GOVERNANCE – DIRECTOR'S RESPONSIBILITY IN RELATION TO INSOLVENCY

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INTRODUCTION

Covid-19 has created unprecedented business liquidity issues. For businesses, foremost among these is the business viability in the long term - this often involves managing the cash flow crisis. This article discusses the difference between cash flow insolvency and balance sheet insolvency, including the director's responsibility.

CASH FLOW INSOLVENCY

In brief, cash flow insolvency is when a company is not able to pay its debts when they fall due. As an illustration, a developer may be asset rich but has little incoming cash flow; it does not have enough cash to pay its obligations when they fall due.

BALANCE SHEET INSOLVENCY

In the UK, a company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.[1] The test is conventionally described as the balance sheet test.[2]

The provision on the inability to pay debts under our Companies Act 2016 is different. Section 466(1)(c) provides that " ... company shall be deemed to be unable to pay its debts if ... it is proved to the satisfaction of the Court that the company is unable to pay its debts and in determining whether a company is unable to pay its debts the Court shall take into account the contingent and prospective liabilities of the company".

Our Companies Act 2016 does not provide for the "assets is less than the amount of its liabilities" test, which the UK has, although it provides that the Court must take into account the company's "contingent and prospective liabilities". Arguably, the definition of "inability to pay debts" under section 466 of the Companies Act 2016 does not refer to the balance sheet test.

[1] Section 123(2) of Insolvency Act 1986, UK
[2] Goode on Principles of Corporate Insolvency Law, Fifth Edition, Page 158

CAN A COMPANY BE WOUND UP IF IT IS ASSET RICH, BUT IS CASH FLOW INSOLVENT?

The short answer is yes. The Companies Act 2016 provides that the Court may order the winding up of a company if the company is unable to pay its debts.[3] The company is deemed unable to pay its debts if the company is indebted in a sum exceeding the amount as may be prescribed by the Minister and a creditor has served a notice of demand requiring the company to pay, but the company has for 21 days after the service of the demand neglected to pay the sum.[4]

The amount prescribed by the Minister currently stands at RM50,000 for the period from 23 April 2020 to 31 Dec 2020.[5] Prior to Covid-19, the amount prescribed by the Minister was RM10,000.

In relation to the period of 21 days, it is 6 months if the notice of demand is served between the period of 23 April 2020 to 31 December 2020.[6] The legality of this change has recently been challenged in court.

DIRECTOR'S PERSONAL LIABILITY IN RELATION TO INSOLVENCY

Section 539(3) of the Companies Act 2016 provides that "... an officer of the company who knowingly was a party to the contracting of a debt had, at the time the debt was contracted, no reasonable or probable ground of expectation ... of the company being able to pay the debt, commits an offence ...". The essence of this provision is insolvent trading – also referred to as wrongful trading in other jurisdictions. Section 540(2) of the Companies Act 2016 provides that the Court may "... if the Court thinks proper ... declare that the person shall be personally responsible without any limitation of liability for the payment of the whole or any part of that debt".

Insolvent trading must be distinguished from fraudulent trading. Fraudulent trading connotes an element of "intention to defraud". The court can hold the director of a company personally liable, without limitation of liability, if he was knowingly a party to the fraud.[7] The Malaysian Federal Court in a recent case held that a director was to be personally liable for RM2.9 million of the company debts incurred but not paid as a result of fraudulent trading[8].

DEFENCE – DOES A DIRECTOR HAVE A DEFENCE?

In Malaysia, the Companies Act 2016 does not make specific mention of the defence(s) available in relation to insolvent trading.

In the UK, the law provides that the court shall not make a declaration of wrongful trading if it is satisfied that the person concerned' ... took every step with a view of minimizing potential loss to the company's creditors...'.[9]

In Singapore, the law provides that the court may relieve "... the person ... from the personal liability for which he or she is declared responsible, if – (a) the person acted honestly; (b) having regard to all the circumstances of the case, the person ought fairly to be relieved from the personal liability".[10]

The Australian statute provides protection for directors against personal liability for debts incurred by an insolvent company if they take a course of action that is reasonably likely to lead to a better outcome compared to the appointment of an administrator or a liquidator. This protection is referred to as the 'safe harbour' protection.[11]

Whilst Malaysia does not have specific protection accorded by the Companies Act 2016, it is noted that section 581 of the Companies Act provides that if it appears to the Court that a person (including an officer of the corporation) is or may be liable for negligence, default, breach of duty or breach of trust, "... but that he has acted honestly and reasonably and that, having regard to all the circumstances of the case, he ought fairly to be excused ... the Court may relieve him either wholly or partly from his liability..." – this is similar to the provision in Singapore, as discussed above.

[3] Section 465(1)(e) of the Companies Act 2016
[4] Section 466(1)(a) of the Companies Act 2016
[5] Direction of the Minister under Section 466(1)(a) dated 21 April 2020
[6] Companies (Exemption) (No 2) Order 2020 issued by the Minister on 23 April 2020
[7] Section 540 Companies Act 2016
[8] *Dato' Prem Krishna Sahgal v Muniandy Nadasan & Ors* [2018] 2 MLJ 693
[9] Section 214(3) of Insolvency Act 1986 (UK)
[10] Section 239(2) Insolvency, Restructuring and Dissolution Act 2018 (Singapore)
[11] Section 588GA Corporations Act 2001

WHAT CONSTITUTES HAVING TAKEN "EVERY STEP WITH A VIEW OF MINIMIZING POTENTIAL LOSS TO THE COMPANY'S CREDITORS" – A DEFENCE UNDER UK INSOLVENCY ACT 1986.

The textbook *Goode on Principles of Corporate Insolvency Law*[12] sets out 12 points "for survival". As described by Goode, these include *"consider carefully with your fellow directors whether the business is viable"*, and if it is, *"ensure an adequate cash flow..", "consider the advisability of putting the company into administration in order to give it breathing space and prevent action by individual creditors."* Administration is similar to judicial management in Malaysia.

THE STANDARD OF KNOWLEDGE AND SKILLS REQUIRED OF DIRECTORS

Section 213 of Companies Act 2016 provides that "A director of a company shall ... exercise his powers in accordance with this Act, for a proper purpose and in good faith in the best interest of the company". "A director shall exercise reasonable care, skill and diligence with - (a) the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and (b) any additional knowledge, skill and experience which the director in fact has."

Therefore, if a director has additional knowledge, skill and experience, he will be held to a higher standard. As an example, if he is an accountant, he will not be able to put forward the defence that he does not have a good understanding of financials.

Arguably, in considering whether the court will grant the director relief from liability in the event of insolvent trading, the court may take into account whether the directors have fulfilled these responsibilities. This is especially so when the company's inability to pay its debts is due to unforeseen circumstances such as Covid-19.

CASH FLOW SOLVENCY PLANNING

At the operational level, when a company has cash flow issues, it would be prudent to have cash flow projections prepared by an appropriately qualified professional. The steps taken to prepare cash flow projections (to determine whether the company is able to pay its debts when they fall due) may be seen by the court as a positive step towards having exercised reasonable care. The projection should take into account contingent and prospective liabilities. The company may consider seeking external help if it does not have sufficient expertise to prepare the cash flow projection to form an opinion on the viability of the company.

DOES COMPANIES ACT 2016 PROVIDES FOR "BALANCE SHEET" TEST?

The Companies Act 2016 requires the directors of the company to provide a solvency declaration in relation to certain transactions.[13] In the solvency statement form prescribed by the Companies Commission of Malaysia (SSM), the items that the directors are required to declare include – "there is no ground on which the company is unable to pay its debts, and the asset of the company is more than the liability of the company at the date of the transaction...". This is akin to a combination of a cash flow test and balance sheet test. It is however not within the scope of this article to discuss transactions that require such a declaration.

CONCLUDING REMARKS

From the perspective of the potential insolvency of a company, it is prudent for directors to take into consideration the points discussed above, as a matter of good governance and to avoid personal liability.

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[12] Goode on Principles of Corporate Insolvency Law, Fifth Edition, Page 775 - 777

[13] Section 112, 113 and 132 of Companies Act 2016