financial condition of the MIC at the time when the dividend is paid. Once a reasonable assessment is made, a Board will have discharged its duty and as long as any future losses of a MIC were not anticipated at the time when the dividends were paid neither the directors nor the shareholders are liable to repay the dividend to the corporation. Boards are not responsible for forecasting future losses of a MIC, unless there are reasonable grounds for anticipating that such losses will occur. It is strongly recommended that a Board exercise proper corporate governance and take care to document its analysis to demonstrate and support the methods used and their reasonableness. This can help protect directors from personal liability by establishing that proper due diligence was conducted and that appropriate and reasonable steps were taken by a Board in arriving at its results on the statutory tests.

Neil is a partner in the Corporate & Commercial group of McLeod Law. He has over 20 years of experience providing comprehensive business focused legal advice. He strives to provide his clients with responsive advice with an emphasis on “getting the deal done”. Working with entrepreneurs, owner-operators and mid-sized enterprises, Neil provides legal advice on mergers and acquisitions, initial public offerings, exempt market financings, equity financing, debt financings, stock exchange listings, corporate governance, regulatory compliance, re-organizations, shareholder agreements and contractual drafting. Neil also has extensive experience structuring and setting up real estate-based joint ventures, limited partnerships and management agreements. Neil has been a member of McLeod Law’s Executive Committee since 2007.

For further information please email anhutton@mcleod-law.com. Neil would like to acknowledge Brett Turnquist and Matthew Burgoyne, both associate lawyers at McLeod Law LLP, for their research, contributions and assistance with this article.