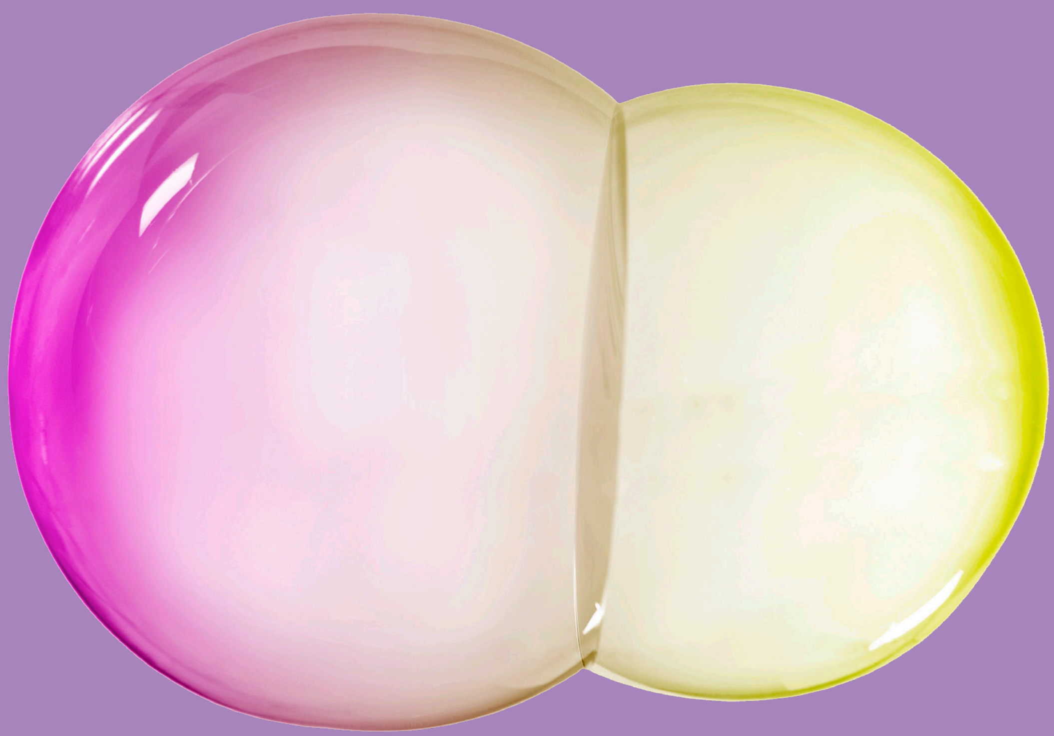
CMS Law . Tax

Advising the Board on **Insolvency Risk in Singapore**



Risk, Resilience and Reputation

Directors' risk report

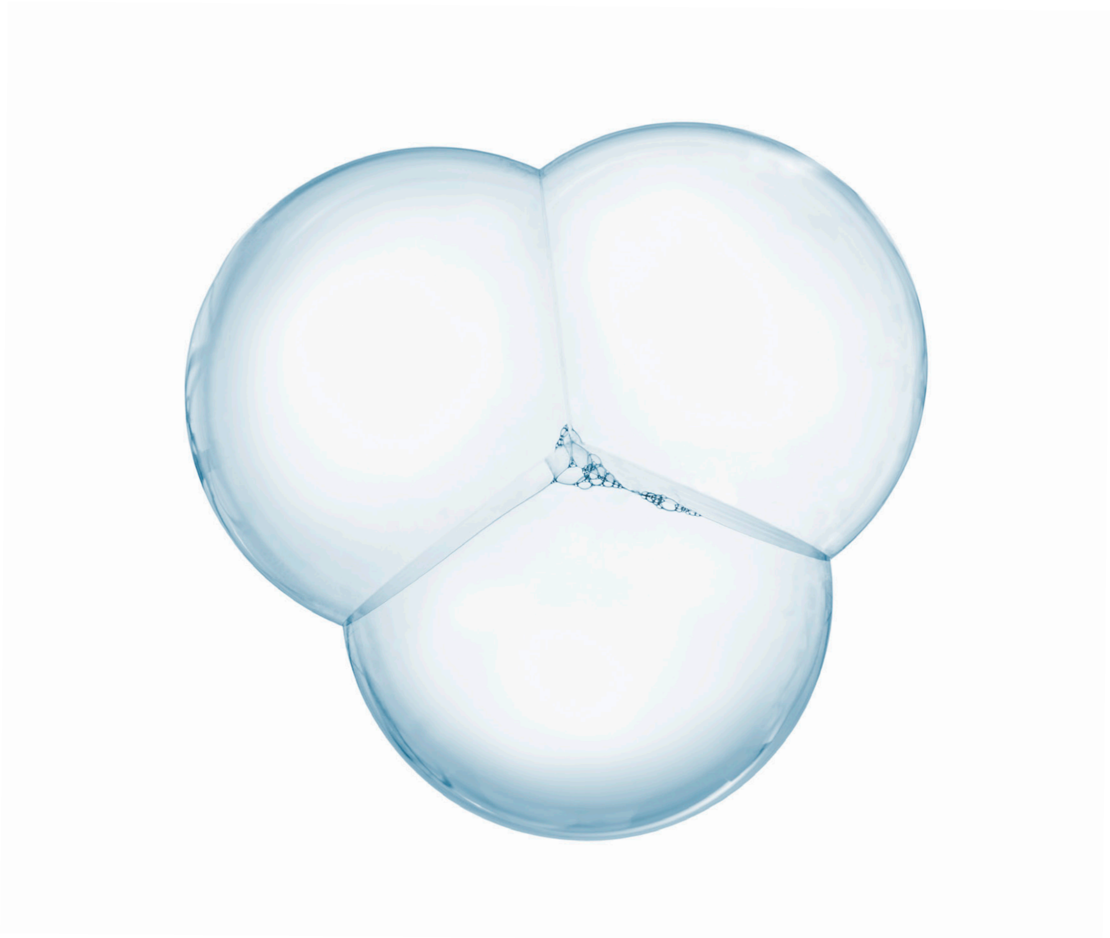
It is crucial for company directors to understand how their duties change and augment in times of financial distress for the company. If these duties are not properly discharged, it can result in personal liability and/or disqualification from acting as a director.

It's equally important to be cognisant of directors' duties if you represent a third party dealing with a distressed company, for example, a lender, supplier or customer.

This will help you anticipate how the distressed company may behave in its ongoing dealings and negotiations with you.

Specifically, the fiduciary duties of directors of a distressed company may be a key factor in determining:

— The time available for key stakeholders to agree the terms of a financial restructuring before the board has no real choice but to file for insolvency protection; and
— What the company may and may not be able to do pending a deal being agreed, during what is often described as the 'twilight zone'.



Impact of COVID-19 on corporate failures and directors' conduct

Given the uncertainties surrounding the COVID-19 pandemic, it is anticipated that the number of formal insolvencies in Singapore will trend upwards across numerous sectors as companies see a decline in their financial position. It is inevitable that some of these corporate failures will result in scrutiny of the actions of the companies' directors.

The duty to take into account creditors' interests

Ordinarily, directors have a statutory duty to promote the success of the company for the benefit of its shareholders. However, when a company is in the zone of insolvency, directors are required to consider and act in the interests of the company's creditors.

How financially distressed does a company need to be for the duty towards creditors to arise?

— A director owes a fiduciary duty towards creditors when the company, through their actions, is insolvent, potentially insolvent or is put in a situation where its creditors will be prejudiced and the company is, or is likely to be, unable to satisfy its debts with its creditors;

— the trigger, therefore, is at some stage before the company actually becomes unable to pay its debts as they fall due, and the courts will undertake a broad assessment of the surrounding circumstances of the case to determine when this 'trigger' has been reached.

Is the board obliged still to balance the interests of shareholders alongside the interests of creditors?

— Directors are required to balance creditors' rights and genuine attempts by directors to revitalise a company's financial difficulties to keep the company afloat. In balancing these interests, directors should avoid any actions which give shareholders or specific creditors a preference over other creditors.

— The courts will generally not be too quick to act where directors are acting in good faith to facilitate the preservation or rehabilitation of a company, and where they have reasonable commercial grounds for believing that the transaction would benefit the company.

— REMEMBER: A breach of duty by a director can result in a claim against a director personally.

Wrongful trading

Singapore has recently introduced a new "wrongful trading" provision under the Insolvency, Restructuring and Dissolution Act ("IRDA") which has been passed by Parliament in 2018 (but has not yet to come into force as at the date of writing). Key points to note are:

- a company trades wrongfully if it incurs debt or liabilities when it is insolvent (or becomes insolvent as a result of incurring such debt or liability), without reasonable prospect of meeting such debts or liabilities in full;
- a claim can be brought by a judicial manager, liquidator, the official receiver or a creditor or contributory of the company declaring that any person who was a party to the company trading wrongfully is personally liable for all or any of the debts or other liabilities of the company if that person:
  - (a) knew the company was trading wrongfully; or
  - (b) as an officer of the company, ought, in all the circumstances to have known that the company was trading wrongfully;
- the court may relieve a director from personal liability where the director acted honestly and, having regard to all the circumstances of the case, ought fairly to be relieved from personal liability;
- while criminal liability for wrongful trading can arise even if the company never enters into judicial management or liquidation, it is no longer necessary to establish criminal liability for the civil provisions to apply;
- there is also a new provision allowing parties to seek the court's declaration as to whether a particular course of conduct, a particular transaction or a particular series of transactions of the company at the time of and after such application would constitute wrongful trading.
- **Note:** Under the COVID-19 (Temporary Measures) Act 2020, which was passed in Parliament on 7 April 2020, a company will not be considered to be trading wrongfully if the debt or other liability is incurred in the ordinary course of the company's business; during the prescribed period (being at first instance, 6 months from the commencement of the Act); and before the appointment of a judicial manager or liquidator of the company.

What every director should know

— **legal duties** – the same legal duties are owed by all directors, whether one is an executive director, non-executive director, de facto director or shadow director – provided there is evidence of the company being accustomed over a certain period of time to act in accordance with the directions or instructions of the director before he can be deemed a "shadow" director. A "de facto" director behaves as a director without having been formally validly appointed.

— **duties are entity-specific** – the basis on which a director owes fiduciary duties towards its creditors is not dependent on whether an entire group of companies is insolvent, as it is assessed on an entity by entity basis and each company in a group (and its respective creditors) must be considered separately;

— **conflicts** – specific steps may need to be taken to address conflicts of interest that may arise, e.g. from a director being on more than one board of different group companies, or also employed by a shareholder or a lender;

— **transactions with connected parties** – directors should ensure that all such transactions are demonstrably on an arm's length basis and undertaken for sound commercial reasons. The transfer cannot be at an undervalue or amount to an unfair preference (that is, the transaction cannot put the person in a better position than he would otherwise have been in when the company was placed in winding up);

— **resignation** – it is generally not advisable for a director to resign without having first discharged his/her duties;

— **listed companies** – companies with listed shares or other securities will have additional obligations, including to update the market;

— **regulated companies** – will have additional obligations (which are outside the scope of this report); and

— **operations abroad** – a Singapore company that operates or has assets in a jurisdiction outside of Singapore can enter a local law insolvency process. The directors' conduct may be scrutinised under that local law. Therefore additional local law advice on directors' duties may be required

— **Note:** Under the COVID-19 (Temporary Measures) Act 2020, directors will be temporarily relieved from their obligations to prevent their companies from trading while insolvent if the debts are incurred in the company's ordinary course of business; during the prescribed period (being at first instance, 6 months from the commencement of the Act); and before the appointment of a judicial manager or liquidator of the company. However, directors will remain criminally liable if the debts are incurred fraudulently.

The restructuring toolkit

Sometimes a consensual restructuring can be achieved by negotiation with key stakeholders, without needing to deploy a formal process. Other times a formal process may be needed to force compromises or other solutions. The main formal regimes under Singapore's restructuring and insolvency legal framework are:

Liquidation

A company may be wound up voluntarily or compulsorily by the court.

Compulsory Liquidation

— In a compulsory liquidation, the company, its creditors (including contingent or prospective creditors), members or directors, can apply to court for a winding up order.

— The court may appoint the Official Receiver or an approved provisional liquidator after the making of a winding up application and before the making of a winding up order. The provisional liquidator has all the functions and powers of a liquidator (subject to statute or discretion of the Court).

— A winding up order may be granted if the court is satisfied that the company is unable to pay off its debts. Typically, this will be deemed as such if:

- a creditor has served a statutory demand on the company for a sum in excess of SGD 10,000 and the company neglected for 3 weeks to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor;

Note: Under the COVID-19 (Temporary Measures) Act 2020, the Singapore government has temporarily increased the monetary threshold of a company insolvency from SGD 10,000 to SGD 100,000. The statutory period to respond to creditor demands has also been temporarily lengthened from 3 weeks to 6 months. The measures will, at first instance, be in place for 6 months from the commencement of the Act.

- the creditor can prove to the court that the company is unable to pay its debts (including contingent and prospective debts if any); or
- there is an unsatisfied judgement, decree or order against the company.

— Note that when a winding up order has been made or a provisional liquidator has been appointed, no action or proceeding can be proceeded with or commenced against a company other than with the court's discretion.

Voluntary Liquidation

— A voluntary liquidation may proceed by way of a members' voluntary liquidation (MVL) or a creditors' voluntary liquidation (CVL).

— Both a CVL and MVL are initiated by way of the company passing a special resolution that it is wound up voluntarily.

— The main difference between an MVL and a CVL is that in a CVL, the creditors drive the process of the liquidation, and the creditors' choice of liquidator prevails.

— An MVL may be converted to a CVL if the company is later found to be insolvent.

MVL

If the directors make a declaration of solvency that the company will be able to pay its debts in full within a period not exceeding 12 months from the time the winding up has commenced, the liquidation will proceed as an MVL.

CVL

The liquidation will proceed as a CVL if the company's directors believe that the company cannot pay its debts in full within 12 months from the commencement of the winding up, and the directors make a statutory declaration to that effect. There are two ways to place a company into CVL – either directly or via a Provisional Liquidation.

(a) Direct to CVL

— Where there is no urgent need to place the company into liquidation, and when the liquidation is contemplated to be straightforward (i.e. there are no ongoing operations of the business, no creditor demands etc.), a company may be placed into CVL directly.

— The directors would first hold a directors' meeting resolving to appoint a liquidator and then call for an Extraordinary General Meeting (EGM). Where there is only one shareholder in the company, the EGM can typically be convened at short notice with 100% shareholder approval.

— At the EGM, the shareholders will confirm the directors' nomination of liquidator, following which ACRA lodgements would be made and the CVL would officially commence.

(b) CVL via a Provisional Liquidation

— If the above assumptions in (a) do not apply, and there is an urgent need to appoint a liquidator (for example, if there are creditor demands, ongoing trades or directors are concerned about personal liability and / or there is simply a preference to pass control to a liquidator as soon as possible) the board can resolve to appoint a provisional liquidator.

— The appointment of a provisional liquidator is effective on lodgement of the directors' resolution and statutory declaration.

— Within 30 days of the appointment of a provisional liquidator, directors would then be required to call for an EGM to have the shareholders "confirm" the directors' choice of liquidator.

In both routes (a) and (b) above, a creditors' meeting would need to be called within one month of the resolution being passed to appoint the provisional liquidator. At the creditors' meeting, creditors will have the ability to nominate their chosen liquidator to replace the provisional liquidator - this is typically only seen in contentious cases. In most cases, a provisional liquidator is first appointed, and such provisional liquidator then handles the process of converting the provisional liquidation to a CVL.

Scheme of Arrangement

— a statutory mechanism for securing agreement between a company and its creditors, members or shareholders in respect of an arrangement or compromise;

— requires approval of a majority in number representing 75% in value of those voting in a meeting of each class of creditors, members or class of members at a scheme meeting;

— the court plays a supervisory role in (i) granting leave for a creditors' meeting to be convened to consider the scheme of arrangement and (ii) sanctioning the scheme of arrangement, provided that this has been approved by the creditors;

— an automatic interim 30-day moratorium arises upon an application being made for a moratorium, to restrain proceedings in any action or proceeding against the company;

— the moratorium can be extended to related companies, can have in personam worldwide effect, restrains secured creditors from enforcing security and may be extended at the discretion of the court; and

— if sanctioned by the court, the scheme of arrangement has statutory force and binds all members of the class whether or not they voted in favour.

Judicial Management

— The company, its directors or creditors can apply to court to place a company which is, or is likely to become insolvent, under judicial management.

— Judicial management is typically used by a company as a tool to restructure its debts to resume business as a going concern.

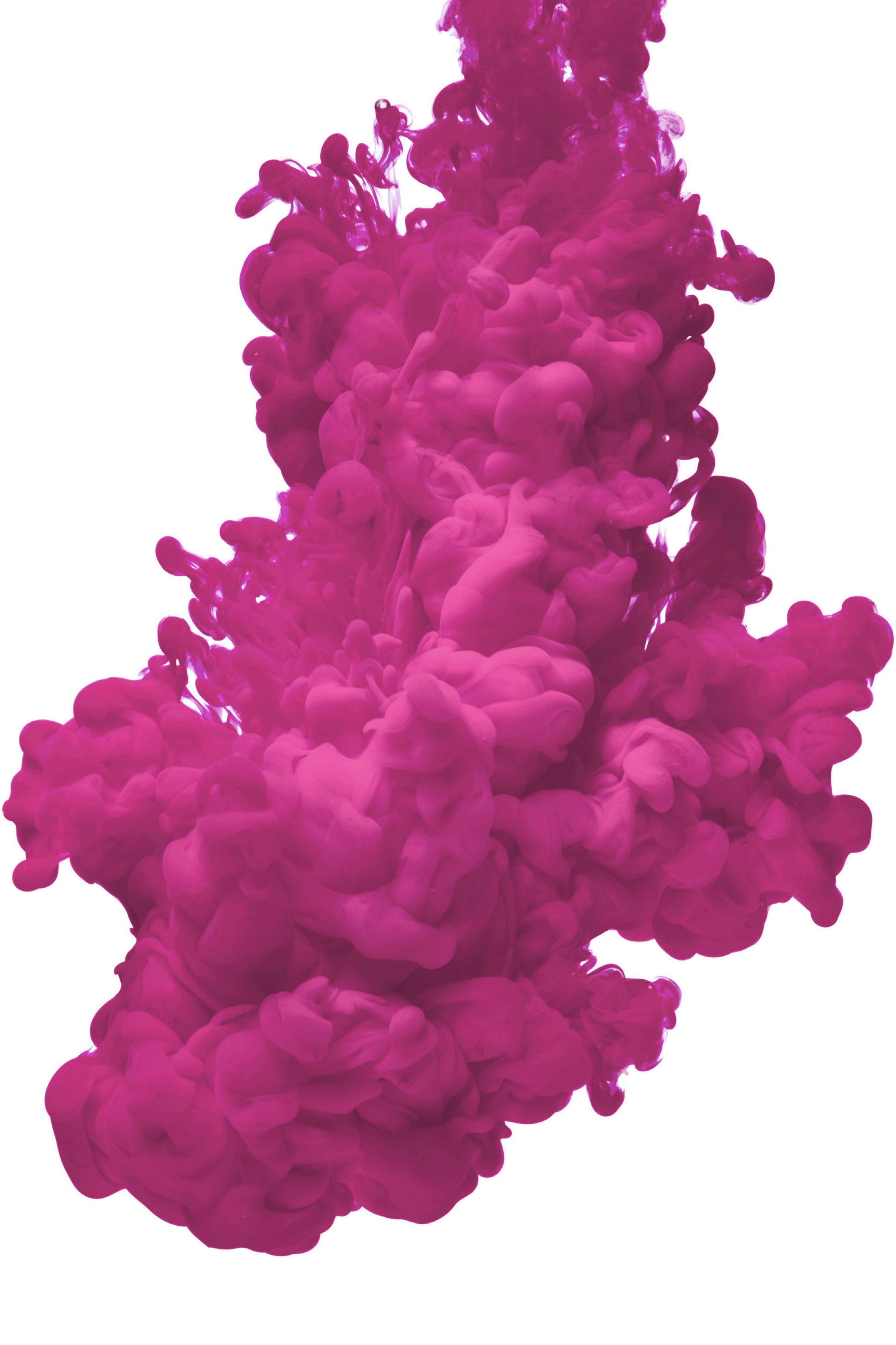
— The court, in exercising its discretion to grant a judicial management order, will consider among others, whether a more advantageous return or realisation of the company's assets will be achieved when compared to a liquidation scenario.

— When a judicial management order is in force, a judicial manager is appointed and the judicial manager will replace the company's existing management.

— The judicial manager will formulate a judicial management proposal for the realisation of assets which must be approved by the company's creditors.

— During the period of judicial management, a moratorium against legal proceedings is automatically put in place to preserve the company's assets.

— The judicial management lasts for 180 days from the date of the relevant judicial management order.



Summary: practical risk management for directors

Seek specialist advice (legal and financial) early on.

Check D&O insurance policy cover.

Ensure all directors have up-to-date information.

Hold regular board meetings to assess which duties are in play and whether there is still a 'reasonable prospect' of avoiding formal insolvency.

Keep detailed board minutes.

Proactively manage cash and credit.

Engage with key stakeholders.

Devise a contingency plan to be deployed if a consensual solution cannot be found.

Contacts

Toby Grainger
Managing Partner
T +65 9837 8559
E toby.grainger@cms-cmno.com

Lakshanthi Fernando
Partner and Managing Director*
T +65 9648 9008
E lakshanthi.fernando@cms-cmno.com

Lynette Chew
Partner and Director*
T +65 9889 8694
E lynette.chew@cms-cmno.com

Sam Ng
Senior Associate*
T +65 8858 3082
E sam.ng@cms-holbornasia.com

Wei Ming Tan
Senior Associate*
T +65 9636 0156
E weiming.tan@cms-holbornasia.com

Charlotte Holder
Senior Associate
T +65 8121 2011
E charlotte.holder@cms-cmno.com

Leonard Chew
Associate*
T +65 8126 1968
E leonard.chew@cms-holbornasia.com

*Holborn Law LLC

Law . Tax

Law-Now™

Your free online legal information service.

A subscription service for legal articles
on a variety of topics delivered by email.
cms-lawnow.com

CMS Cameron McKenna Nabarro Olswang LLP
Cannon Place
78 Cannon Street
London EC4N 6AF

T +44 (0)20 7367 3000
F +44 (0)20 7367 2000

2004-0125839-7