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SOLVENCY, COMPANY DIRECTORS' DUTIES AND THE PROBLEM  
OF PROCESS AND ENFORCEMENT- A COMPARATIVE STUDY

A Thesis

Submitted in Fulfillment of the Requirement for the Degree of

Doctor of Philosophy in Law

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By

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## ABSTRACT

This study examines the legal provisions in relation to creditors' protection, particularly when the company is insolvent and seeks to compare different statutory approaches with the view of determining the best reforms for Malaysia. Three jurisdictions have been chosen; the United Kingdom, New Zealand and Australia as the basis of comparison due to similar legal history as these countries have often been referred by the Malaysian Courts to assist in the interpretation of the law. To determine the question of creditors' protection, the thesis will address several main issues. Firstly, the thesis examines the relationship between separate legal entity and limited liability. To do so it questions the circumstances when directors will be personally liable for the debt of the company and the extent to which they are liable. The issue will be explored in the light of the shareholder primacy theory which forms the basis of company law. Directors' duties therefore are developed with the view of protecting shareholders; and the failure to do so will cause directors to be personally liable. The thesis also considers the arguments for stakeholders' theory which mandates directors to take account of other stakeholders' interests in addition to shareholders' when making decisions. Secondly, it also investigates on how the piercing of the corporate veil and imposing liability on directors will provide protection to creditors especially when the company is insolvent. In order to do so, it scrutinizes the legislative initiatives on the issue as well as the judicial response to the statute. The thesis traces the reforms of the historical doctrine of capital maintenance and the use of solvency test as a replacement to protect creditors. It also provides comprehensive analyses of the law on the issue of remedies in order to ascertain whether the current legal provisions are adequately to protect creditors.

(Keyword: separate legal entity, limited liability, shareholders, stakeholders, insolvency, capital maintenance)

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## ABBREVIATIONS

AAR	Australian Accounting Review
ABLR	Australian Business Law Review
ACLC	Australian Company Law Cases
ACLR	Australian Company Law Reports
ACSR	Australian Company And Securities Reports
AJCL	Australian Journal of Corporate Law
All ER	All England Reports
ALJ	Australian Law Journal
ALJR	Australian Law Journal Reports
ALR	Australian Law Reports
Am. J. Comp L	American Journal of Comparative Law
ANCERTA	Australia New Zealand Closer Economic Relation Trade Agreement
App Cas	Appeal Cases (England)
ASIC	Australian Securities and Investments Commission
Asia Pacific J. Manage.	Asia Pacific Journal of Management
ATPR	Australian Trade Practices Reports
Barn. & Cr.	Barnewall and Creswell's King's Bench Reports
BCC	British Company Cases
BCLC	Butterworths Company Law Cases (England)
BCR	Butterworths Company Reports (New Zealand)
Bond LR	Bond Law Review
Brookings Pap. Econ. Act.	Brookings Papers on Economic Activity
Bus. Law	The Business Lawyer
Cambridge J. Econ.	Cambridge Journal of Economics
Can. Bus. LJ	Canadian Business Law Journal
Cant. LR	Canterbury Law Review
Cardozo L. Rev	Cardozo Law Review
Ch	Chancery Division (England)
ChD	Chancery Division (England)

CLC	Australian Company Law Cases
CLJ	Cambridge Law Journal
CLJ	Current Law Journal (Malaysia)
CLR	Commonwealth Law Reports (Australia)
CLRC	Corporate Law Reform Committee (Malaysia)
Co Law	Company Lawyer
Columbia LR	Columbia Law Review
Connecticut L. Rev	Connecticut Law Review
Com Cas	Commercial Cases (England)
CSLB	Company and Securities Law Bulletin
C&SLJ	Company and Securities Law Journal
DBP	Dewan Bahasa dan Pustaka (Malaysia)
Delaware JCL	Delaware Journal of Corporate Law
Econ. Hist. Rev	Economic History Review
EWHC	England and Wales High Court Decisions
FCR	Federal Court Reports (Australia)
Federal LR	Federal Law Review
FLR	Federal Law Reports (Australia)
Hare	Hare's Reports (Chancery) (England)
Harv. LR	Harvard Law Review
ILJ	Insurance Law Journal
IL & P	Insolvency Law and Practice
Insol LJ	Insolvency Law Journal
Int. Insolv. Rev	International Insolvency Review
Iowa J. Corp. L.	Iowa Journal of Corporation Law
JBL	Journal of Business Law
LJ Ch	Law Journal Chancery Division
JL& Soc'y	Journal of Law and Society
J. Finan. Econ	Journal of Financial Economics
J. Legal Stud.	Journal of Legal Studies
J Manage. Studies	Journal of Management Studies

J Polit. Economy	Journal of Political Economy
LMCLQ	Lloyds Maritime and Commercial Law Quarterly
LR Eq	The Law Report-Equity Cases (England)
LQR	Law Quarterly Review
KB	Kings Bench (England)
Lloyd's Report	Lloyd's Law Report (England)
Macq	Macqueen's Scotch Appeal Cases
Michigan L. Rev	Michigan Law Review
Mees & W	Meeson & Welsby Exchequer Reports
MLJ	Malayan Law Journal (Malaysia)
MLR	Modern Law Review
MULR	Melbourne University Law Review
Monash U.L Rev	Monash University Law Review
NSWLR	New South Wales Law Reports
NZBLC	New Zealand Business Law Cases
NZBLQ	New Zealand Business Law Quarterly
NZCLC	New Zealand Company Law Cases
NZLJ	New Zealand Law Journal
NZLR	New Zealand Law Reports
NZ Law Review	New Zealand Law Review
NZULR	New Zealand Universities Law Review
OJLS	Oxford Journal of Legal Studies
Oxford Econ. Pap.	Oxford Economic Papers
QB	Queens Bench (England)
QBD	Queens Bench Division (England)
Quart. J. Econ.	Quarterly Journal of Economics
SASC	Supreme Court of South Australia
Singapore JLS	Singapore Journal of Legal Studies
SLR	Singapore Law Reports
SLT	Scots Law Times Reports
Syd L Rev	Sydney Law Review

Stanford LR	Stanford Law Review
Stetson LR	Stetson Law Review
TCLR	Trade & Competition Law Reports
Tex. L.Rev	Texas Law Review
TPC	Trade Practices Cases (Australian)
TPD	Transvaal Provincial Division
TPLJ	Trade Practices Law Journal
Tulane LR	Tulane Law Review
Uni.Chi.L Rev	The University of Chicago Law Review
Uni. Toronto LJ	The University of Toronto Law Journal
UNSWLJ	The University of New South Wales Law Journal
Vand. L. Rev	Vanderbilt Law Review
Virginia LR	Virginia Law Review
VLR	Victorian Law Reports (Australia)
VSCA	Victoria Supreme Court of Appeal Decisions
Yale LJ	Yale Law Journal
Waikato LR	Waikato Law Review
Wash. L. Rev	Washington Law Review
Wash. & Lee L Rev	Washington & Lee Law Review
WLR	Weekly Law Reports

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## **CHAPTER 1            THE STRUCTURE OF THE THESIS**

The two introductory chapters, Chapters 2 and 3, provide an overview of the research undertaken in the thesis. Chapter 2 looks at the broad research question which is the central theme of the thesis and explains the doctrinal and comparative legal methods adopted. Chapter 3 discusses the main literature reviewed in the thesis.

Chapter 4 traces the historical development of corporate and insolvency law in all four jurisdictions, i.e. Malaysia, the UK, New Zealand and Australia. The purpose is to trace and show the close historical, legislative connection between these countries. The Malaysian judges and Law Commission have always referred to these jurisdictions in construing the law as well as in proposing law reforms. Due to these factors, the three jurisdictions have been identified for the purpose of comparison with Malaysia in the thesis.

Chapter 5 provides the foundation of the thesis. It looks at theories of the corporation such as the corporate personality, limited liability and separate legal entity, and illustrates the relationship of these theories with the need to protect creditors. It illustrates situations when creditors' interests are affected and the legal response to problems such as courts' reluctance to lift the veil, directors' duties in groups of companies, as well as the liability of holding companies to subsidiaries. It also provides analyses of cases to determine whose interests directors are representing when the company is insolvent.

The discussion in Chapter 6 focuses on the interests of various parties in a corporation, particularly the shareholders and creditors. Two main themes - the shareholders wealth maximization and stakeholders - form the basis of the chapter. The shareholder theory works on the assumption that shareholders are part of the company and they are vulnerable and would not be able to protect themselves without legal provisions. The stakeholders' theory argues that a company is comprised of an intricate web of relationships with many parties, including

shareholders, and that this is responsible for the success of the company. Stakeholders are as vulnerable as shareholders in most circumstances, and cannot make personal arrangements to protect themselves; hence they too should be protected by the law. The chapter hence seeks to find the harmonization between the two competing theories.

Chapter 7 inquires into the relationship between the doctrine of capital maintenance and creditors' protection. The chapter discusses the relevant sections in the Companies legislation of Malaysia, the United Kingdom and Australia which have adopted the common law principles as well as their exceptions. Statutes have allowed companies to depart from the doctrine, provided they are solvent at the time of the action. It raises the question as to the relevance of the principles which were developed in the early stage of the development of company law. The New Zealand Companies Act 1993 leads in this aspect by abolishing the principle and replacing it with a solvency test. The chapter thus looks at this concept as a means to protect creditors.

Chapter 8 continues to explore insolvency as the preferred method to protect creditors and why it is more suitable to be used for such purpose. It discusses the meaning and tests of solvency, together with the advantages and disadvantages of each test. This chapter also looks at the differences between a company's insolvency and illiquidity, and their relationship with a director's personal liability.

Having discussed the fundamental theories of company law, Chapters 9-11 provide the legal response at common law and statutes to circumstances when directors are held personally liable. The ability to hold directors liable personally is particularly beneficial to creditors when the company is insolvent, since assets are scarce at that time, and imposing liability on directors would increase the pool of assets available for distribution. Legislation from New Zealand, the UK, Australia and Malaysia is examined, compared and contrasted in order to determine which provisions are mostly appropriate.

A discussion of directors' duties at common law is the focus of Chapter 9. Common law imposes duty on directors to act in the interest of the company and courts have equated it with that of shareholders. However, there is a tendency of the court to shift the duty to consider the interest of creditors when the company's finance is unhealthy. The chapter looks at directors' fiduciary duties and illustrates their relationship with protection to creditors.

Chapter 10 reviews the statutory provisions on fraudulent trading/wrongful trading/insolvent trading/reckless trading in the four selected jurisdictions. It contains a detailed analysis of the provisions in the company and insolvency legislations, and examines the courts' interpretations of them so as to determine the extent to which creditors are protected.

Chapter 11 investigates the consequences of breach of the provisions discussed and analysed in Chapter 10. It evaluates cases on these issues in order to ascertain whether the primary aims of protecting creditors when the company is insolvent, and to provide compensation, have been achieved. In addition, it looks at the corporate insolvency process and other remedies available to creditors, as well as problems of enforcement.

The concluding Chapter 12 summarises the analyses and arguments of the thesis, and based upon them, offers recommendations for the best reforms in Malaysia.

## CHAPTER 2            DEFINING THE RESEARCH QUESTION AND METHODOLOGY

### 2.1.    The Research Question

The law has long established that the directors must exercise their duty or discretion “bona fide in what they consider –not what a court may consider- is in the interest of the company, and not for any collateral purposes.”<sup>1</sup> The term “in the interest of the company” has always been associated with the interest of the shareholders, present and future. This approach is also known as the shareholder primacy principle (or paradigm), shareholder value principle or the shareholder wealth maximization norm.<sup>2</sup> It requires that the company is managed in such a way as to maximize the interest of the shareholders ahead of other interested parties who may have claim against the company.<sup>3</sup>

Creditors, on the other hand, have always been regarded as outsiders; thus their interests are seldom taken into account by the directors. The creditors themselves may not be overly concerned with the directors’ actions when the company’s financial state is healthy, but when it is not so, how far should directors be allowed to take the risks and pursue trade without regard to interest of the creditors, in particular, the unsecured creditors? The shareholders whose liability was limited to the amount unpaid on the shares they subscribed to in the company could not be held liable for any debts of the company. Creditors could not take any action against them in respect of the unpaid debts. Due to this, when times are hard shareholders would want directors to take risks and continue to trade in the hope to the turn the company around. This was usually at the expense of creditors.

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<sup>1</sup> *Re Smith and Fawcett Ltd* [1942] Ch 304 at 306.

<sup>2</sup> Andrew Keay “Enlightened Shareholder Value, The Reform Of The Duties Of Companies Directors And The Corporate Objective” [2006] LMCLQ 335 at 336.

<sup>3</sup> *Ibid.*

The far-reaching implication of corporate personality status conferred on a corporation which aims to overcome the procedural problems of enforcement in partnership was not fully appreciated until the judgment in *Salomon v Salomon & Co*<sup>4</sup> which enunciated that the company and the person controlling it are two separate persons. The rule which requires any action being taken against the company and not the person responsible for the action has resulted in difficulty for creditors in enforcing the right of repayment when the company is insolvent. This thesis explores the relationship between these two concepts; i.e. the separate legal entity and limited liability.

The thesis asks a specific question: Does the law impose personal liability on directors in circumstances where their actions prejudice the creditors' right to be repaid? In pursuing this question, the thesis will also explore the doctrine of maintenance of capital and the piercing of the corporate veil. It seeks to compare different statutory approaches with the view to recommending the best reform in Malaysia.

## **2.2. Methodology**

The thesis will engage in doctrinal and comparative legal studies for the purpose of identifying the extent to which the law provides protection to creditors. The doctrinal research concerns the discovery and development of legal doctrines and its research questions take the form of asking What is the law? in particular contexts.<sup>5</sup> To answer, the methods of deductive and analogical reasoning are adopted.

Deductive reasoning identifies a general rule and then applies it to particular facts. The conclusion of the research will then state whether the general rule is applicable to the specific facts and whether the specified legal outcome takes effect.

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<sup>4</sup> [1897] A.C. 22.

<sup>5</sup> Paul Chynoweth "Legal Research" in Andrew Knight and Les Ruddock (Eds) *Advanced Research Methods in the Built Environment* (Blackwell Publishing Ltd, Chichester (UK), 2008) at ch 3.

Analogy involves a process of reasoning from one specific case to another specific case. In a situation where it is unclear whether the general rule is applicable to the specific facts, it is helpful to examine similar cases. If, upon examination, it is found that the facts are sufficiently similar, it can be concluded that the facts of the case should be treated in the same way.

A comparative study is undertaken in this area to aid legislative and other law reforms.<sup>6</sup> Accordingly, selected legislation, which provides for directors' duties during insolvency, will be reviewed to determine the extent to which the interests of the creditors have been considered, and the application of such provisions. Comparative law is also an effective tool of construction<sup>7</sup> especially in common law jurisdictions where interpretations of case law (judge made law) form an essential part.

The method of study is to compare foreign and domestic legislation to ascertain similarities and differences. In addition, an analysis of solutions offered by different laws will be looked into, in particular, on issues relating to the protection of creditors. Therefore, cases in areas such as directors' duties, maintenance of capital, and duties of liquidators, will be considered to determine how the law is applied and whether the legal objective of the statute has been achieved.

For the purpose of comparison with Malaysia, three jurisdictions have been identified: the UK, New Zealand and Australia. These countries have been chosen because they share a common historical legal background with Malaysia, as a former colony of the British Empire, and they all have similar legal systems which are based on the English Common Law.<sup>8</sup>

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<sup>6</sup> Peter De Cruz *Comparative Law in a Changing World* (3<sup>rd</sup> ed, Routledge-Cavendish, London, New York, 2007) at 6.

<sup>7</sup> Ibid.

<sup>8</sup> Lucian Arye Bebchuk and Mark J. Roe "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 *Stanford LR* 127 at 129- the theory proposes the choice of legal system of the country depending on the pattern it had earlier.

### 2.2.1 The United Kingdom

The common law system which originates from the United Kingdom is a case-based system of law in which judges use analogical reasoning to make law.<sup>9</sup> Hence, case law makes up an integral part of the common law system and lower courts are bound by precedent to follow the decisions of the courts higher in the hierarchy. Nevertheless, the lower courts can depart from the principle of *stare decisis* by distinguishing the facts of the case. In addition to cases, statutes are also one of the important sources of law.<sup>10</sup> Traditionally, a judge's role is to interpret the legislation and leave the function of making law to Parliament. However, if there is any lacuna in the legislation, it will be supplemented by case law. Since becoming a member of the European Union, European law has also become an influential source of law in the UK.

The UK company law is based on case law as well as legislation. The relevant statutes on modern company law were found in the Companies Acts 1948, 1967, 1980, and 1985 until the recent amendments in 2006. The European Communities Act 1972 also contains provisions on company law and is applicable in the UK as a result of the harmonization of law. The governing principles and rules of statutes are interpreted by judges through cases brought before the courts.

The company laws in the UK are founded on two basic principles: limited liability and separate legal entity. The English Courts have been very strict in the application of these principles and are reluctant to depart from them unless an exceptional circumstance, such as fraud, is involved. Parliament prefers that the development of the law in this area is left to the courts and only provides for the statutory exceptions in limited circumstances. One of the exceptions expressed in the statute can be

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<sup>9</sup> De Cruz above n6 at 103.

<sup>10</sup> Ibid.

found in the area of wrongful trading and fraudulent trading.<sup>11</sup> The courts, however, play an important role in interpreting the provisions and ensuring they are consistent with the intention of the Parliament.<sup>12</sup>

At first, as a result of British Colonisation, many companies in New Zealand and Australia were branches of UK companies and later they became subsidiaries. Due to the similar structures of companies, as well as close economic ties with the motherland, it was convenient to follow the UK model. However, dependence on the UK legislation began to waver once the countries began to shape their own economies and trade in accordance with their needs.<sup>13</sup>

### 2.2.2 New Zealand

Until 1993, New Zealand company law was largely based on UK legislation. In 1989, the Law Commission had been given the task of looking into the then current legislation and suggesting reforms. When the report was published, the Law Commission rejected harmonization with Australian law on the basis that Australian legislation was not very much in advance of the then current New Zealand statute.<sup>16</sup> The Commission shifted its focus to North America for direction. As a result, the majority of its provisions are based on the Canadian and American models.<sup>17</sup>

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<sup>11</sup> Also referred to insolvent trading in Australia and reckless trading in New Zealand. See John Farrar “Corporate Personality” in John Farrar (ed) *Companies and Securities Law* (Brookers, Wellington 2008) 69 at 75.

<sup>12</sup> Niall F Coburn “Insolvent Trading in Australia: The Legal Principles” in Ian Ramsay (ed) *Company Directors’ Liability for Insolvent Trading* (CCH Australia Centre for Corporate Law and Securities Regulation, University of Melbourne, 2000) 73; Chris Noonan and Susan Watson “Rethinking the Misunderstood and Much Maligned Remedies for Reckless and Insolvent Trading” (2004) 24 NZULR 26.

<sup>13</sup> The UK’s membership in the European Union signalled the departure of dependency of these two countries on the UK legislation. They began to look elsewhere, particularly to North America, as a model for their company law legislation- see John Farrar *Corporate Governance Theories, Principles and Practice* (3rd ed., Oxford University Press, South Melbourne, 2008) at 15-19.

<sup>16</sup> Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [31].

<sup>17</sup> Ibid.

### 2.2.3 Australia

Australia has been the most active in shaping and reforming its legislation in accordance with the country's economic and business cultures. Since the 1960s, several changes had been made to its company statutes, particularly in the area of directors' liabilities when the company is trading during insolvency. Its current legislation, which was enacted in 2001, was a result of various amendments since the publication of the Harmer Report.<sup>18</sup>

### 2.2.4 Malaysia

Malaysian Company law is governed by the Companies Act 1965, a statute which is influenced by various jurisdictions. The Mohar Commission, which was in charge of preparing the draft legislation, considered the law then in force in the UK, Australia, New Zealand and India.<sup>19</sup> In addition, the Commission also referred to the Ghanaian draft Code as well as the UK Cohen and Jenkin Reports.<sup>20</sup> As a result of this, the Companies Act 1965 contains a mixture of various Commonwealth countries' company law legal theory although the most dominant input came from the UK and Australia.

Hence, the Malaysian courts when interpreting the statute often refer to those Commonwealth countries, particularly the UK and Australian cases, as and when the wording of the provisions are similar. Although the status of these decisions is persuasive and not binding on the Malaysian courts, most judges prefer to adopt the decisions to the letter. Nevertheless, through time, changes have been made to the

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<sup>18</sup> Australia Law Reform Commission, *General Insolvency Inquiry Report* (ALRC R45 Vol 1 1988) <[http://www.austlii.edu.au/au/other/alrc/publications/reports/45/45\\_vol\\_1.pdf](http://www.austlii.edu.au/au/other/alrc/publications/reports/45/45_vol_1.pdf)> at 25 January 2008.

<sup>19</sup> Malaysia, *Parliamentary Debates*, Dewan Negara, (16 August 1965) Vol II No 6 at 768. The Malaysian Companies Act is generally based on the Victoria Companies Act 1961 (Australia). Nevertheless, the UK Companies Act 1948, the New Zealand Companies Act 1955, as well as the Indian Companies Act 1956 also influenced the drafting of the Malaysian Act.

<sup>20</sup> Ibid.

Malaysian Companies Act and the most recent amendment was made in 2006. Therefore, judges have to be cautious when applying foreign decisions to local cases because the principles used may not be consistent with the local statute.<sup>21</sup>

### **2.3 Aim Of The Research**

The thesis starts with the historical backgrounds of the Companies legislation of the four jurisdictions. Then it discusses the relationship between separate legal entity and limited liability, particularly in relation to its effects on creditors. In doing so, provisions intended to protect creditors, such as the doctrine of capital maintenance and solvency test, are examined. In addition, the research looks at the circumstances when directors are personally liable for debts of the company and their impact on creditors. Finally, it studies the issue of remedies and determines whether the awards granted reflect the intention of the Parliament in addition to other alternative remedies available to creditors.

Thus, the thesis aims to:

1. Research the differences and similarities of the relevant provisions on creditors' protection in the statutes; and
2. To consider whether reforms are needed in Malaysia in respect of protection of creditors and if so, whether the laws in the UK, New Zealand and Australia are suitable to be adopted in their current form or after adaptation taking into consideration the Malaysian context.

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<sup>21</sup> See comments by Gopal Sri Ram JCA in *Owen Sim Liang Khui v Piasu Jaya Sdn Bhd & Anor* [1996] 1 MLJ 113 at 125-6.

## CHAPTER 3            LITERATURE SURVEY - AN OVERVIEW OF THE MAIN THEMES

### 3.1            Introduction

The premise of this thesis is that when a company is insolvent, its shareholders have the incentive to continue trading as they have everything to gain and nothing to lose because they are protected by the principle of limited liability. Thus, the principle of limited liability creates a perverse incentive for the company to continue trading. The common law has been very reluctant to depart from this principle and statutes have taken the initiative to impose personal liability on directors for debts of the company if it continues trading during insolvency.

In conjunction with limited liability, another important principle, separate legal entity, has emerged. This principle shields a person who is responsible for the management of the company from liability because any action is deemed to be the act of the company and not the individual who makes decisions. This principle is first enunciated in the case of *Salomon v Salomon & Co Ltd*.<sup>1</sup>

This chapter provides a general background of the thesis and explores the legal development of directors' liability to creditors in Malaysia and other countries such as the UK, New Zealand and Australia. The literature traces the relationship between limited liability and separate legal entity and looks at the inadequacy of separate legal entity to support the existing company structures. The literature on these areas is abundant in relation to the laws in the UK, New Zealand and Australia but there is dearth of discussion in respect of Malaysia.

The literature relevant to this thesis is divided into three main themes:

- a) Relationship between limited liability and separate legal entity in the legal and economic literature;

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<sup>1</sup> [1897] A.C. 22.

- b) Reforms of the historical doctrine of capital maintenance and the use of solvency test as a replacement to protect creditors; and
- c) Circumstances justifying piercing of corporate veil in relation to creditors' protection, particularly when the company is insolvent and the remedies accorded by the law to them.

### **3.2 Relationship between Limited Liability and Separate Legal Entity in the Legal and Economic Literature**

The decision in *Salomon v Salomon & Co Ltd*<sup>2</sup> created a revolution in the area of corporate law which was never intended by the legislation. The concept was developed purely for convenience to overcome the difficulty associated with the law of partnership, which later was extended to limiting the liability of shareholders. The decision ruled that a one-man company was not an abuse of the Companies Act and the company, A Salomon Ltd, was different from Salomon an individual. The decision was criticised to have gone too far.<sup>3</sup> The principle has been described as inadequately justified in terms of principle and policy as well as inadequate for doctrinal purposes of decision-making.<sup>4</sup> Scholars grappled to fit the principle within the existing framework of the common law and statute law where recognition of principles of law has been made on the basis of analogy, metaphor or fiction.<sup>5</sup>

The principle in Salomon has in effect acted to the prejudice of creditors which was never intended by the legislature. The decision was described as 'calamitous' by Professor Sir Otto Kahn-Freund because the courts while developing fiduciary principles to protect

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<sup>2</sup> [1897] A.C. 22.

<sup>3</sup> John Farrar 'Corporate Personality' in John Farrar (ed) *Company and Securities Law* (Thompson Brookers, Wellington 2008 ) at 74.

<sup>4</sup> John Farrar "Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance" (1998) 10 Bond LR 142 at 147 [Frankenstein].

<sup>5</sup> John Farrar *Corporate Governance in Australia and New Zealand* (Oxford University Press, Melbourne 2001) at 55 ; see also comments in (1897) 13 LQR 6

shareholders, had failed to mitigate "the rigidities of the 'folklore' of corporate entity in favour of the legitimate interests of the company's creditors."<sup>6</sup>

The modern economic theories of corporation generally can be divided into two main approaches: managerialism and contractarianism.<sup>7</sup> Managerialism stems from the work of Berle and Means in 1932 and influences the development of corporate law.<sup>8</sup> The heart of this theory based on a study of American capitalism, revealed that the majority of large public companies' managements have escaped effective shareholder control.<sup>9</sup> The current economic system shows that most companies are owned by passive investors who, in many cases, have not even seen the property from which they derive their profits.<sup>10</sup> A company's control, as a result lies, with the management.

The idea of the company and the person controlling the company as separate does not sit well with the company structures.<sup>11</sup> This is because the decision-making which lies with directors raises opportunity for them to swindle the company's assets at the expense of both creditors and shareholders.<sup>12</sup> This weakness of control results in shareholders opting to remain passive or to vote with management.<sup>13</sup> The state of shareholders' inactivity enables managers to pursue objectives of their own choosing, other than the

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<sup>6</sup> Otto Kahn-Freund "Some Reflections on Company Law Reform" (1944) 7 MLR 54 at 55.

<sup>7</sup> Adolf A Berle and Gardiner C Means *The Modern Corporation and Private Property* (The Macmillan Company, New York, 1932); Adolf A Berle and Gardiner C Means *The Modern Corporation and Private Property* (Revised ed., Harcourt, Brace & World, New York, 1968) at 312-313; Ross Grantham and Charles Rickett *Company and Securities Law Commentary and Law* (Brookers Ltd, Wellington, 2002) at 54-55; Brian Cheffins *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997) 31-41; John Parkinson *Corporate Power and Responsibility* (Clarendon Press, Oxford, 1993) at 54-56 and at 97-132.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

<sup>11</sup> Farrar "Frankenstein" above n4 at 149.

<sup>12</sup> Berle and Means above n7 at 67; Grantham and Rickett above n7 at 62; Cheffins above n7 at 65; Parkinson above n7 at 63-70.

<sup>13</sup> Ibid; Edwin M Dodd: For Whom are Corporate Managers Trustees?" (1932) 45 Harv LR 1145 at 1153.

maximisation of wealth of shareholders.<sup>14</sup> The problem classified as ‘shirking’ also extends to incompetence, since if shareholders are for practical purpose unable to replace the management, the company may suffer from inept leadership.<sup>15</sup> The public nature of the company therefore warrants and justifies the role of the State to regulate the affairs of the company.<sup>16</sup>

In the 1980s, there was the emergence of a new economic theory, the contractual or nexus of contracts theory.<sup>17</sup> The theory sees the company as the web or nexus of contracts between the various human participants in the enterprise, including shareholders, managers, employees, creditors and consumers.<sup>18</sup> The essence of the theory is that the company is regarded as a private arrangement in which each of the individual participants seeks to maximise their own wealth by entering mutually beneficial contracts.<sup>19</sup> The behaviour of those involved, therefore, is regulated by market forces that regulate company’s relationship with outsiders.<sup>20</sup> The central premise of the theory is that the company is managed for the benefit of shareholders, though it rejects the historical view that shareholders own the company.<sup>21</sup>

This theory that the company is managed for the benefit of shareholders, however, is seen as no longer representing the current notion of business whereby many other players are involved in the success of the company.<sup>22</sup> In fact, the complexity of the modern structure

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<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> Rickett above n7 at 60; Cheffins above n7 at ch 3.

<sup>17</sup> Rickett above n7 at 55; Cheffins above n7 at 31-36; ; Frank H Easterbrook and Daniel R. Fischel “The Corporate Contract” (1989) 89 Columbia L.R 1416 at 1426-1434.

<sup>18</sup> David Millon “ New directions in corporate law: Communitarians, contractarians and the crisis in corporate law” (1993) 50 Washington & Lee LR 1373 at 1374.

<sup>19</sup> Ibid, at 1375.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

was mainly responsible for the challenge to the theory of shareholders as owners of the company.<sup>23</sup> The communitarianism theory concerns the wider range of stakeholders on the company. It emphasises that the company's economic wealth and social and political powers affect many more than merely those contractually related to the company.<sup>24</sup> The theory, therefore, seeks to present that the company recognises and accommodates wider community interests.

The evolution of the laws which impose regulations in the interests of employees, consumers or others may limit directors' methods of managing the company to maximise profits for shareholders.<sup>25</sup> Public opinion of the business responsibility towards its employees and customers also helped to shape the better conduct of business ethics. This has led to the notion of a company being 'professionalized.'<sup>26</sup> To achieve a 'professionalized company' (i.e. the duty is not owed to the shareholders alone), it is essential to look at the conduct of the managers/directors instead of the owners.<sup>27</sup> The view that the company should consider wider community interests has gained much support, particularly in the public utility field.<sup>28</sup> The notion of social responsibility toward employees, customers and the general public has gained such popularity that the law has, to a certain extent, compelled the company to recognise, to a certain extent, the rights of other persons besides its owners.<sup>29</sup>

In 1998, the Labour Government in the UK initiated a fundamental review of the framework of core company law. The Steering Committee considered the possibility of inclusion of the stakeholders' theory into the company statute. After much consideration,

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<sup>23</sup> Oliver Williamson "Corporate Governance" (1984) 93 Yale L.J 1197 at 1198-1200.

<sup>24</sup> Ibid; Rickett above n7 at 101; Millon above n18 at 1378-1379.

<sup>25</sup> Rickett above n7 at 65; Millon above n18 at 1378-1379.

<sup>26</sup> Dodd above n13 at 1160

<sup>27</sup> Ibid.

<sup>28</sup> Ibid, at 1160.

<sup>29</sup> Ibid.

the Committee concluded that adopting the stakeholders' maximisation theory in place of the existing framework would involve radical change to the British corporate cultures and would not gain support. Nevertheless, the Committee suggested a compromise and it was then enacted by Parliament. The current section 172 of the Companies Act 2006 requires directors to take into consideration the wider community's interests but at the same time insists that the primary duty is still owed to shareholders-owners.

Economic literature refers to the relationship between owners of the company (shareholders) and the persons who manage it (directors) as agency.<sup>30</sup> The integral characteristic of agency is the divergence of interests between owners and management.<sup>31</sup> The competing interests between parties create agency costs, which are the costs incurred to monitor the agent.<sup>32</sup> The recognition of the management's tendency to diverge from the interests of shareholders as owners prompts the need for shareholders and company laws to devise strategies to minimise the agency cost.<sup>33</sup> Economic literature regards limited liability as efficient in this circumstance because it reduces the monitoring costs on both the directors and other shareholders.<sup>34</sup> In addition, limited liability allows investors to make optimal decisions regarding investments which they may otherwise not take but which are beneficial to society as a whole.<sup>35</sup>

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<sup>30</sup> Rickett at 73; Michael Jensen and William Meckling "Theory of the firm: Managerial behaviour, agency costs and ownership structure" (1976) 3 J Finan.Econ 305 at 308-310.

<sup>31</sup> Ibid.

<sup>32</sup> Ibid.

<sup>33</sup> Ibid.

<sup>34</sup> Paul Halpern Michael Trebilcock and Stuart Turnbull "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 Uni. Toronto L.J 117 at 139-142; Easterbrook and Fischel "The Corporate Contract" above n17 at 1426-1434; Frank H Easterbrook and Daniel R Fischel "Limited Liability and the Corporation" (1985) 52 Uni. Chi L.Rev 89 at 103-109; Ian M Ramsay "Holding Company Liability for the Debts of an Insolvent Company: A Law and Economic Perspective" (1994) 17 UNSWLJ 520 at 535-537; Eugene F Fama "Agency Problems and the Theory of the Firm" (1980) 88 J. Polit. Economy 288 at 290-292.

<sup>35</sup> Ibid.

### 3.3 Interests in the Company-Shareholders v Stakeholders

Traditionally, shareholders were regarded as the owners of the company and their interests were the only interests to be recognised as the object of the company's activity.<sup>36</sup> Hence a company is viewed as an association of shareholders formed for their private gain, to be managed by its board of directors solely for that purpose.<sup>37</sup> To prevent directors from diverting profits for their own purpose, the law has developed various fiduciary duties.<sup>38</sup> As the residual claimants on the dividends i.e. after the claims of employees, creditors and consumers have been made, shareholders are given rights under the law to have the company managed for their benefit.<sup>39</sup>

The separation of ownership and control has further contributed to the problem, although in small companies most control remains with the shareholders who are usually the directors.<sup>40</sup> Berle and Means found in their study that economic activities were mostly carried out by large enterprise resulting in a wide spread of ownership. Ownership of wealth lies in the hands of shareholders who invest their money (wealth) in the company, while control is in the hands of the management who makes decisions on how this wealth should be managed. A legal control to prevent directors from diverting profits from shareholders into their own pockets takes the form of fiduciary duty. The law imposes personal liability on directors who are found to have breached their duty towards the company. Courts have also, in appropriate circumstances, been willing to ignore the separate legal entity and held directors liable.

In contrast, the law perceived creditors as outsiders who are capable of protecting themselves through contracts and other mechanisms. This is based on the assumption that

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<sup>36</sup> Ibid; *Re Smith and Fawcett Ltd* [1942] 1 All ER 542; *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286.

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

<sup>39</sup> Ibid.

<sup>40</sup> Berle and Means above n7 at 312-313.

creditors have equal bargaining power to that of the company. While this may be true with regard to some creditors such as financial institutions, others are as vulnerable as the shareholders.<sup>41</sup> So company law has to be adjusted to accept the notion and to take into account creditors' interests in a situation of doubtful solvency that is likely to be achieved if the courts are prepared to accept a more interventionist role to review directors' commercial and policy decisions.<sup>42</sup>

### **3.4 Doctrine of Capital Maintenance and the Solvency Test**

The capital maintenance doctrine relies on the capital contributed by shareholders as a buffer to protect creditors. The doctrine, however, does not provide a guarantee that the company will be solvent throughout its life because the law acknowledges the vicissitudes of business.<sup>43</sup> Creditors have the right to expect that the company will not reduce or return the assets while the company is a going concern, except in the form of dividend payable out of the profits.<sup>44</sup> The basis of the expectation was that creditors gave credit to the company on the faith of the representation that the capital would be utilized for the purpose of the business.<sup>45</sup>

The doctrine has been slowly replaced by the solvency test as a means to protect creditors because it is deemed to be insufficient. One of the main reasons for replacing the doctrine is that the capital set out in the company's constitution represents the historical figure

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<sup>41</sup> David Millman "Priority Rights on Corporate Insolvency" in Clarke A. (Ed.) *Current Issues in Insolvency Law* (Stevens and Sons, London, 1991) 57.

<sup>42</sup> Len Sealy "Directors Wider Responsibilities- Problems Conceptual, Practical and Procedural" (1987) 13 *Monash U.L. Rev.* 164)

<sup>43</sup> RP Austin and Ian Ramsay *Ford's Principles of Corporations Law* (14<sup>th</sup> ed., Lexis Nexis Butterworths, NSW, 2010); John Farrar and Brenda Hannigan *Farrar's Company Law* (4th ed., Butterworths, London 1998); LCB Gower *Modern Company Law* (6<sup>th</sup> ed., Stevens, London, 1997).

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*

contributed by the shareholders and does not reflect the current value of the company.<sup>46</sup> So, when the company is in difficulty, the creditors could not rely on the amount represented to be used to pay them because it did not represent the company's current position.

Hence, the solvency test has begun to replace the doctrine as a tool to protect creditors. This test can give more adequate protection to creditors because it reflects the company current status. Creditors too are concerned with the company's flow of funds instead of the amount of shares capital.<sup>47</sup> This is because creditors will be able to gauge their position more accurately from the cash flow of the company.

New Zealand has taken the initial step of replacing the doctrine with that of the solvency test. The Act allows directors to take advantage of the limited liability, provided the company is solvent, although the duty to maintain company's solvency is not absolute.<sup>48</sup> Directors lose the protection if they expose the company's assets and capital to risks deemed as illegitimate risks.<sup>49</sup> Other jurisdictions have slowly followed suit and provided that directors should first satisfy the solvency test before any assets are returned to shareholders in relation to rules of capital maintenance.<sup>50</sup> The purpose of prohibiting a company from making distributions to shareholders prior to satisfying a solvency test is to prevent misallocation of wealth.<sup>51</sup>

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<sup>46</sup> Mike Ross *Corporate Reconstructions Strategies for Directors* (CCH, Auckland, 1999).

<sup>47</sup> Ibid.

<sup>48</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104.

<sup>49</sup> Ibid.

<sup>50</sup> See the UK Companies Act 2006, the Malaysian Corporate Law Reform Committee "A Consultative Document on Capital Maintenance and Share Capital: Simplifying and Streamlining Provisions Applicable to the Reduction of Capital, Share Buy Back and Financial Assistance (2006) and section 67A of the Malaysian Companies Act 1965.

<sup>51</sup> Ross above n46.

### 3.5 Piercing of the Corporate Veil and Remedies

The concept of legal personality is seen as a fiction, a metaphorical use of language by analogy with a natural person and the application of the principle has, on occasion, led to some extreme results.<sup>52</sup> Nevertheless, courts have been adamant in upholding the principle and even extended it to groups of companies. The application of the principle to groups of companies is seen as limited liability within limited liability, an idea which was never intended by the legislature and has led to abuse.<sup>53</sup> There are concerns that the strict application of the principle and the clash between commercial realities may lead to injustice and may not reflect common sense.<sup>54</sup> However, the departure from commercial practice may be still being justified provided it can sensibly be applied to real commercial life.<sup>55</sup>

In the area of directors' duties, the courts have found it necessary to go beyond the fiction and this has led them to consider the interests of the shareholders as a general body.<sup>56</sup> Nevertheless, there has been recognition that when the company is insolvent or near insolvent, directors have a duty to consider their interest. The courts' reluctance to depart from the separate legal personality principle has given rise to statutory provisions in favour of the legitimate interests of creditors. Consequently, provisions relating to wrongful/insolvent/reckless trading have been enacted. In addition, New Zealand and statute confer discretionary powers on the Court to make contribution and pooling orders in case of related companies.

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<sup>52</sup> Farrar above n3 at 74.

<sup>53</sup> Ibid, at 75.

<sup>54</sup> Robert Baxt "The Need to Review Rule in Salomon's case as it Applies to Groups of Companies" (1991) 9 C&SLJ 185.

<sup>55</sup> R.P Austin "Problems for Directors Within Corporate Groups" in Michael Gillooly (Ed.), *Law Relating to Corporate Groups* (The Federated Press, NSW, 1993) at 133.

<sup>56</sup> Farrar "Frankenstein" above n4 at 150.

Statutes have attempted to address the issue by imposing liability on directors in circumstances where the company's financial position is doubtful. Most literature on this is written on the law in the UK, Australia and New Zealand. Likewise, any comparisons made between these statutes are in relation to these three countries. The imposition of personal liability on directors by statute and common law has been criticized as an erosion of the principle of limited liability.<sup>57</sup> Further, the use of the concept of interests of a company as a basis to build protection for the interests of the creditors has put the principle under a considerable degree of strain.<sup>58</sup>

Due to different wording of the statute, the extent of directors' liability varies in each jurisdiction.<sup>59</sup> The provisions are regarded to be overly protective of creditors and are inherently impracticable because instead of improving directors' skill or catching errant directors, they would discourage good managers from joining the company.<sup>60</sup> In addition, the availability of remedies to creditors also depends on the construction of the wording of the statute. In regard to the law in Malaysia, not much has been written on this issue and this thesis attempts to address that.

On the issue of remedies, the relevant provisions in the Act and interpretations of the provisions by the court are being scrutinised. It was found that courts sometimes provided inconsistent interpretations of the Acts and therefore it is essential that the Law Commission should be clear on the meanings of these provisions.<sup>61</sup> For example, the

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<sup>57</sup> Daniel Prentice "Creditor's Interests and Director's Duties" (1990) 10 OJLS 265.

<sup>58</sup> Ibid.

<sup>59</sup> Fidelis Oditah "Wrongful Trading" [1990] LMCLQ 205; Andrew Keay and Michael Murray "Making Companies Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" [2005] 14 Int. Insolv. Rev 55; Justin Dabner "Trading Whilst Insolvent" (1994) 17 UNSW LJ 546.

<sup>60</sup> Dale Oesterle "Corporate Directors' Personal Liability for Insolvent, Reckless and Wrongful Trading: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders" (2001) 7 NZBLQ 20.

<sup>61</sup> Chris Noonan and Susan Watson "Rethinking the Misunderstood and Much Maligned Remedies for Reckless and Insolvent Trading" (2004) 21 NZULR 26; Mike Ross "Assessing Damages for Reckless Trading" (2002) NZLJ 178; Richard Schulte "Enforcing Wrongful Trading as Standard of Conduct for

divergent approaches by the courts in New Zealand on the issue of remedies are viewed as being unpredictable and inconsistent with the legislation.<sup>62</sup> This is because the statutory provisions lack any formula to assess damages and the courts have wide discretion to determine the quantum of damages.<sup>63</sup>

The different interpretations made by the court also raise the question of the effectiveness of the provisions as a tool to compensate creditors. The UK wrongful trading, for instance attempts to serve both the private and public functions although the current judicial developments make it clear that the provisions are achieving neither function.<sup>64</sup> There is a tendency by the courts to ignore statutory provisions, particularly in cases relating to preferences, and the decisions often indicate different results from those envisaged by the legislation.

In the area of remedies available to creditors, consequent to breach of duty by directors, most articles focus on shareholders and literature which deals with creditors' remedies only discusses the effect of breaching provisions of wrongful/insolvent /reckless trading. In relating to Malaysian law, discussions on fraudulent and insolvent trading in company law books have been very brief and no attempt was made to discuss the remedies in detail. Hence, there is the need to examine the area and analyses of other jurisdictions are necessary in order to find the best reforms in Malaysia.

In addition to compensating creditors who have suffered losses as a result of a director's action, disqualification injects an element of public deterrent. Farrar and Tennent explore the question of the level of directors' unfitness that justifies imposing disqualification and

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Directors and a Remedy for Creditors: The Special Case of Corporate Insolvency" (1999) 20 Co Law 80; Andrew Hicks "Advising on Wrongful Trading: Part 1" (1993) 14 Co Law 16; Andrew Hicks "Advising on Wrongful Trading: Part 2" (1993) 14 Co Law 55; Rebecca Parry "The Destination of Proceeds of Insolvency Litigation" (2002) 23 Co Law 49.

<sup>62</sup> Noonan and Watson above n61.

<sup>63</sup> Ibid.

<sup>64</sup> Parry above n61.

how the matter should be dealt with.<sup>65</sup> The writers do so by analysing various relevant statutory provisions in the New Zealand Companies Act 1993 as well as decisions by courts and compare them with the positions in the UK and Australia.

With this background, the thesis aims to make a comparative study of the relevant laws relating to a director's personal liability in relation to creditors' protection in the UK, New Zealand, Australia and Malaysia.

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<sup>65</sup> John Farrar and Doug Tennent "The Unfitness of Directors, Insolvency and the Consequences-Some Comparison" [2005] 12 Cant. L.R 239.

## **CHAPTER 4: THE HISTORICAL DEVELOPMENT OF CORPORATE AND INSOLVENCY LAWS**

### **4.1 Introduction**

British colonisation in Malaya<sup>1</sup> charted a passage for the latter's legal system. The importation of English law into Malaya at the time was appropriate and seemly since it was subject to the British administration. The continuance of reliance on English law after Malaya reached its independence was acceptable to ensure smooth transition in the country. In relation to company legislation, the law employed was based on English company legislation in the early twentieth century.

English law, as elucidated below, metamorphosed as a result of various reforms. Though English law has progressed since then, Malaysia continues to depend on the law enacted in the 1960s. Any reforms or amendments made to the legislation were slow and on an *ad hoc* basis as demonstrated during the Asian financial crisis. Any weaknesses in the law identified and remedied by subsequent legislation in the UK remain part of Malaysia's company legislation.

Australia and New Zealand are also considered as the basis of comparison because of their similar legal history i.e. the adaptations of English law in their jurisdiction. However, where English law became part of Malaya through colonisation, it is woven through Australia and New Zealand due to the establishment of self governing dominions. Unlike Malaysia, these countries, especially Australia, are dynamic in reforming their company law legislation to reflect changes in social and economic structures.

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<sup>1</sup> Malaya was the name prior to the formation of Malaysia on 16<sup>th</sup> September 1963 which comprises Malaya, Sabah and Sarawak.

## 4.2 Development of Corporate and Insolvency Laws

### 4.2.1 Historical Development of Corporate Law

The development of English company law can be traced back to medieval times when corporate activities were often conducted through religious affiliations or grants from the Crown.<sup>2</sup> The early form of association was based on trade conducted in accordance with the commercial policy of a state.<sup>3</sup> The medieval structures of commerce were the guild of merchants in which each member traded on his account, subject to the rules of the guilds.<sup>4,5</sup> There was no room for the principle of limited liability in this form of association since each member traded on his account and would be personally liable. The guilds eventually obtained charters from the Crown in order to monopolise a particular commodity of a particular trade. Over time the medieval guilds could not accommodate increasing foreign trade and began to evolve into new forms, appropriate to foreign trade the regulated company.<sup>6</sup> The regulated company was the forerunner to the early joint stock company.

Initially, the formation of joint stock companies did not attain any corporate status since such status can only be conferred by a Royal Charter or an Act of Parliament.<sup>7</sup> The incorporation of companies was seen at the time as privileges rather than as rights. The benefits associated with incorporation included a monopoly of trade, and

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<sup>2</sup> William Holdsworth *A History of English Law* (Sweet & Maxwell, London 1903-66) Vol VIII at 206.

<sup>3</sup> Ibid.

<sup>4</sup> Guilds or gilds existed from Anglo-Saxon times for various purposes - religious, social and commercial. The earliest form of association linked with commercial purposes was Gild Merchants. It was often necessary to pass bye-laws in order to accomplish the objectives which gilds were formed and to keep and audit accounts. There were close fellowships among members - conditions of membership generally by birth or apprenticeship - traits similar to earliest joint stock companies (Holdsworth above n2 at 193-194).

<sup>5</sup> L.C.B Gower *Gower's Principles of Modern Company Law* (5<sup>th</sup> ed., Sweet & Maxwell, 1992) at 21.

<sup>6</sup> Clive Schmitthoff "The Origin of the Joint-Stock Company" (1939) 3 *Uni Toronto LJ* 74 at 81.

<sup>7</sup> John Farrar and Brenda Hannigan *Farrar's Company Law* (Butterworths, London, 1998) at 16.

dispensation from particular laws as to export and import, as well as other laws which might hinder their trade.<sup>8</sup> In return, the company conferred assistance to the state's foreign policies in matters relating to disputes in mercantile activities.<sup>9</sup> The granting of monopolistic rights to the company were also hoped to be able to feed the Crown's coffers, to encourage the growth of home industries, to protect the small manufacturers and to guarantee the availability of quality goods at a reasonable price.<sup>10</sup> The Companies Act, enacted in 1844, later conferred the corporation status on companies which had complied with necessary statutory procedures.

The essential purpose of a corporation during the seventeenth and eighteenth centuries was that it must have a public function, either for the benefit of the general public or for the advancement of religion, of learning or of commerce.<sup>11</sup> A corporation was also used as a tool to advancing the interests of the state by representing the government abroad.<sup>12</sup> These public functions of a corporation were more important than those of private gain. Only at a later date were associations formed strictly for commercial purposes of making profits for their members.<sup>13</sup>

To facilitate increasing trade activities, large amounts of capital were needed by businesses, and, investments from the public were seen as one of the options to carry on trading. This contributed to the development of joint stock companies which were formed in order to persuade members of the public to invest. In England, the need to incorporate companies was caused by the need to organise foreign trade and to found

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<sup>8</sup> Holdsworth above n2 at 201.

<sup>9</sup> Colin Arthur Cooke *Corporation Trust and Company An Essay in Legal History* (Manchester University Press, 1950) at 51.

<sup>10</sup> *Ibid*, at 53.

<sup>11</sup> *Ibid*, at 51.

<sup>12</sup> *Ibid*, at 52.

<sup>13</sup> Holdsworth, above n2 at 206.

colonies.<sup>14</sup> The emergence of companies such as East India Company, Virginia Company, Bermuda Company and numerous others were for the purpose of foreign trade and to found colonies on behalf of the Crown.<sup>15</sup> These companies strove for friendly relations with local tribes and leaders while establishing posts for trade.<sup>16</sup> In exchange, companies provided protection against pirates and hostile natives.<sup>17</sup> Over time, there the need developed to shift trading risks from individuals, and trading ventures were set up which prompted the grant of legal status by Acts of Parliament or Royal Charters.<sup>18</sup>

At the domestic level, trade continued to develop on the basis of partnership which had its roots of origin in Roman law, known as *societas* and *commenda* until the end of seventeenth century.<sup>19</sup> Until then, joint ventures in domestic trade seldom used the corporate form though later they became beset with enforcement problems. In the event of dispute, all partners had to be joined together and any error meant that proceeding had to begin afresh.<sup>20</sup> In addition, disputes among partners often ended up in dissolution, which would create uncertainty and would not command business confidence.<sup>21</sup> Therefore, the idea of a corporation began to be an attractive solution to barriers of commercial viability.

*Societas* was a form of partnership in which each partner shared profits and losses in proportion to his contributed shares, but his liability to outsiders remain unlimited.

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<sup>14</sup> Cooke above n9 at 209; William R. Cornish and Geoffrey de N Clark *Law and Society in England 1750-1950* (Sweet & Maxwell, London, 1989) at 248.

<sup>15</sup> Ibid.

<sup>16</sup> Cornish and Clark above n14 at 248.

<sup>17</sup> Ibid.

<sup>18</sup> Farrar and Hannigan above n7 at 16.

<sup>19</sup> Cooke above n9 at 195.

<sup>20</sup> Cornish and Clark above n14 at 248- 249.

<sup>21</sup> Ibid.

*Commenda* was the situation in which management partners bore full responsibility, but the sleeping contributors were only liable to the extent of the contributions. *Societas* continued to prosper in England because it was seen as the legal formula available to meet the growing demand of trade while *commenda* did not take root.<sup>22</sup> *Commenda* was believed not to have any impact on English law due to their poor book-keeping system compared to continental countries.<sup>23</sup> An efficient book-keeping system was essential in order to determine the extent of an individual's liability.

Changes in trade and political conditions in the sixteenth and early seventeenth centuries resulted in a large number of joint stock companies dissolving because they were no longer viewed as acceptable.<sup>24</sup> During this time, there was a movement for free trade and monopoly privileges conferred on joint stock companies were successfully attacked.<sup>25</sup> As a consequence of the free trade movement, some companies were compelled to give up their monopolistic rights and make changes to the companies' structures.<sup>26</sup> These companies did so by adopting regulated forms which allowed greater freedom to individuals' trade.<sup>27</sup>

Some companies, however, were more fortunate in surviving with monopolistic rights due to their governmental rather than commercial functions.<sup>28</sup> The example of such company was the East India Company which succeeded in accumulating vast empires in Asia.<sup>29</sup> The success of the East India Company had ensured its survival until the middle of nineteenth century. Likewise, other companies which were

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<sup>22</sup> Ibid, at 249.

<sup>23</sup> Cooke above n9 at 46.

<sup>24</sup> Holdsworth above n2 at 209.

<sup>25</sup> Ibid, at 209.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid, at 202

<sup>29</sup> Ibid.

originally incorporated in order to found colonies, began to disappear once those colonies had become political societies and obtained independence.<sup>30</sup>

The principle of joint stock companies to persuade members of the public to lend and to invest their money in the companies was later used to finance the government expenditures at the end of the seventeenth century. The Bank of England, for example, was formed on the principle of a joint stock company and was granted privileges in exchange for a loan to the government.<sup>31</sup> The principle was later extended to allow companies such as the South Sea Company to take over the whole of the state's debt. The South Sea Act was passed by the government to permit the company to pay anyone who owned government annuity by paying in the form of shares in the company.

Consequently, public confidence in the company as well as the business escalated and its share prices soared.<sup>32</sup> The success of the South Sea Company spurred the formation of other similar companies, and these financial methods had created such frenzies for speculating, that companies started to carry out projects which had no chances of success, such as for the invention of melting down sawdust and chips and casting them into clean boards without cracks or knots.<sup>33</sup> By the end of seventeenth century, joint stock companies were seen as a valuable instrument to provide funds for trading purposes and for mobilisation of national credit.<sup>34</sup> On the other hand, there were also opportunities for joint stock companies to perpetrate frauds on

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<sup>30</sup> Ibid.

<sup>31</sup> Ibid, at 209.

<sup>32</sup> Farrar and Hannigan above n7 at 18.

<sup>33</sup> Ronald R Formoy *The Historical Foundations of Modern Company Law* (Sweet & Maxwell, London, 1923) at 27-28.

<sup>34</sup> Holdsworth above n2 at 213.

members of the public as well as to encourage them to participate in wild speculations and gamble in stock and shares.<sup>35</sup>

In order to overcome the problems of wild speculation and fraud, Parliament passed the Bubble Act 1720 with the aim of restricting the use of corporations except when authorised by an Act of Parliament or Royal Charter.<sup>36</sup> The restriction impelled the formation of a new form of companies known as deeds of settlement companies, which were a combination of trusts and associations.<sup>37</sup> Deed of settlement companies became an option because it was expensive and cumbersome to obtain incorporation through an Act of Parliament and it was very unlikely to obtain the incorporation status via a Royal Charter.<sup>38</sup>

Development of companies continued to prosper despite the restrictions imposed by the Bubble Act 1720. In order to finance business activities, businessmen began to form companies under the deeds of settlement so that they were able to raise money from the public.<sup>39</sup> The need for additional capital from the public became more acute with the growth of the railway industry and the numbers of companies continued to grow.<sup>40</sup> However, not all of those companies were successful and as the numbers of companies escalated, so did the number of company failures.<sup>41</sup>

This spurred reforms in the area of the law though they were gradual and piecemeal, and the first Companies Act was enacted in the UK with the aim of overcoming

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<sup>35</sup> Ibid.

<sup>36</sup> Ibid, at 209.

<sup>37</sup> Farrar and Hannigan above n7 at 19.

<sup>38</sup> Ibid.

<sup>39</sup> Clive Schmitthoff *Palmer's Company Law*, (Stevens, London, 1987) Vol 1 at 7.

<sup>40</sup> Ibid.

<sup>41</sup> Ibid.

business fraud.<sup>42</sup> In 1825, the Bubble Act was repealed and the history of modern company law in England began.<sup>43</sup> The rising numbers of joint stock companies had also witnessed a new form of insolvency, i.e. the winding up of companies and partnerships.<sup>44</sup>

English law provides the foundation for its former colonies including Australia, New Zealand and Malaysia. These former colonies initially relied on the English law, including company law, as models. Over the past century, the relative importance of English law has varied depending on the domestic circumstances at the time. Nevertheless, continued reliance on English law as templates provided opportunities for these jurisdictions to develop over time their own legislation peculiar to their business cultures. In the area of insolvency law, however, dependence on English legislation remains and has often been referred to and followed by the Law Commissions, particularly in the area of company rehabilitation.

The company laws in Australia in the early stages were based on the English law and its legislation was mostly replicas of English Companies Acts. This practice was convenient and advantageous since most companies in Australia at the time were branches of UK companies of which they later became subsidiaries.<sup>45</sup> The adoption of the UK legislation allowed for the formation and operation of limited liability companies both in the UK and the colonies.<sup>46</sup> Thus, the early laws were adopted mostly from the UK in order to cater for the needs of British interests in the colonies rather than for the domestic companies which operated at smaller scales.<sup>47</sup> Any

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<sup>42</sup> Farrar and Hannigan above n7 at 18.

<sup>43</sup> Ibid.

<sup>44</sup> Ibid.

<sup>45</sup> John Farrar *Corporate Governance Theories, Principles and Practice* (3<sup>rd</sup> ed., Oxford University Press, 2008) at 12.

<sup>46</sup> Rob McQueen “Limited Liability Company Legislation-The Australian Experience” (1991) *AJCL* 22 at 24.

<sup>47</sup> Ibid.

developments in England at the time were relevant and important to the development of company legislation in Australia.<sup>48</sup>

The English influence on New Zealand company law has been apparent since the introduction of the first Companies Act in 1860.<sup>49</sup> English company law exerted its influence in New Zealand law through the adoption of that statute without any alterations or modifications.<sup>50</sup> Australia too plays an important role in influencing the shape of New Zealand company law. The dominant influence of Australia, especially Victoria, during the economic boom of the 1860s and 1870s on New Zealand legislation was apparent, and was as great as the English influence before.<sup>51</sup> Other external influences on New Zealand company law in the twentieth century came from North American law - that of Canada and the United States.<sup>52</sup> The reliance on North America has increased since the UK's entry into the European Union, as the latter now has to comply with various EU Directives for the harmonisation of law in the European Union.<sup>53</sup>

As a result, English law is no longer deemed as a suitable model to be adopted because priorities and focus in the development of the law have become distinctive. However, there are features of the Companies Act 2006 which are worth consideration such as provisions relating to director's duties.<sup>54</sup> The trend in the

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<sup>48</sup> Ibid.

<sup>49</sup> Law Commission *Company Law Reform and Restatement* (NZLC R9,1989) at [29].

<sup>50</sup> Ibid.

<sup>51</sup> Peter Spiller, Jeremy Finn and Richard Boast *A New Zealand Legal History* (Brookers, Wellington, 2001) at 87 - "The Australian dominance particularly that of Victoria was due to the strong ties of the two colonies. Many of the migrants attracted to the goldfields in South Island were formerly the residents of Victoria and a number of them rose to prominence in New Zealand."

<sup>52</sup> NZLC above n49 at 31.

<sup>53</sup> Farrar above n45 at 12.

<sup>54</sup> More discussions on this will be made later in the chapter. See the Role of Law Reform Agency below.

Companies Act also reveals providing assistance and remedies to the aggrieved parties rather than concentrating on punishing the offenders.<sup>55</sup>

Due to the British administrative structure in Malaya, before the Second World War, there was no uniform company legislation applicable throughout Malaya. Initially, the Straits Settlements applied the Indian Companies Ordinance 1866.<sup>56</sup> The Indian legislation was later repealed and replaced by the Straits Settlements Ordinance 1889 which constituted the first local company legislation.<sup>57</sup> The 1889 legislation was later repealed and replaced in 1915 and 1923 and continued until the introduction of the Straits Settlements Companies Ordinance 1940.<sup>58</sup>

In the Federated Malay States, the statute applicable was the Companies Enactment 1897 which was later repealed and replaced by the Companies Enactment 1917, while in those outside the federation, each has its own separate but similar companies statute.<sup>59</sup> Although there were separate laws governing the states of Malaya, the basic principles of the statute remained similar because they were based on the English law at the time.<sup>60</sup>

English law was first introduced into Malaya through the first Royal Charter of Justice 1807 which applied only to Penang.<sup>61</sup> This was later followed by the second

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<sup>55</sup> See Company Law Review Steering Group “Modern Company Law for a Competitive Economy: The Strategic Framework” A Consultation Document (DTI, London, 1999) <<http://www.bis.gov.uk/files/file23279.pdf>> at June 2010 [The Steering Group].

<sup>56</sup> Since Straits Settlements formed part of India, any Statutes enacted in India before 1 April 1867 were extended to Straits Settlements. -Wan Arfah and Ramy Bulan *An Introduction to Malaysian Legal System* (Fajar Bakti, Malaysia, 2003 ) at 107.

<sup>57</sup> Wan Arfah and Ramy Bulan, *ibid.*

<sup>58</sup> Malaysia Company Law Reform Committee “Strategic Framework for the Corporate Law Reform Programme of Companies Commission of Malaysia” A Consultation Document (2006) at 12 [CLRC ].

<sup>59</sup> *Ibid.*

<sup>60</sup> *Ibid.*

<sup>61</sup> Wu Min Aun, *Malaysian Legal System* (3<sup>rd</sup> ed, Longman, Malaysia 2005) at 17-21.

Royal Charter of Justice in 1826 which extended the applicability of English law to Singapore and Malacca.<sup>62</sup> The third Royal Charter of Justice 1855 further extended the applicability of English law to the Straits Settlements. In the Federated Malay States, English law was employed through the Civil Law Enactment 1937, and when the Unfederated Malay States became part of the Federation of Malaya in 1948, the application was extended to those states through the Civil Law (Extension) Ordinance 1951.<sup>63</sup> Later, both Enactments were replaced by the Civil Law Ordinance 1956 which applied to all states in the Federation.<sup>64</sup> When Malaysia, which included Sabah and Sarawak, was formed in 1963, the Civil Law Ordinance was replaced by the Civil Law Act 1956 (Revised 1972).<sup>65</sup>

After the Second World War, there were attempts by the British to coalesce the Federated and the Unfederated Malay States into a single administration. This led to the introduction of the Malayan Union in 1946, and the Companies Ordinance 1946 was enacted.<sup>66</sup> Due to the resistance and objections of the Malays to the Malayan Union, the Federation of Malaya was established in 1948 although the Companies Ordinance 1946 remained until 1965 when it was replaced by the Companies Act of that year.<sup>67</sup> Until 1965, there were two Companies laws; the Straits Settlements Companies Ordinance 1940 which applied to the Straits Settlements and the Companies Ordinance 1946 which was applicable in the Federation of Malaya.<sup>68</sup> Sabah and Sarawak too remained separate and had separate legislation: the

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<sup>62</sup> Ibid.

<sup>63</sup> Ibid.

<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid.

<sup>67</sup> CLRC above n58 at 12.

<sup>68</sup> Ibid.

Companies Ordinance 1953 of Sabah and the Companies Ordinance 1958 of Sarawak.<sup>69</sup>

Economic growth provides opportunities for members of the public to invest in the company and to earn profits. At the same time, unscrupulous persons in the company may take advantage of their investments. Hence there must be legal mechanisms to protect the public interests in the company. However, in doing so, the law must not be burdensome and fetter commercial activities. The same concern was echoed by various law commissions in other jurisdictions referred to by the Mohar Commission.<sup>70</sup>

After careful consideration, a statute based on the UK Companies Act 1948 and the Australian Uniform Companies Act 1961 was enacted.<sup>71</sup> The Companies Act 1965 remains until today as the statute which governs company law and winding up in Malaysia. There have been no major reforms in the area of company law and insolvency law since it was first enacted in 1965 and any amendments made to the Act have been piecemeal reforms. Since the Act was first enacted, the focus of the government has always been to facilitate commerce in order to spur the country's economic growth. Thus, as long as the country's economy remains vibrant and healthy, there is no urgent need to implement drastic reforms.

#### **4.2.2 Role of Law Reform Agencies**

Law Reform Committees and the Law Commission play important roles and contribute significantly toward the development of company and insolvency law. Practice has developed in the UK for major reviews and consolidation of statutes to

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<sup>69</sup> Ibid.

<sup>70</sup> Malaysia, *Parliamentary Debates*, Dewan Negara ,(16 August 1965) Vol II No 6 at 768.

<sup>71</sup> Shanty Rachagan, Janine Pascoe and Anil Joshi *Principles of Company Law in Malaysia* (Malayan Law Journal, Malaysia, 2002) at 6.

take place every twenty years.<sup>72</sup> This policy is to ensure that company and insolvency law are up to date as well as reflecting current developments in commercial activities.<sup>73</sup> Other jurisdictions may not have a fixed time frame to review the law, but have done so as and when the need arises.

In 1906, the Loreburn committee was appointed to review the winding up law, and consistent with the trend of company's responsibility approach at the time, the committee made some recommendations on creditors' protection.<sup>74</sup> Recommendations made by the committee were largely adopted and implemented in the Companies (Consolidation) Act 1908.<sup>75</sup>

The Greene Committee in 1925 was later given the task of looking into issues of fraud and dishonest dealings by companies.<sup>76</sup> Recommendations by the Committee were adopted in the Companies Act 1929, and consistent with the trend to have major reforms every twenty years, in 1945 the Cohen Committee made recommendations which were adopted and implemented in the Companies Act 1947 and 1948. The 1948 Act failed to address the issues of fraudulent and dishonest directors in insolvent companies.<sup>77</sup> The Jenkins Committee in their 1962 report made detailed recommendations for improvements where directors were found to be reckless or incompetent in their actions but most of the recommendations were not implemented by the government.<sup>78</sup>

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<sup>72</sup> Farrar and Hannigan above n7 at 21.

<sup>73</sup> Ibid.

<sup>74</sup> See Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982 at [86] [Cork Report].

<sup>75</sup> Ibid.

<sup>76</sup> Ibid.

<sup>77</sup> Ibid at [97].

<sup>78</sup> Ibid at [1761].

In 1977, the Cork Committee was appointed to look into comprehensive reforms on insolvency law. As a result of the report by the Cork Committee, a separate law, the Insolvency Act 1985 was enacted, and on the very same day it was passed, the Act was repealed and replaced by the Insolvency Act 1986.<sup>79</sup> Prior to the introduction of the Insolvency Act 1986, the laws and procedures of corporate insolvency law remained a part of Companies Act. The trend of having corporate insolvency law as part of Company law legislation was followed in other Commonwealth countries whose laws were derived from the English insolvency law, such as New Zealand, Australia and Malaysia.

In 1998, the Labour Government launched a series of consultation documents by Department of Trade and Industry in an attempt to reform the company law regime in the UK. As a result of the commitment, a Steering Group was established to be in charge of reviewing all aspects of company law and to recommend the new company law legislation. The then company legislation was thought to be ‘patchwork’ legislation, originating from the Victorian times and not suitable in the current economy.

A Consultative Committee was appointed with the aim to create modern company law for competitive economy and in order to achieve that, the law should facilitate the operations of the companies so as to maximize wealth and welfare as a whole.<sup>80</sup> During the consultation stage, debate sparked between various respondents on the possibility of advancing beyond the interests of members. The then existing company structures reflect three purposes; firstly, company is formed for the benefit of the shareholders subject to rights of existing and potential creditors:<sup>81</sup> secondly, accounting and disclosure requirements act for the benefit of actual and future

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<sup>79</sup> Roy Goode *Principles of Corporate Insolvency Law*, (Sweet & Maxwell, London, 2005) at [1-06].

<sup>80</sup> The Steering Group above n55 at [2.5].

<sup>81</sup> *Ibid*, at [5.1.4].

shareholders as well as creditors;<sup>82</sup> thirdly, the public disclosure of such information will also benefit the community as a whole.<sup>83</sup>

The call for reforms of the scheme was due to the failure of the law to recognize wealth was best generated when all participants operated harmoniously as teams and the management should appreciate the wider interests in their decision-making.<sup>84</sup> There were mainly two groups of arguments on these matters, the enlightened shareholder value<sup>85</sup> and the pluralist<sup>86</sup> approaches. The committee held the view that, in order to implement the pluralist approach, the law on directors' duties needed to be reformed in order to bring it in line with the furtherance of non-shareholder participants' interests.<sup>87</sup> Alternatively, the duty could be enforced by requiring directors to promote the success of the company, an entity, without regarding any participants as having an overriding interest.<sup>88</sup> The committee, however, rejected the approach because directors' duties needed to be drafted subjectively to confer a wide range of discretion and this would involve potential contentious issues.<sup>89</sup> Moreover

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<sup>82</sup> Ibid.

<sup>83</sup> Ibid.

<sup>84</sup> Ibid, at [5.1.9]

<sup>85</sup> The enlightened shareholder value principle targets to maximize the returns to shareholders as a whole although it was difficult to fulfill in practice. The management had failed to comprehend that way to success requires long term relationship and therefore it should not focus mainly on the short term financial returns. It is important to cultivate the long term cooperation base in trust which will likely to involve costs in the short run but to bring greater benefits later on and the law had failed to include this fact- The Steering Group above n54 at [5.1.12].

<sup>86</sup> The pluralist on the other hand demands for law reform to include wider interests in the company in order to generate maximum wealth and prosperity. This approach requires these interests to be treated as equal rather than subordinate to shareholders' interests which inevitably involve the need to balance the potential competing interest. Hence the duty owe to the company provided in the law should be extended to those who have made commitment to it such as employees as well as creditors and not to be applied exclusively to current and future shareholders only- The Steering Group above n54 at [5.1.13] – [5.1.14].

<sup>87</sup> The Steering Group above n55 at [5.1.30].

<sup>88</sup> Ibid.

<sup>89</sup> Ibid.

the Committee foresaw difficulty due to lack of remedy in the event directors abused their powers.<sup>90</sup>

It also rejected a proposal to alter board composition to represent wider interest, as in Germany, because it would involve radical changes to British company law structure and would not gain wide support.<sup>91</sup> In the end, the Committee recommended, and the legislature adopted, a duty to promote the success of the company which enshrined the principle of enlightened shareholders value. The duty requires the director to consider in good faith the way which will promote the success of the company and in doing so to have regard to the factors listed in the section.<sup>92</sup> The factors listed in the Act are not exhaustive and represent the wider expectation of business behaviour and the expectation that business decisions should be exercised by the directors subject to good faith. The director has to exercise his duty of care skill and diligence<sup>93</sup> when considering factors listed in section 172(1).

The legislature accepted the recommendation by the Committee that there should be statutory statements regarding the director's general duties. Consequently, the Companies Act 2006 sees the codification of the common law duties and equitable principles into the Act. The statute also provides for remedies if the director breaches his or her duty in section 178. In addition to the codification of the director's duties, the Committee suggested reforms of the law to reflect the changes in the economy which includes globalization, the European influences on the British company law, the advance in the information technology as well as the changes in the pattern of ownership and the pattern of productive activity.<sup>94</sup>

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<sup>90</sup> Ibid.

<sup>91</sup> Ibid, at [5.1.32].

<sup>92</sup> Companies Act 2006 Explanatory notes at [325].  
<[http://www.opsi.gov.uk/acts/acts2006/en/ukpgaen\\_20060046\\_en.pdf](http://www.opsi.gov.uk/acts/acts2006/en/ukpgaen_20060046_en.pdf)> at 6 June 2010.

<sup>93</sup> This principle is codified in section 174 of the UK Companies Act 2006.

<sup>94</sup> The Steering Group above n55 at Ch 2.

In Australia, reforms to insolvency law were undertaken by the Law Reform Commission on a General Insolvency Inquiry whose report is known as the Harmer Report. The appointment presented the committee with an opportunity to make the first extensive reviews of corporate insolvency law. The needs to review insolvency law and procedures were accentuated when more companies became insolvent as a result of economic and social changes.<sup>95</sup> Besides, other countries sharing common features on insolvency law with Australia such as the UK, Canada and the United States were also in the process of reviewing their own insolvency law.<sup>96</sup> Recommendations made in the Harmer Report were largely implemented in the Corporate Law Reform Act 1992.<sup>97</sup>

The task of reviewing the New Zealand Companies Act 1955 was first undertaken by the Macarthur Commission in 1973.<sup>98</sup> The recommendations by the Commission were based on the report submitted by the UK's Jenkins Committee in 1962 as well as the Australian Uniform Companies Act 1961.<sup>99</sup> The proposals put forward by the Macarthur Committee, however, were not implemented and due to the developments in the UK and Australia at the time, the recommendations were seen as out-dated and no longer relevant.<sup>100</sup>

The second attempt to review the 1955 Act was made in 1989 by the appointment of the Law Commission. The Law Commission in 1989 generally recommended that the 1955 Act be replaced with a new Act, covering matters such as the formation,

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<sup>95</sup> Australia Law Reform Commission, *General Insolvency Inquiry Report* (ALRC R45 Vol 1 1988) at [3] <[http://www.austlii.edu.au/au/other/alrc/publications/reports/45/45\\_vol\\_1.pdf](http://www.austlii.edu.au/au/other/alrc/publications/reports/45/45_vol_1.pdf)> at 25 January 2008.

<sup>96</sup> *Ibid.*, at [4].

<sup>97</sup> Andrew Keay McPherson *The Law of Company Liquidation* (LBC Information Services, Sydney, 1999) at 23.

<sup>98</sup> NZLC R9 above n49 at [31].

<sup>99</sup> *Ibid.*

<sup>100</sup> *Ibid.*

operation and termination of a company and at the same time preventing the possibility of abuse as well as not undermining the social and economic benefits.<sup>101</sup> The Commission concluded that the new legislation should be modelled after the work of the Canadian Dickerson Committee.<sup>102</sup>

The Commission regarded the Australian Code, apart from insolvency law, to be inadequate, inefficient and not so far advanced as that of New Zealand, hence the departure.<sup>103</sup> Despite the harmonisation of business law through the Australian and New Zealand Closer Economic Relations Trade Agreement (ANZCERTA),<sup>104</sup> the Committee felt that it did not mean that the laws of the two countries should be identical in all aspects. Instead, the law must be able to provide avenues for solutions and should not create barriers to trade and investment.<sup>105</sup> At about the same time, the Commonwealth Government in Australia sought to introduce unified legislation in order to administer control over company matters. Since the success of the legislation was yet to be seen, the Commission felt that there was no point in adopting that model, and instead decided to focus on the improvement of the New Zealand legislation.<sup>106</sup> As a result of the recommendations, the Companies Act 1993

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<sup>101</sup> Ibid, at [23].

<sup>102</sup> Ibid, at [32].

<sup>103</sup> Ibid, at [145-153].

<sup>104</sup> Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) was formally signed by Australian and New Zealand Governments on 28 March 1983. The objectives of this agreement are stated in Article 1 of the ANZCERTA and provide:

- a) to strengthen the broader relationship between Australia and New Zealand
- b) to develop closer economic relations between Member States through a mutually beneficial expansion of free trade between New Zealand and Australia
- c) to eliminate barriers to trade between Australia and New Zealand in a gradual and progressive manner under an agreed timetable and with a minimum of disruption
- d) to develop trade between New Zealand and Australia under conditions of fair competition.

<sup>105</sup> As part of the review of the ANZCERTA, Australian and New Zealand Governments signed a Memorandum of Understanding (MOU) on 1 July 1988. As a result of the MOU, the Steering Committee was appointed to examine the scope for harmonization of business law and regulatory practices in areas identified by the MOU. On 31 August 2000 another MOU was signed to replace the 1988 MOU.

<sup>106</sup> NZLC above n49 at [31]

was enacted and to date, it remains the principal act in relation to company law and insolvency law.

In addition to the Companies Act 1993, the Receivership Act 1993 and the Personal Property Securities Act 1999 (PPSA) also govern matters relating to companies. The Receivership Act 1993 deals with receivership<sup>107</sup> for both corporate and personal debtors. It codifies the law relating to private and court appointed receivers. In 2006, amendments were made to the Receivership Act 1993 by the Companies (Amendments) Act 2006 which clarifies employee's wages and salary, during the 14 days grace period when a receiver decides whether to adopt or terminate the employment contract, as a preferential debt.<sup>108</sup> It also elucidates clearly the order in which a receiver must pay preferential and secured creditors<sup>109</sup> as well as the position of transactions voidable by receiver.<sup>110</sup>

The PPSA 1999 provides for an integrated code of personal security law by replacing the Chattels Transfer Act 1924, the Companies (Registration of Charges) Act 1993, the Motor Vehicle Securities Act 1989 and the Industrial and Provident Societies Amendment Act 1952.<sup>111</sup> It provides, in particular, for the creation and

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<sup>107</sup> A receivership is an external mechanism in which the company's management is placed at the hand of a receiver to act in the interests of a debenture holder who appointed him. A receiver can also be appointed by the court in certain circumstances. A receivership differs from liquidation because the receiver's duty is to the person who appoints him, unlike a liquidator who owes a duty to the company.

<sup>108</sup> See section of 30(3)(d) and( e) of the New Zealand Receivership Act 1993.

<sup>109</sup> See section 30(2A) of the New Zealand Receivership Act 1993; see also Schedule 2 Companies (Amendments) Act 2006.

<sup>110</sup> Schedule 7, para 2(1) (B) and (C) of the New Zealand Companies Act 1993 as inserted by Schedule 1 of the Companies (Amendments) Act 2006 provides that the preferential claims listed in schedule 7 will have priority over the claims of any person under the security interests over accounts receivable and inventory which is "not a purchase money security interests that has been perfected at the time specified in section 74 of the Personal Property Securities Act 1999."

<sup>111</sup> Ministry of Economic Development *Personal Property Securities Act* <[http://www.med.govt.nz/templates/ContentTopicSummary\\_15159.aspx](http://www.med.govt.nz/templates/ContentTopicSummary_15159.aspx)> at 17 June 2010; See also John Farrar "Debt Capital" in John Farrar (Ed.) *Companies and Securities Law* (Brookers, Wellington, 2008) at [25.1].

enforceability of security interests in personal property and the determination of priority between security interests in the same property. Prior to the passing of the Act, the question of priority is determined by a complex relationship between common law, equitable priority rules and the statute.<sup>112</sup>

The Act also provides a searchable register, called Personal Property Securities Register, in order to perfect the security. The existence of this register provides for simple and cheaper avenue for creditors to know their priority and their position in relation to the security. The Companies (Amendments) Act 2006 also attempts to give solutions to the conflict of priority under PPSA and schedule 7 of the Companies Act 1993.<sup>113</sup>

The formation of Malaysia in 1963 and the growth of commercial activities, prompted the need to review the existing legislation and to have uniform companies legislation throughout Malaysia. As a result, the Ministry of Commerce and Industry set up a committee on 30<sup>th</sup> October 1963 chaired by Raja Mohar bin Raja Badiozaman (the committee is also known as the Mohar Committee) to recommend the new Companies legislation in Malaysia.<sup>114</sup> In recommending the new legislation, the Committee considered legislation in force at the time in England, Australia, India and New Zealand.

In addition, references were also made to the Cohen Report, the Jenkins Report, the report and draft code for Ghana prepared by Gower, as well as various comments

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<sup>112</sup> Farrar, *Ibid* at [25.1]

<sup>113</sup> Schedule 7, para 2(1) (b)(i)(B) of the New Zealand Companies Act 1993 as inserted by Schedule 1 of the Companies (Amendments) Act 2006 provides that the preferential claims listed in schedule 7 will have priority over the claims of any person under the security interest over accounts receivable and inventory which is not a purchase money security interests that has been perfected at the time specified in section 74 of the Personal Property Securities Act 1999. See also Schedule 7 para 2(1) (C) of the same Act.

<sup>114</sup> Malaysia Parliamentary Debates above n70 at 768.

and suggestions from interested persons and bodies within Malaysia.<sup>115</sup> There have been changes to the companies legislation since 1965 although these are all piecemeal amendments which attempt to address some issues as and when they arise. However, in 2006, in response to the financial crisis in the late 1990s, a Law Committee was established to look into the existing legislation. (These proposals will be discussed later in this chapter)

### 4.2.3 Major Trends in Company Law

The period between 1862 and 1972, saw two competing approaches to company law, the utility approach and the responsibility approach.<sup>116</sup> The utility approach, based on the premise of company's ability to perform rational economic and social ends, was apparent in the earlier statutes of 1844 and 1855.<sup>117</sup> In the latter years, the responsibility approach, centred on company's responsibility towards members and outsiders, was more dominant.<sup>118</sup>

At the time when the Joint Stock Companies Act 1856 was passed, the prevailing theme was the doctrine of economic liberalism and laissez-faire.<sup>119</sup> This is in line with the utility approach.<sup>120</sup> The objective was to encourage the formation of businesses and to reduce excessive rules and formalities in order to stimulate the economy at the time.<sup>121</sup> This objective was apparent where the Act allowed greatest freedom in the formation and working of a limited liability by introducing a simple

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<sup>115</sup> Ibid.

<sup>116</sup> Farrar and Hannigan above n7 at 21.

<sup>117</sup> Ibid.

<sup>118</sup> Ibid.

<sup>119</sup> Schmitthoff *Palmer's Company Law* above n39 at 10.

<sup>120</sup> Ibid.

<sup>121</sup> Ibid.

procedure, and dispensed with the old burdensome system in the 1844 Act.<sup>122</sup> The company could be formed through the registration of the constitutional documents<sup>123</sup> and payment of the registration fees, upon which the certificate of incorporation was issued, and thereupon the company can commence its business.<sup>124</sup>

At the end of the nineteenth century, concerns over liability for misleading statements in companies' prospectuses arose and the law at the time was modified to impose liability on those responsible for making such statements, including the directors.<sup>125</sup> During this time, the law had shifted towards the regulatory approach in order to exercise control over the company.<sup>126</sup> Nevertheless, the introduction, in the Companies (Consolidation) Act 1908, of private companies which did not require the company to file its balance sheet and annual return so as to be more attractive to the public, indicated that the *laissez faire* doctrine was still very important.<sup>127</sup>

The tendency of company law to adopt the regulatory approach became more apparent during the times of economic slowdown which saw many companies come apart. This can be seen, for example, in the introduction of the Companies Act 1896 due to the collapse of the economy in Victoria. The Companies Act 1896 focussed on regulating the company and was a reversal of the *laissez faire* principle evident in existing company legislation.<sup>128</sup> The departure from the *laissez faire* principle was intended to control the company and to prevent the same occurrences in the future.

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<sup>122</sup> Ibid.

<sup>123</sup> The company needs to register memorandum of association together with articles of association (if any) with the Registrars as well as any other documents prescribed by the Companies legislation, upon which, the Registrar will issue certificate of incorporation certified under his hand and seal.

<sup>124</sup> Schmitthoff *Palmer's Company Law* above n39 at 10.

<sup>125</sup> Ibid, at 12.

<sup>126</sup> Ibid.

<sup>127</sup> Ibid.

<sup>128</sup> John Waugh "Company Law and the Crash of the 1890s in Victoria" (1992) 15 UNSWLJ 356 at 382 ["Company Law and the Crash"].

The Act introduced new provisions relating to winding up and an auditing system to verify the accuracy of the financial systems.<sup>129</sup> It also imposed statutory duties and liabilities on directors as well as on auditors.<sup>130</sup>

Although the requirement of disclosure by the company existed from the beginning of the introduction of company law, a more stringent approach in terms of disclosure of information can be seen in the subsequent Acts and the trend of a company's responsibility became more prominent.<sup>131</sup> The emphasis of the later Acts is on public accountability, by which recognised accounting principles are required to be applied in the preparation of the company's accounts, protection of minority shareholders as well as strict provisions on disclosure of director's interests in the company.<sup>132</sup> The trend of company responsibility is also consistent with the creditors' protection through the development of the capital maintenance doctrine, the distribution of improper dividends and can also be seen from the prohibition of the company to purchase its own shares.<sup>133</sup>

Provisions in the UK Companies Act 1948 gave discretionary power to the court to exercise jurisdiction to restrain fraudulent persons from managing the company.<sup>134</sup> The Jenkins Committee in its 1962 report made detailed recommendations for improvements where directors were found to be reckless or incompetent in their actions, but most of the recommendations were not implemented by the government.<sup>135</sup>

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<sup>129</sup> Ibid.

<sup>130</sup> Ibid.

<sup>131</sup> Schmitthoff *Palmer's Company Law* above n39 at 14-15

<sup>132</sup> Ibid.

<sup>133</sup> Farrar and Hannigan above n7 at 21-22.

<sup>134</sup> Cork Report n 74 above at [1761].

<sup>135</sup> Ibid.

The creditors' protection principle is further enhanced in the UK Insolvency Act 1986 with the introduction of director's personal liability and other provisions on wrongful and fraudulent trading. Although the Insolvency Act 1986 did not provide for automatic disqualification of directors found to be unfit, provisions relating to disqualification orders were further enhanced.<sup>136</sup> Subsequently, provisions relating to directors' disqualification were expanded to include various aspects of directors' disqualification. Later, a separate Act, the Company Directors Disqualification Act 1986, was enacted in order to govern disparate facets of directors' disqualifications.<sup>137</sup>

In the late 1980s and early 1990s, the goal of insolvency law has shifted from assisting the company to wind up, to reorganising the company and saving the business as far as it is possible to do so. During this period a new theme, the rescue culture, emerged. This principle became more important with the Asian financial crisis in 1998. Hence, the administration procedure was introduced in the Insolvency Act and was later followed and modified by other jurisdictions.

## **4.2 Development of Corporate and Insolvency Laws**

### **4.3.1 Introduction**

Corporate insolvency law historically originated from the development of bankruptcy law. Prior to the establishment of systematic bankruptcy procedures in the early sixteenth century, creditors had to resort to the ordinary process of the court to recover their debts.<sup>138</sup> Remedies afforded by insolvency law at the time were either to seize the body or the effects of the debtor.<sup>139</sup> During that time, there was no

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<sup>136</sup> Schmitthoff *Palmer's Company Law* above n39 at 18.

<sup>137</sup> *Ibid*, at 18-19.

<sup>138</sup> V Markham Lester *Victorian Insolvency* (Clarendon Press, Oxford, 1995) at Ch 6; Edward Abbott Parry *The Law and the Poor* (The Lawbook Exchange Ltd, New Jersey, 2004) at Ch III.

<sup>139</sup> Goode above n79 at [1-05].

collective action and therefore the debtor was subjected to multiple actions.<sup>140</sup> The creditors were competing against each other for the effects of the debtor on a first come first served basis because the principle of equal distribution had not yet been developed.<sup>141</sup>

Legislation borrowing (from Roman Law), the concept of equal distribution of the debtor's assets in proportion to his debts to the creditors was passed in 1543 and was further enhanced with the passing of subsequent legislation in 1570.<sup>142</sup> The same legislation also established provisions on fraudulent trading and they remained part of insolvency law until replaced by the Companies Act 1925.<sup>143</sup>

A new form of insolvency later emerged with the growing numbers of joint stock companies. Until the passing of the winding up Act in 1844, the matter of dissolving failed companies was dealt with by the Court of Chancery.<sup>144</sup> The early legislation on winding up applied bankruptcy principles to winding up cases and conferred jurisdiction to bankruptcy courts as well as Courts of Chancery.<sup>145</sup> The reason for allowing bankruptcy courts to have jurisdiction over such matters was to grant power to the court to investigate the causes of failure and to determine whether abuses had occurred.<sup>146</sup> The Courts of Chancery, on the other hand, had jurisdiction over the granting of winding up orders and over contribution orders.<sup>147</sup> The overlapping of jurisdiction had subjected shareholders to duplication of liabilities both as

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<sup>140</sup> Ibid.

<sup>141</sup> Ibid.

<sup>142</sup> Ibid.

<sup>143</sup> Ibid.

<sup>144</sup> Formoy above n33 at73

<sup>145</sup> Ibid.

<sup>146</sup> Ibid.

<sup>147</sup> William Holdsworth *A History of English Law* (Sweet & Maxwell, London (1903-66)) vol XV at 52 ["A History"].

shareholders and on personal bankruptcies.<sup>148</sup> Members of the company still continued to be personally liable for the debt of the company and creditors were allowed to pursue their own actions against individual members of the company.<sup>149</sup> Even so, before creditors could proceed to bring an action against an individual member of the company, they had to prove their debts and obtain leave of the Court of Chancery.<sup>150</sup>

The passing of the successive Acts from 1862 onwards allowed for the development of specialised winding up procedures.<sup>151</sup> The transfer of jurisdiction to the Court of Chancery by the 1862 Act presented further opportunity to develop specialised winding up procedures and also provided an appropriate moment for case law to progress along its own particular lines and to diverge from the principles of the law of bankruptcy.<sup>152</sup> This Act also resolved the conflict of jurisdiction between the bankruptcy court and Court of Chancery under the previous Acts by transferring matters pertaining to winding up of companies to the Court of Chancery.<sup>153</sup> Insolvency law later developed into two specialised branches of law; individual and corporate and by the end of the nineteenth century, two separate statutes, the Bankruptcy Act and the Companies Act governed the two branches of insolvency law.<sup>154</sup>

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<sup>148</sup> Cornish and Clark above n14 at 255.

<sup>149</sup> Formoy above n33 at 73.

<sup>150</sup> Holdsworth *A History* above n147 at 51.

<sup>151</sup> Ian Fletcher *The Law of Insolvency* (Sweet & Maxwell, London 2002) at [1-021].

<sup>152</sup> *Ibid.*

<sup>153</sup> *Ibid.*

<sup>154</sup> *Ibid* at [1-022].

### 4.3.2 Economic Trends and Insolvency

At the end of the seventeenth century, encouraged by the possibility of trade overseas, companies began to venture into stock trading.<sup>155</sup> This scheme was initiated by the success of the South Sea Company. When the company collapsed, the assets and stock prices in public credit plummeted.<sup>156</sup> The effect then spread to the whole trade and industries sector and later the economy declined into the depths of a depression.<sup>157</sup> The government reacted to the crisis by passing the Bubble Act 1720 which was to restrict the formation of companies.<sup>158</sup> The deed of settlement company was later set up as a form of evasion technique developed by businessmen to overcome the restriction placed under the Bubble Act.<sup>159</sup>

The deed of settlement companies were unincorporated companies made up of various shareholders and a trustee(s) where parties agreed to observe the provisions of the deeds.<sup>160</sup> Founders of this type of company would include various provisions in the deed with the aim of making them as close as possible to corporations. The covenant would include provisions which stated the company would have a specific name comprised of person who held shares in its capital.<sup>161</sup> In addition, the agreement would make shares in the company transferable and the management of the company was handed to a select body of directors, to the exclusion of the members generally, in order to ensure the continuity of the company was not affected by death or bankruptcy of members while properties were vested in

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<sup>155</sup> Farrar and Hannigan above n7 at 17.

<sup>156</sup> Ibid.

<sup>157</sup> Julian Hoppit "Financial Crises in Eighteenth-Century England" (1986) 39 *Econ. Hist. Rev.* 39 at 47.

<sup>158</sup> Schmitthoff *Palmer's Company Law* above n39 at 7

<sup>159</sup> Ibid.

<sup>160</sup> Ibid.

<sup>161</sup> Ibid.

directors as trustees.<sup>162</sup> Members were held to be liable for debts and liabilities only to the extent of their means.<sup>163</sup>

In the late eighteenth century, there were many areas of economic development in fixed capital projects, both domestically and overseas.<sup>164</sup> High risk investment contributed to the rapid expansion of domestic industry and trade, but it also sparked the working capital crisis.<sup>165</sup> Overseas traders, meanwhile, demanded that credit be extended for a long time and for long gestation periods.<sup>166</sup> The instability of working capital had affected public confidence in the market and contributed to the general collapse of business credit.<sup>167</sup> Businessmen found it difficult to obtain credit and, consequently, businesses suffered. This was evident during the economic downturn in Australia which followed after the economic boom in the 1880s.

Economic growth began to slow down during the first half of the 1880s and there was a significant number of corporate collapses.<sup>168</sup> It started with the collapse of land companies and building societies, and later spread to trading banks. The collapse of trading banks prompted the government to declare a five-day bank holiday for restructuring during which most banks resumed their normal activities after having remained closed for a month.<sup>169</sup> The disruptions to the financial system by banks' closure worsened the economy and affected investors' confidence and, as a result, the flow of capital both locally and overseas declined.<sup>170</sup>

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<sup>162</sup> Ibid.

<sup>163</sup> Ibid.

<sup>164</sup> Hoppit above n157 at 52.

<sup>165</sup> Ibid.

<sup>166</sup> Ibid.

<sup>167</sup> Ibid, at 53.

<sup>168</sup> Waugh "Company Law and the Crash" above n128 at 360-363.

<sup>169</sup> Ibid, at 366.

<sup>170</sup> Ibid, at 367.

This cycle was repeated during the great depression in the 1930s during which many businesses had to close down due to the lack of capital and high inflation rates.<sup>171</sup> Similarly, the financial crisis in 1987 affected the business community and caused the governments of Australia and New Zealand to review their companies legislation. The Asian financial crisis in 1998, once again, saw failures of many businesses in Asia which compelled governments to review their insolvency legislation and their corporate governance systems in order to avoid similar circumstances in the future.

Threats of wars had also created panic and caused trust in the financial markets to waver.<sup>172</sup> Creditors began to cut lending and seek liquidity, believing that trade would be affected by war.<sup>173</sup> Hence the business community was hit by a lack of credit which contributed to the numbers of business failures.<sup>174</sup> The aftermath of the First World War, for example, saw the world economy slump to the era of the Great Depression with high inflation rates and high unemployment.<sup>175</sup> The introduction of limited liability not only generated more company formation to be formed, but was also indirectly responsible for the growing number of company failures.<sup>176</sup>

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<sup>171</sup> Robert Higgs *Depression, War and Cold War: Studies in Political Economy* (Independent Institute, Oakland, CA 2006) at 5-9.

<sup>172</sup> Hoppit above n157 at 49.

<sup>173</sup> *Ibid.*

<sup>174</sup> *Ibid.*

<sup>175</sup> *Ibid.*

<sup>176</sup> As a result of stiff competition, small businesses and inefficiently managed companies were driven out of business, especially during the depression era in the late nineteenth century. In addition, the availability of limited liability also encouraged the formation of companies for fraudulent and unsound purposes. Promoters took advantage of limited liability to set up companies which were never intended to exist, or if they were formed, they would be subjected to winding up soon after the formation. Frauds were also committed by directors during the operations of the company. Promoters and directors were able to profit from the company's failures at the expense of shareholders and creditors. See Geoffrey Todd "Some Aspects of Joint Stock Companies, 1844-1900" (1932) 4 *Econ. Hist. Rev.* 46 at 64-66.

### 4.3.3 Development of Insolvency Legislation

Studies have cited mismanagement and incompetence as major causes and fraud only encompasses small percentage of companies' failures.<sup>177</sup> The law must, therefore, respond to reflect this and duty should not be imposed solely on a director's intention but to cover situations where the director is merely negligent or incompetent. The Cork Committee had highlighted the same and recommended that the law should be amended to provide for civil liability for directors who committed wrongful trading, this was adopted in the Insolvency Act 1986.<sup>178</sup> In addition, the law has to set a standard of care in which a director has to adhere to in performing his or her duty. The setting of standard of care is essential in order to ensure the director has the competency required.<sup>179</sup> The current trend in the law is on rehabilitation of the company and not merely focusing on punishing directors. However, in imposing liability on a director, apart from punishing him or her, it is also essential for the law to provide for compensation for creditors.

The legislative history of companies' winding up in the UK began from the passing of a statute in 1844 named An Act for facilitating the winding up the affairs of Joint Stock Companies unable to meet their Pecuniary Engagements.<sup>180</sup> The 1844 Act was supplemented by an Act in 1848 which was later amended in 1849. When the two Acts were passed, it was the period of great depression and there were many bankruptcies; hence there were concerns about dissolutions and winding-ups.<sup>181</sup> As such, the Acts were designed to facilitate companies in their winding up process. The

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<sup>177</sup> Farrar and Hannigan above n7 at 622-623.

<sup>178</sup> Cork Report above n74 at [1776] – [1780].

<sup>179</sup> Discussion in the later chapters of the thesis - see Chapter 9 and Chapter 10.

<sup>180</sup> The objectives of this Act were stated in its preamble as "to make better provision for discovery of the abuses that may have attended the formation or management of the affairs of any such companies or bodies and for ascertaining the causes of their failure." See Formoy above n32 at 73.

<sup>181</sup> Cooke above n9 at 152.

courts were also granted powers under these Acts to investigate, to ascertain the causes of the companies' failures and to discover any abuses inflicted on them. Members were personally liable for the companies' debts because, at the time, limited liability had not been available to all companies.

Some provisions in Australian legislation on joint stock companies and their winding-up preceded the legislation in England; for example, the provisions contained in the Absent Debtors Act were passed in New South Wales in 1840 while the legislation in England with the same provisions was passed in 1844.<sup>182</sup> The Absent Debtors Act 1840 permitted an action being instituted against members of a partnership as representatives without having to name every member in the suit, which was not available to creditors in England until 1844.<sup>183</sup>

The introduction of the principle of limited liability by the UK Limited Liability Act 1855 marked a new beginning in the history of company law. The Act conferred limited liability on members of the company and the concept of corporate personality was introduced. The UK Companies Act 1862 simplified the procedures for companies to obtain limited liability status by complying with the statutory formality of registration.<sup>184</sup> The Act provided detailed winding up procedures including the application of the bankruptcy *pari passu* principles into corporate insolvency and imposing personal liability on the directors or officers of the company who, in the course of winding up, proved guilty of misfeasance.<sup>185</sup> In addition, the courts were to have regard to the wishes of creditors and contributories when making an order for compulsory winding up.<sup>186</sup>

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<sup>182</sup> Keay above n97 at 21.

<sup>183</sup> Ibid.

<sup>184</sup> Cork Report n 74 above at [76].

<sup>185</sup> Holdsworth *A History* above n147 at 58.

<sup>186</sup> Ibid.

In Australia, the government response to the collapse of the economy and of significant numbers of companies was the prompt introduction of the Voluntary Liquidation Act 1891 (Vic).<sup>187</sup> The Act made it difficult to obtain compulsory winding up by court order and at the same time preserved the secrecy of companies' dealings, which might otherwise be exposed through court's scrutiny.<sup>188</sup> The main purpose of the Act was to defeat creditors, who may compel a company into a premature liquidation, when it still has the potential of being rescued.<sup>189</sup> However, the company could still resort to voluntary liquidation and often did so in order to evade creditors' or members' application for winding up, which defeated the purpose of the Act.<sup>190</sup> In voluntary liquidation, the company's dealings were not subjected to court's scrutiny and directors or their associates could also be appointed as liquidators.<sup>191</sup>

Another reform made in the aftermath of the economic breakdown was the passing of the Directors Liability Act 1891, modelled after the English Directors Liability Act 1890.<sup>192</sup> A new company Act was also enacted in Victoria and some of its provisions were stricter than the UK Companies Act it was based on.<sup>193</sup> The additional requirements in the Companies Act 1896 included the need to obtain approval by special resolution to mortgage the uncalled capital and the usage of the caveat system in the registration of company charges.<sup>194</sup>

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<sup>187</sup> Waugh "Company Law and the Crash" above n128 at 364. The urgency to pass the legislation was apparent in that the Bill for the Act was passed through all stages in both houses in one day. See also John Waugh "The Centenary of the Voluntary Liquidation Act 1891" (1991) 18 MULR 170 at 172 ["The Centenary"]

<sup>188</sup> Waugh "The Centenary" above n187 at 172-173.

<sup>189</sup> Ibid at 172.

<sup>190</sup> Ibid, at 173.

<sup>191</sup> Ibid.

<sup>192</sup> Waugh "Company Law and the Crash" above n128 at 381.

<sup>193</sup> Ibid, at 386.

<sup>194</sup> Ibid.

The Cork Committee pointed out that the aim of a good insolvency law was to diagnose and treat imminent insolvency at an early stage, and to provide mechanisms to preserve the company as a going concern if possible.<sup>195</sup> The law must also recognise that there are other parties affected by insolvency apart from the insolvent debtor and its creditors, and that they should also be protected.<sup>196</sup> The aims of insolvency law pointed out by the Cork Committee were consistent with the rescue culture being advocated in the 1990s.

The recommendations of the Cork Committee were implemented in the UK Insolvency Act 1986. The Insolvency Act 1986 contained detailed provisions on corporate insolvency. It was later amended by the Insolvency Act 1994 on issues relating to personal liability of administrators and administrative receivers and was further amended by Insolvency (No 2) Act 1994.<sup>197</sup> In 2000, the Insolvency Act 1986 was again amended to allow the company to obtain an initial moratorium when a voluntary arrangement has been proposed.

The Act also amended the provisions on directors' disqualification in the Company Directors Disqualification Act 1986. Further amendments were made in the Enterprise Act 2002, such as permitting companies to have voluntary arrangements without the court's order, introducing prohibition on the appointment of administrative receivers and abolishing the crown preferences.<sup>198</sup> Prior to the introduction of voluntary arrangement in the Insolvency Act 1986, there was no mechanism to put the company under the management of a third party for the benefit of the company and the unsecured creditor.<sup>199</sup> The only available mechanism was the

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<sup>195</sup> Cork Report above n74 [198(a),(b) and (j)].

<sup>196</sup> Ibid.

<sup>197</sup> Goode above n79 at [1-06].

<sup>198</sup> Ibid at [1-21].

<sup>199</sup> Ibid at [1-22].

appointment of an administrative receiver by a floating charge holder whose primary duty is to safeguard rights of the charge holder and not to the unsecured creditors.<sup>200</sup>

Following the developments in the UK, a similar reform took place in Australia in 1988. Among the recommendations made in the Harmer Report was the introduction of new voluntary procedures for insolvent companies by the appointment of an administrator.<sup>201</sup> The new voluntary procedures were the combination of voluntary winding-up procedures and schemes of arrangement.<sup>202</sup> The Committee also recommended the employment of creative alternatives to insolvency with the objective of preserving the property and business of the company, if it was possible and practical, while the creditors decided on the next course of action.<sup>203</sup>

The recent Asian financial crisis in 1998 has spurred many Asian countries to review their insolvency laws and as a result of that, some Asian countries adopted sophisticated insolvency laws.<sup>204</sup> The impact of this event on New Zealand was that all its major trading partners had insolvency laws which were more sophisticated, and this had wider implications in terms of reciprocity issues and the international reputation of its financial infrastructure.<sup>205</sup>

Reviews of corporate and personal insolvency law began in May 1999 by the Ministry of Economic Development. The introduction of new mechanisms, which include rehabilitation of companies as one of its key reforms, reflects fundamental policy changes in its insolvency law. Voluntary administration was introduced in

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<sup>200</sup> Ibid at [1-23].

<sup>201</sup> ALRC R45 above n95 at [56].

<sup>202</sup> Ibid, at [54].

<sup>203</sup> Ibid, at [52-53].

<sup>204</sup> David Brown *Corporate Rescue*, Report for the Ministry of Economic Development November 2000 at 7. <<http://www.med.govt.nz/>>.

<sup>205</sup> Ibid.

New Zealand through the Companies (Amendment) Act 2006 which came into effect on 1 November 2007 in Part 15A.<sup>206</sup> This rescue device has been widely used in many jurisdictions including Australia,<sup>207</sup> Canada,<sup>208</sup> the United States<sup>209</sup> and the UK.<sup>210</sup>

Malaysia was badly affected by the financial crisis in 1998, and several reforms took place pursuant to the crisis. Reforms of company law did not take centre stage or become a priority for the government. Reforms were made as and when the need arose and mostly when the country was having economic downturns. The financial crisis of 1998 accentuated the weaknesses in the current company legislation and acted as a catalyst to company law reform. A high number of companies' failures demonstrated that there are loopholes in the current legislation. It is submitted that

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<sup>206</sup> The objective of Part 15A is to provide mechanisms for insolvent companies present and future to maximise their chances of continuing their business, and if that is not possible, to provide a better return for creditors and shareholders than it would have in liquidation. See section 239A of the New Zealand Companies (Amendment) Act 2006. See also section 435A of the Australian Corporations Act 2001.

<sup>207</sup> Voluntary administration is a regime under Part 5.3A in section 435A of the Australian Corporations Act 2001 - an administrator is appointed to take control of the company, investigate into the company's affairs and report to the creditors on the company's future. If creditors decide to execute a deed of arrangement, the administrator will administer the company according to the deed. (R.P Austin and Ian M. Ramsay *Ford's Principles of Corporations Law* (14<sup>th</sup> ed., Lexis Nexis Butterworth, NSW, 2010) at [27-020]).

<sup>208</sup> Canada has similar voluntary administration but, unlike in Australia, an administrator does not necessarily take over in the management of the company. Another notable point is the requirement for secured creditors to give 10 days prior notice before enforcing security and they are not able to veto the process as in Australia. In the UK, secured creditors no longer have the option to veto the process when administrative receivership was abolished by the Enterprise Act 2002. Holders of qualifying floating charges created on or after September 15, 2003 are no longer allowed to appoint an administrative receiver - a procedure previously used in order to defeat the administration process. See Goode, above n78 at [10-07-10-08].

<sup>209</sup> Due to different structures, adaptation of Chapter 11 similar to the United States is prevented. Chapter 11 is a system with an automatic stay of 120 days against secured and unsecured creditors when filing for such proceeding. The mechanism does not depend insolvency as a criterion to operate. The effect of filing for Chapter 11 is that secured creditors are prohibited from exercising their rights under the law. Such a device may not be suitable in New Zealand with its strong secured creditors culture (NZLC SP11 at [186]).

<sup>210</sup> Administration procedures were introduced in Part II of the UK Insolvency Act 1986. However, the procedures were substituted for a new Part II consisting of section 8 by Enterprise Act 2002 clause 40 part 10 and section 248(1).

the current statutes were not efficient enough to allow companies to detect problems at the earliest possible stage and to avoid their collapse. In addition, financial and private sectors also contributed to corporate failures and hence the law and government's policies need to be reformed in order for the businesses to remain competitive in the global market.

In response to the crisis, the government made some amendments to the provisions of the Companies Act 1965. The purpose of these amendments was to ensure transparency in the transactions and to overcome weaknesses identified in corporate governance. One of the shortcomings of the current company legislation is the lack of rescue mechanisms for companies in financial difficulties. The only such mechanism is available under section 176 of the Act which stipulates the power to compromise with creditors and members. Companies in financial difficulties had resorted to section 176 to avoid liquidation due to the dearth of any other alternatives.<sup>211</sup>

To remedy these weaknesses, the provision in section 176 was amended with the objectives to:

- a) Ensure transparency in obtaining protection orders;
- b) Ensure creditors are protected by having strict time periods for applications to extend protection orders;
- c) Prevent disposition of assets; and
- d) Enable creditors to decide the viability of the proposals by requiring the company to make full disclosure at an early stage.<sup>212</sup>

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<sup>211</sup> CLRC above n58 at 12. Although heavily relied on during the financial crisis, the mechanism in section 176 has several weaknesses;

- a) The provision did not specify the timeframe for companies to make with proposals. The companies have thus used this as an opportunity to delay obligations towards creditors rather than making any proposals in a genuine attempt to compromise;
- b) The management which was responsible for the company's financial difficulties was allowed to take charge and manage the company which might result in disposition of its assets to the detriment of creditors; and
- c) The provision did not specify the period of protection accorded to the company.

<sup>212</sup> Ibid.

The government also introduced various measures to soften the impact of the crisis. Amongst the measures taken was the establishment of the Pengurusan Danaharta Nasional Bhd (Danaharta), a wholly government-owned assets management company for the purpose of acquiring non-performing loans from financial institutions. In order to achieve its objectives, the Pengurusan Danaharta Nasional Berhad Act 1998 (the Danaharta Act 1998) was passed outlining the framework and existence of Danaharta, together with special powers of acquisition and disposal of assets.

In 2003, the Companies Commission of Malaysia established the Corporate Law Reform Committee (CLRC) with the purpose of reviewing the current corporate law in order to ensure that the law conforms to the international standard of corporate governance. The CLRC undertook the task of reviewing the current Companies Act 1965 in 2004. Among the areas reviewed were directors' duties, corporate insolvency and capital maintenance rule and share capital.

A consultative document was published in 2006 on reforming directors' roles and duties. The consultative document took the view that in considering directors' roles and duties, the interests of other stakeholders should be taken into consideration.<sup>213</sup> The CLRC did not directly propose that directors should directly consider the interests of creditors in insolvent situations and considered the relationship between a company and its creditors is sufficiently dealt by the existing law.<sup>214</sup> The committee also recognized the need to introduce the business judgment rule in the company legislation, a suggestion which has been adopted in the latest amendment to the Companies Act in 2007.<sup>215</sup> The view sanctioned by the committee on the need to

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<sup>213</sup> Malaysia Corporate Law Reform Committee "A Consultative Document on Clarifying and Reformulating the Directors' Role Duties, (2006) at [4.4]. [CLRC Clarifying and Reformulating the Directors' Role Duties]."

<sup>214</sup> Ibid, at [4.5-4.9].

<sup>215</sup> See section 132 of the Malaysian Companies Act 1965 (Companies (Amendment) Act 2007 Act A1299 in force from 15.8.2007.

insist on protection to directors in discharging their duties by including the business judgment rule is to protect honest directors and also to dissuade them from leaving the company so that they will continue to use their skills to manage the company.<sup>216</sup>

This is consistent with one of the objectives of company legislation which is to facilitate commerce. The committee did not address specifically the issue of directors' duties in insolvent situations; instead, the emphasis was on the need to incorporate director's common law duties for proper purpose and in good faith in the interests of the company into the Act. The priority of the committee, it seems, is not the person who is responsible for the company's dire financial state, but on how to salvage the company. Hence, in the area of corporate insolvency reform, the committee emphasized the need to have rehabilitation measures in addition to the provisions in section 176. As such, directors' liability in insolvent situations continued to be governed by section 303(3) and section 304, which are based on the English 1948 Act.

The influences of English law in Malaysian courts remain steadfast, although the decisions by English courts are only persuasive and not binding. In addition, English commercial law will be applicable in Malaysia, provided there is a lacuna in the law and so long as the law is appropriate to the local circumstances. Section 5(1) of the Civil Law Act 1956 stipulates that the law in England as at 7 April 1956 is applicable in all States in Malaysia except for Penang and Malacca. In Sabah, Sarawak, Penang and Malacca, section 5(2) of the Civil Law Act 1956 allows continuing reliance on the current English law. Although section 5(2) allows for the continuing reception of English commercial law in the four states, in practice, judges seldom refer to the provision in section 5 when making decisions and do not make distinctions as to where the cases took place.

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<sup>216</sup>CLRC Clarifying and Reformulating the Directors' Role Duties above n213 at [3.18].

## 4.4 Development of Directors' Duties in an Insolvency Situation

### 4.4.1 Introduction

The doctrine of limited liability allows the shareholders to limit their liability to the amount of unpaid shares. This doctrine was introduced by the Limited Liability Act 1855, and at the time, opinion was divided as to the expediency of allowing this privilege to companies. One of the implications of limited liability is that shareholders are no longer subjected to situations where creditors could claim their personal wealth to satisfy the company's debts. They are also in the position to know the extent of their liability and this will encourage members of the public to invest in the company.

Nevertheless, limited liability also provides opportunity to unscrupulous directors to take advantage of the situation by exposing the company to risks of failure because they will not be personally liable for such failure. A company's failure may have adverse effects on many parties such as the company, shareholders, creditors, employees and members of the public. The law has always been sympathetic and lenient towards directors by imposing a low standard of prudence, care and skills.<sup>217</sup>

Various Law Commissions Reports concluded that the inadequacy of the law on directors' liability in incurring debts of the company was either because no specific section was available or if there was, it was difficult to enforce.<sup>218</sup> Hence, recommendations were made to introduce new direct provisions or to amend the law in order to improve any existing shortcomings. In doing so, care must be taken to ensure the law must not impose too many restrictions on directors to use their skills

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<sup>217</sup> *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407. Per Romer J at 428 "A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience."

<sup>218</sup> Cork Report n 74 above at [1776]; ALRC R45 above n95 at [278-279].

and judgment to run the company.<sup>219</sup> It is essential that the law recognise the running of businesses involves risks and allows directors freedom to decide as they deem fit.<sup>220</sup> Therefore, the law should only intervene in circumstances where directors' decisions entail immense risks and result in companies' failures.<sup>221</sup>

#### **4.4.2 Directors' Duties and Insolvent Companies**

Since the introduction of the first insolvency legislation, there were concerns over abuses or fraud administered to the company and whether one of the causes of the company's failure could be traced to it. Hence, the early legislation was designed not only to provide for winding up of the insolvent companies but also to address the issue of fraud. This has since been repealed and amended by inserting new provisions relating to fraud as and when new frauds emerged which injured the company, shareholders and members of the public.<sup>222</sup> Frauds against the company were often committed by those who were involved in the management of the company such as directors, thus it is important for the law to be able to address this situation.

In imposing duties on directors, there must be a balance between the rights of the directors to manage the company and the rights of other parties involved in the company such as the shareholders, creditors and members of the public. The common law, therefore, imposes fiduciary duties on directors to act bona fide in the interest of the company. This is to ensure that directors adhere to the minimum standard of behaviour, failure to do so will subject them to penalties. The test used by the court to measure whether the director has adhered to the minimum standard is a subjective test, in which case the director generally will be able to get away as long

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<sup>219</sup> Cork Report n 74 above at [1805].

<sup>220</sup> NZLC R9 above n49 at [516].

<sup>221</sup> Ibid.

<sup>222</sup> Holdsworth *A History* above n147 at 60.

as he can show that he honestly believes that his act is for the benefit of the company.<sup>223</sup>

The provision on fraudulent trading was first introduced in the Companies Act 1929 (UK) as a result of the Greene Committee's finding on the likelihood that the floating charge holder, who was in control of the company which was on the verge of liquidation, would realise his security ahead of other creditors.<sup>224</sup> The fraudulent trading provision was one of the devices aimed at fraudulent and dishonest directors and promoters.<sup>225</sup> The provision imposed both civil and criminal liability on the persons who were carrying on the company's business with intent to defraud creditors.<sup>226</sup> The difficulty with this provision in terms of implementation was that the liquidator has a high standard of burden of proof and this provision was limited to only situations where the company was in liquidation.

Australia inherited the same problem because it adopted the same provision. The fraudulent trading provision was first enacted in Queensland and later followed by other states.<sup>227</sup> Although Australia later developed its own legislation which had separate provisions on criminal offences and civil liability in respect of directors incurring debts in insolvent companies, the basis of the provisions remained similar to the UK. The Act stipulated that enforcing civil liability against the director would depend on his conviction for the related criminal offence.<sup>228</sup> The problem with this requirement was the high standard of proof in criminal offences and this could be difficult to discharge.<sup>229</sup> Consequently, the civil liability provision was seldom used

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<sup>223</sup> *Re Smith & Fawcett Ltd* [1942] 1 All ER 542, *Re W. & M. Roith Ltd* [1967] 1 W.L.R 432.

<sup>224</sup> Cork Report n 74 above at [92].

<sup>225</sup> Holdsworth *A History* above n147 at 60.

<sup>226</sup> *Ibid* at [1758].

<sup>227</sup> ALRC R45 above n95 at [278].

<sup>228</sup> *Ibid*, at [279]

<sup>229</sup> *Ibid*.

due to the difficulty in obtaining a conviction. Even when a conviction could be secured, there was the possibility that the court would still insist on the criminal standard.<sup>230</sup> As in the UK, most potential cases were not brought to court due to the difficulties of discharging the burden of proof.<sup>231</sup> The criminal penalty was seen as an unsuitable remedy, either to the particular creditor or creditors in general because of their inability to recover compensation from the convicted directors.<sup>232</sup>

In New Zealand, there was no specific section to deal with directors' liabilities in incurring debts of a company in the earlier legislation. For example, the section in the Companies Act 1908 focussed on the court's power to order delinquent directors or officers to repay any money or restore any property they had misappropriated or had become liable.<sup>233</sup> However, in order for the court to make such an order, there must be a prior conviction of the offences under the Act. Such requirement would be a hurdle to recover money from the director and consequently the director may escape liability.

Despite the difficulty, the provision remained in the UK Companies Act 1948 and the Act also imposed personal liability on any persons who committed an act deemed to be a misfeasance. These provisions allowed the liquidator to recover compensation from the director on behalf of the company or creditors who had suffered losses as a result of the director's misconduct.<sup>234</sup> However, if the court was satisfied that the director has acted honestly and reasonably under all circumstances of the case, the court had the power to excuse the director from such liability.<sup>235</sup> The

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<sup>230</sup> Ibid.

<sup>231</sup> Ibid.

<sup>232</sup> Ibid.

<sup>233</sup> Section 254 of the Companies Act 1908.

<sup>234</sup> Cork Report n 74 above at [1753].

<sup>235</sup> Ibid.

section on fraudulent trading<sup>236</sup> in the Companies Act 1948 contained both civil and criminal elements and,, as previously, the court had always focused on the criminal aspect of the provision and insisted that the liquidator discharge a high burden of proof.<sup>237</sup> This could have resulted in deterring the liquidator from bringing many potential cases to court and the delinquent directors being able to escape liability.<sup>238</sup>

When the Cork Committee was appointed, provisions on creditors' protection had been identified as one of the areas which needed reform.<sup>239</sup> In making recommendations, the committee emphasised that the new law must strike a balance between the rights of an honest prudent businessman and the rights of creditors to recover their money.<sup>240</sup>

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<sup>236</sup> Malaysia also inherited the same defects in section 304(1) of the Malaysian Companies Act 1965, the usage of the words 'intent to default creditors of the company or creditors of any other person or for any fraudulent purpose," resulting in the court using beyond reasonable doubt as the standard of proof. The standard of proof for fraud in civil cases in Malaysia is beyond reasonable doubt - *Saminathan v Pappa* [1981] 1 MLJ 121, *Eastern & Oriental Hotel (1951) Sdn Bhd v Ellarious George Fernandez* [1989] 1 MLJ 35, *Lee Wai Fay v Lee Seng Ein* [2005] 4 MLJ 701.

<sup>237</sup> *Re Patrick Lyon* [1933] Ch 786 at 790-791 to establish intent it has to be shown "actual dishonesty involving according to current notions of fair trading among commercial men, real moral blame."

<sup>238</sup> Cork Report n 74 above at [1776].

<sup>239</sup> *Ibid* at [241]; The complaints received by the Committee in respect of the inadequacy of creditor's protection in the law included:

- a) the unsatisfactory positions regarding parent's company liability for the debt of an insolvent subsidiary;
- b) the law of fraudulent preference which imposes a high burden on the liquidator;
- c) the inadequacy of the fraudulent trading provisions to constraint dishonest and delinquent directors; and
- d) the inadequacy of the law prohibiting directors of failed companies from becoming directors of another company too soon after their failures in previous companies.

<sup>240</sup> The committee proposed that there should be two separate provisions on director's liability and suggested that the criminal aspect should be retained in the fraudulent trading provision, and a new civil provision on trading in an insolvent company known as wrongful trading should be introduced. However, the recommendation that fraudulent trading should not contain a civil element was not adopted. The provision on fraudulent trading retained both the civil and criminal element though they are now dealt with in two separate sections, namely section 213 of the UK Insolvency Act 1986 which deals with civil liability, while section 458 of the UK Companies Act 1985 covers criminal liability. A new wrongful trading provision which is also a civil liability is governed under section 214 of the UK Insolvency Act 1986.

The Australian Law Commission in 1988 also felt reforms in the area were necessary because before then directors did not owe any direct duty to the company.<sup>241</sup> Prior to 1988, the law did not impose any duty on directors not to incur further liability when the company was insolvent. Instead, any directors' liabilities were based on the notion of joint responsibility on the part of the directors when a particular debt was incurred.<sup>242</sup>

The Commission proposed that a new provision be included in the legislation to make directors directly liable to the company if they failed to prevent the company from engaging in insolvent trading.<sup>243</sup> The commission specifically rejected attaching a criminal liability to insolvent trading provisions. The commission stressed that the purpose of insolvent trading provisions is for creditors to recover their money and not to punish the directors.<sup>244</sup> Recommendations on insolvent trading were incorporated in the Corporate Law Reform Act 1992 and, to date, the provision remains in sections 588G of the Corporations Act 2001. Nevertheless, the criminal liability is now provided for in section 588G(3) of the Act and it requires an element of dishonesty to be proven.

The New Zealand Companies Act 1955 had specific sections on directors' responsibility for debt and the condition of previous conviction was conspicuously absent from the Act. The Companies (Amendment) Act 1980 introduced two new provisions relating to directors' liability for incurring debt into the Companies Act 1955. In addition to the existing fraudulent trading<sup>245</sup> provision, the amendment provided that the director would be responsible if he unreasonably caused the

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<sup>241</sup> ALRC R45 above n95 at [280].

<sup>242</sup> Ibid.

<sup>243</sup> ALRC R45 above n95 at [285].

<sup>244</sup> Ibid, at [323].

<sup>245</sup> Section 320(1) (c ) of the New Zealand Companies Act 1955.

company to incur debt<sup>246</sup> and when he caused the company to carry on its business in a reckless manner.<sup>247</sup> The court applied the civil standard in cases under section 320.<sup>248</sup>

The realisation that company law urgently needed reform was triggered by the share market crash in 1987.<sup>249</sup> The commission suggested that the reckless trading provision in section 320(1)(b) be reformed because the provision hindered the company's ability to venture into risky business.<sup>250</sup> Business often involved an element of risk and investing in risky undertakings does not necessarily mean that the director is trading in a reckless manner. A high risk investment normally generates a high return if successful and the company may benefit from this endeavour. The commission acknowledged that companies should be allowed, to a certain extent, to undertake risky investments as long as the company is not exposed to unreasonable risk of insolvency.<sup>251</sup>

The Law Commission proposed that section 320 of the Companies Act 1955 be amended to reflect the view that high risk-taking can be reasonable and therefore should be allowed as long as it does not expose the company to the risk of insolvency.<sup>252</sup> The proposal, however, was not taken up by the legislature who

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<sup>246</sup> Section 320(1) (a) of the New Zealand Companies Act 1955.

<sup>247</sup> Section 320(1) (b) of the New Zealand Companies Act 1955.

<sup>248</sup> *Re Wait Investments Ltd (In Liquidation)* [1997] 3 NZLR 96 (HC) at 103; *Vinyl Processors (New Zealand) Ltd v Cant* [1991] 2 NZLR 416 (HC) at 420; *Re Petherick Exclusive Fashion Ltd (In liq)* (1986) 3 NZCLC 99,946 (HC); *Thompson v Innes* (1985) 2 NZCLC 99,463 (HC).

<sup>249</sup> NZLC R9 above n49 at [43].

<sup>250</sup> *Ibid*, at [516].

<sup>251</sup> *Ibid*.

<sup>252</sup> Section 105(1) of the New Zealand Law Commission Draft Companies Act proposed by the commission reads "A director of a company must not agree to the company entering into a contract or arrangement or acting in any other manner unless he or she believes at that time on reasonable grounds that the act concerned does not involve an unreasonable risk of causing the company to fail to satisfy the solvency test"- NZLC R9 above n49 at [516].

instead, enacted section 135<sup>253</sup> in the Companies Act 1993. Section 135 prevents directors from agreeing, causing or allowing a company to carry on business which is likely to create substantial risks of serious loss. The said section applies equally to both solvent and insolvent companies and the effect of such is a high probability that the shareholders or creditors will use the section to restrain the company from engaging in risky investments in the first place.<sup>254</sup>

Another provision proposed by the commission was adopted in section 136 of the Companies Act 1993. These two sections have been incorporated into the director's duties provision and not into the insolvency provisions as suggested. Fraudulent trading remains in the 1993 Act under the offences and penalties provisions.<sup>255</sup>

#### **4.4.3 Directors and Disqualification**

In addition to imposing personal liability on directors to contribute to compensating the loss incurred by creditors in insolvency, there is also a great concern over the inability of the law to curb directors who have been found responsible for the company's insolvency from being directors in another company.<sup>256</sup> The concept of disqualifying directors was first established in the Companies Act 1929 and the disqualification was made on the basis of the director's status as a bankrupt. The provision that a bankrupt person is disqualified from becoming a director was

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<sup>253</sup> Section 135 of the New Zealand Companies Act 1993 provides: " A director of a company must not-

- a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors: or
- b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

<sup>254</sup> See discussion by Justice Sian Elias, 'Company Law After Ten Years of Reform' in *The Company Law Conference of the New Zealand Law Society* (1997) at [9-10.1].

<sup>255</sup> Section 380 of the Companies Act 1993.

<sup>256</sup> Cork Report n 74 above at[1813].

adopted in New Zealand, Australia and Malaysia and remains until today.<sup>257</sup> Subsequent Acts expanded lists of circumstances of disqualification to include directors who had committed fraud, breach of duties, having a conviction of offences in relation to formation, promotion or management of companies. In addition, directors were also disqualified if they persistently failed to furnish company's financial documents and if proven to have been acting improperly, recklessly or incompetently in discharging duties.

Attempts to disqualify directors on the basis of unfitness to manage a company was firstly made in the UK Insolvency Act 1976<sup>258</sup> and later re-enacted in the Companies Act 1985.<sup>259</sup> With the introduction of the Insolvency Act 1986, provisions on disqualification of directors in the Companies Act 1985 and the Insolvency Act 1985 were repealed and enacted in separate legislation, the Company Directors Disqualification Act 1986.<sup>260</sup> At the time of the passing of the Company Directors Disqualification Act in 1986, the then Labour government had been promoting a free market ideology and the passing of an Act which imposed commercial morality did not reflect such beliefs.<sup>261</sup> However, the passing of the Act was seen as the response to complaints by the public that companies have sometimes been used as instruments of fraud by directors and as being consistent with responsibility and accountability principles.<sup>262</sup> It should be noted that the Cork committee emphasised that the aim of disqualifying directors was not to punish but to protect members of the public from dishonest directors.

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<sup>257</sup> Section 151(2)(b) of the New Zealand Companies Act 1993, section 206B(3) of the Australian Corporations Act 2001, section 125(1) of the Malaysian Companies Act 1965. In the UK, the provision is in section 11 Company Directors Disqualification Act 1986.

<sup>258</sup> Section 9 of the UK Insolvency Act 1976.

<sup>259</sup> Section 300 of the UK Companies Act 1985.

<sup>260</sup> Goode above n79 at [1-06]. The UK CDDA was further amended by the Insolvency Act 2000 and the Enterprise Act 2002.

<sup>261</sup> Sally Wheeler, Disqualification of Directors: A Broader View in Harry Rajak (ed) *Insolvency Law Theory & Practice* (Sweet & Maxwell, London, 1993) 187 at 189.

<sup>262</sup> *Ibid.*

## 4.5 Conclusion

Malaysia, New Zealand and Australia adopted English law as the basis of their company/insolvency legislation. Initially, New Zealand and Australia inherited the English law model due to necessity of trade, while Malaysia inherited it due to the British administrative structures. Later, the law in each jurisdiction began to diverge, searching for its own identity to reflect the needs and conditions of its society.

However, in the light of the introduction of the UNCITRAL Model Law on Cross-Border Insolvency Law, a new trend of converging insolvency law to conform to the said international insolvency has emerged. The model law attempts to assist States to furnish their insolvency law with a modern, harmonized and fair framework to address issues of cross-border insolvency.<sup>263</sup> It does not aim at a unification of substantive insolvency but offers solutions for enforcing judgment in cases where insolvent debtors have assets in more than one state or where creditors are not from the state where the proceeding is taking place. Economic downturns and financial crises often act as catalysts to legislative reforms in the area of company/insolvency law. This can be seen from the Asian financial crisis which prompted many Asian countries, as well as others like New Zealand, to review their legislation.

The crisis illustrated the importance of having regulatory and rehabilitation frameworks in legislation. Having good corporate governance provisions is also crucial in order to detect problems at an early stage. As such, the laissez faire principle which was introduced at the beginning of company legislation was later replaced by regulatory frameworks due to mismanagement or fraud.

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<sup>263</sup>United Nation Commission on International Trade Law, *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment* (1997) <[http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html)>at 20 September 2010.

Since mismanagement and fraud have been identified as the main cause of a company's failure, there is the need to tighten controls on directors and those involved in the management of the company. This trend co-exists with the modern tendency towards business rehabilitation.

## CHAPTER 5: THE THEORY OF THE CORPORATION AND CORPORATE GROUPS

### 5.1 Introduction

The decision in *Salomon v Salomon & Co*<sup>1</sup> Ltd has been described as calamitous as it changed the intended purpose of corporate personality.<sup>2</sup> The principle in the decision has been seen by many writers as problematic because it has been used by companies to avoid liability at the expense of creditors, particularly in a group of companies' situation. This chapter, therefore, will focus on the relationship between the principles and creditors' protection. In order to do so, the area of director's duty will be looked into to determine whether there is a duty owed to creditors, and if so, in what circumstances. The legal response both at common law and statute will also be addressed in the chapter.

### 5.2 Corporate Personality

The status of corporate personality was initially conferred by the Royal Charter or by Act of Parliament.<sup>3</sup> Later, such status was obtained once the company complied with the statutory requirements specified in the (UK) Companies Act 1844.<sup>4</sup> Corporate personality is a concept whereby a corporation is conferred with characteristics akin to a human being, hence it is also known as an artificial legal person. The notion of

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<sup>1</sup> [1897] A.C. 22.

<sup>2</sup> See O. Kahn-Freud "Some Reflections on Company Law Reform" (1944) 7 MLR 54. The writer described the decision in *Salomon v Salomon Co Ltd* as a calamitous one which changed the intended purpose of corporate personality from being to enable capitalists to embark on risky adventure without shouldering personal liability to allowing a sole trader taking advantage to set up limited company even though no risk and outside capital were involved.

<sup>3</sup> John Farrar and Brenda Hannigan *Farrar's Company Law* (Butterworths, London, 1998) at 16; Clive Schmitthoff *Palmer's Company Law*, (Stevens, London, 1987) Vol 1 at 7

<sup>4</sup> Schmitthoff above n3 at 8-9; L.C.B Gower *Gower's Principles of Modern Company Law* (5<sup>th</sup> ed., Sweet & Maxwell, 1992) at 39.

treating a corporation as having similar traits to human being is not without difficulties, especially in connection with criminal liability and other areas of law where intention is relevant.<sup>5</sup>

Dewey argued that the conception of 'person' is a legal conception; roughly, the term 'person' signifies what the law makes it signify.<sup>6</sup> In technical legal terms, person could be interpreted as a group of legal relations and not a human being, which is the common definition normally found in ordinary literature and common speech.<sup>7</sup> Blumberg, on the other hand, argued that such a conclusion did not address all the problems associated with corporate personality since legal theories are animate concepts and are kept alive by judges in their judgments.<sup>8</sup> He also reasoned that culture has an impact on the use of language,<sup>9</sup> hence the word 'person' in reference to a corporation may have started off as an analogy, but later it led to a connotation of the characteristics of a person.<sup>10</sup>

It has to be acknowledged that a corporation, despite having a status similar to a human being, does not have capabilities similar to a human being.<sup>11</sup> A corporation

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<sup>5</sup> Michael J. Whincop *An Economic and Jurisprudential Genealogy of Corporate Law* (Ashgate Dartmouth, 2001) at 49. See also the judgment of Buckley L.J. in *Continental Tyre and Rubber Co (G.B.) Ltd v Daimler Co* [1915] 1 K.B. 893 at 916 The artificial legal person called the corporation has no physical existence. It exists only in contemplation of law. It has neither body, parts, nor passions. It cannot wear weapons nor serve in wars. It can neither be loyal nor disloyal. It cannot compass treason. It can be neither friend nor enemy. Apart from its corporators it can have neither thoughts, wishes nor intentions, for it has no mind other than minds of the corporators.

<sup>6</sup> John Dewey "The Historical Background of Corporate Legal Personality" (1926) 35 Yale LJ 655 at 655.

<sup>7</sup> Max Radin "The Endless Problem of Corporate Personality" (1932) Columbia LR 643 at 647.

<sup>8</sup> Phillip Blumberg "The Corporate Entity in an era of Multi-National Corporation" (1990) 15 Delaware JCL 283 at 324 [Corporate Entity].

<sup>9</sup> See article by Sanford A. Schane "The Corporation is a Person: The Language of a Legal Fiction" [1987] 61 Tulane LR 563.

<sup>10</sup> Blumberg "Corporate Entity" above n8 at 324.

<sup>11</sup> John Farrar "Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance" (1998) 10 Bond LR 142 at 149-150 [Frankenstein].

needs someone to run it on its behalf and has powers to act only in circumstances allowed by the law. The law has recognised the organ of the company, i.e. the board of directors and members in general meeting, as the company itself when they acted within the parameter of the powers conferred by the Memorandum of Association.<sup>12</sup> This is because they are regarded as being the "directing mind and will" of the company.<sup>13</sup> The company also can act indirectly through its agents who have been conferred authority to act.<sup>14</sup> The agents who act within the scope of their actual or apparent authority will bind the company.<sup>15</sup> In making a decision, the court must consider both the economic reality of the organisation, and the legal recognition of a corporation as an artificial human being.<sup>16</sup>

Corporate personality was originally created for convenience purposes such as to allow succession, holding of property and to appear in court.<sup>17</sup> Later, the principle progressed into the idea of protecting shareholders by limiting their liability in respect of the company's debts.<sup>18</sup> This was done through the introduction of the Limited Liability Act in 1855.<sup>19</sup> Prior to 1855, members of a corporation continued to be personally liable for a company's debts.<sup>20</sup> The legislation imposed on members

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<sup>12</sup> Gower above n4 at 139.

<sup>13</sup> The phrase 'directing mind and will' of the company is coined by Viscount Haldane LC in *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705; see also Denning LJ in *H L Bolton (Engineering) Co Ltd v T J Graham & Sons Ltd* [1957] 1 QB 159.

<sup>14</sup> Farrar 'Frankenstein' above 11 at 149; Gower above n4 at 165.

<sup>15</sup> *Ibid.*

<sup>16</sup> Nicholas James "Separate Legal Personality; Legal Reality and Metaphor" [1993] 5 Bond LR 217 at 218.

<sup>17</sup> David Parker "Piercing the veil of incorporation: company law for a modern era" [2006] 19AJCL 35 at 38-39.

<sup>18</sup> Schmitthoff above n3 at 9.

<sup>19</sup> *Ibid.*

<sup>20</sup> Gower above n4 at 39.

a liability only to the extent of the unpaid amount of their value of shares in the company. When limited liability was first introduced, there had been sustained resistance<sup>21</sup> but it has survived till today. It continues to exist because of the need to encourage contributions of capital from the public in order to finance extensive investments, while at the same time not exposing their entire personal wealth.<sup>22</sup>

### 5.2.1 Separate Legal Entities

In 1897, the House of Lords pronounced a decision which later became the foundation of modern company law, and the implication of such decision is still a major debate among legal scholars.<sup>23</sup> The impact of limited liability was not fully realised until the decision in *Salomon v Salomon & Co Ltd*,<sup>24</sup> where the court recognised a one-man company.<sup>25</sup> Lord Macnaghten, in a famous judgment held:

The company is at law a different person altogether from subscribers...; and though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers, as members, liable in any shape or form, except to the extent and manner provided in the Act.<sup>26</sup>

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<sup>21</sup> Adam Smith in his book *The Wealth of Nations* (733-758) wrote that principle would allow a third party to manage public's money and who would then use it negligently and profusely-W.R Cornish and G.de.N Clark *Law and Society in England 1750-1950* (Sweet & Maxwell, London, 1989) at 247.

<sup>22</sup> Ibid; see also Otto Kahn-Freund "Some Reflections on Company Law Reform" (1944) 7 MLR 54 at 54.

<sup>23</sup> Kahn-Freud above n2. The writer described the decision in *Salomon v Salomon Co Ltd* as a calamitous one which changed the intended purpose of corporate personality from being to enable capitalists to embark on risky adventure without shouldering personal liability to allowing a sole trader taking advantage to set up limited company even though no risk and outside capital were involved.

<sup>24</sup> [1897] A.C. 22.

<sup>25</sup> Gower above n4 at 85.

<sup>26</sup> [1897] A.C. 22 at 51.

The implication of the decision is that the shareholders and the company are two distinct entities. Any act done is the company's act and not the shareholders. This doctrine is also known as the separate legal entity or veil of incorporation. It is worthwhile to note that 'limited liability' and 'separate legal entity' are two different concepts and can exist independently of one another.

As mentioned earlier, limited liability is a concept where a shareholder is only liable to contribute up to the amount unpaid on their shares in the event that the company becomes insolvent. On the other hand, separate legal entity refers to the company as another entity; separate from its shareholders. As such, the principle allows directors, managers and those involved in the management of the company to be insulated from liability since the company will be the one responsible for the liability.

Cases have illustrated that judges are reluctant to depart from this principle since it was first enunciated in Salomon's case. The courts have safeguarded this principle for a long time<sup>27</sup> and only in certain circumstances would the courts depart from it. It provides an opportunity for those managing the company to swindle or exploit the company's assets since it would enable those in control of the company to hide behind the veil of incorporation. Directors are tempted to use the company's assets in an attempt to maximise shareholders' profits.<sup>28</sup>

When the company is financially sound, the directors' actions may not have any significant bearing on creditors because they would still be repaid. However, when the company's finances are in jeopardy, directors will be trading with creditors' money and that has caused concerns for creditors.<sup>29</sup> In this circumstance, directors

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<sup>27</sup> See *Lee v Lee's Air Farming Ltd* [1961] 1 AC 12; *Macaura v Northern Assurance Co Ltd* [1925] AC 619.

<sup>28</sup> Traditionally courts have interpreted directors to owe duty to shareholders. See *Re Smith and Fawcett Ltd* [1942] 1 All ER 542; *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286.

<sup>29</sup> Ian M Ramsay "Holding Company Liability for the Debts of an Insolvent Company: A Law and Economic Perspective" (1994) 17 UNSWLJ 520 at 522.

will be tempted to stake company's funds in precarious undertakings which may generate high returns in order to bring the company back to profitability.<sup>30</sup> If the gamble pays off, shareholders will gain the most in dividends but if it fails, creditors may be left without compensation.<sup>31</sup> Directors and shareholders will not be liable to creditors in respect of debts owed to the company because of the refuge conferred by the separate legal entity and the limited liability respectively.

The principle is applied throughout common law jurisdictions including Australia, New Zealand and Malaysia. The courts' decisions in these jurisdictions mirror the English court's propensity in strictly applying the principle. In Malaysia, the principle is binding by virtue of section 5 of the Civil Law Act 1956; hence it is woven into the fabric of Malaysian Company Law which courts have continued to uphold until today.<sup>32</sup> Judges have a penchant for referring to various English decisions and applying them into their own decisions. Hence, any developments in the area in the UK, Australia and New Zealand to a certain extent have an impact on Malaysian law. Decisions from these jurisdictions often find their way into Malaysian courts, and mostly without any modification, as if these decisions are still binding on Malaysian courts.

In doing so, judges have not taken into consideration the proviso that the law should be compatible with local conditions and applied only in the absence of local law.<sup>33</sup> It has been indoctrinated into judges that English law is applicable to Malaysian cases which is why, despite its persuasive status, courts have the tendency to refer to

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<sup>30</sup> Ibid.

<sup>31</sup> Ibid, at 523.

<sup>32</sup> In *Goh Hooi Yin v Lim Teong Ghee & Ors* [1977] 2 MLJ 26 at 29 where Arulnandom J held “ the principle on which our limited liability companies are incorporated are identical and derive from English law and it is incumbent on our courts to abide by the doctrines laid down by English courts unless there are compelling reasons not to”; see also *Abdul Aziz bin Atan v Ladang Rengo Malay Estate Sdn Bhd* [1985] 1 CLJ 255; *Lim Kar Bee v Duofortis Properties(M) Sdn Bhd* [1992] 3 CLJ 1667; *Hong Kong Vegetable Oil Co Ltd v Malin Srinaga Wicker* [1978] 2 MLJ 13.

<sup>33</sup> See *Goh Hooi Yin v Lim Teong Ghee & Ors* [1977] 2 MLJ 26 at 29 This is evident from judgment where judges did not mention anything on it although there is lacuna in the law.

English decisions as guidance and to a certain extent to treat them as if they are still binding.

### **5.2.2 Differences between Limited Liability and Separate Legal Entity**

It is worthwhile to note that ‘limited liability’ and ‘separate legal entity’ are two different concepts and can exist independently of one another. As mentioned earlier, limited liability is a concept where a shareholder is only liable to contribute up to the amount of unpaid shares in the event that the company becomes insolvent. On the other hand, separate legal entity refers to the company as another entity; separate from its shareholders. As such, the principle allows directors, managers and those involved in the management of the company to be insulated from liability since the company will be the one responsible for the liability.

It was often thought that incorporation entails separate legal entity, though historically there was no mention of this notion until the decision in *Salomon v Salomon & Co Ltd*.<sup>34</sup> Initially, incorporation of a company only created a corporate personality and the company was still identified with its members, which was clear from the wording of the sections and decided cases.<sup>35</sup> Over time, through legal evolution, both separate legal entity and limited liability are now known to be the legal consequences of incorporation.<sup>36</sup> The said principle was the cause of the changing economic and legal nature of the joint stock company share.<sup>37</sup>

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<sup>34</sup> [1897] A.C. 22.

<sup>35</sup> Paddy Ireland, Ian Grigg-Spall and Dave Kelly “The Conceptual Foundations of Modern Company Law” (1987) 14 *JL& Soc’y* 149 at 150-151.

<sup>36</sup> See for example section 16(5) of the Malaysian Companies Act 1965.

<sup>37</sup> Ireland, Grigg-Spall and Kelly above n35 at 150-151.

Shareholders seldom become actively involved in the management of the company, leaving it in the hands of the managers and directors of the company.<sup>38</sup> The existence of limited liability makes it possible for shareholders to diversify their investments and risks.<sup>39</sup> Varying their investments and acting passively becomes a rational strategy for shareholders, because they will benefit should the company succeed and if the company fails, their personal wealth will be protected.<sup>40</sup> This action has the potential of minimising the operating costs or transaction costs.<sup>41</sup> However, the argument of separation of ownership and control may not be available to all types of companies and is more prevalent in large public corporations.

In private companies, particularly in family-run companies, there is rarely any distinction between ownership and management. In this type of company, the shareholders are also the directors of the company and, in certain cases, the majority shareholder is the sole director. The Salomon case is an example of this, in which Mr. Salomon had total control of the management of the company. Shareholders in this family business or other small private companies, thus, could not diversify their investment and it is likely that they had put all their risks in one basket.

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<sup>38</sup> See Adolf A Berle and Gardiner C Means *The Modern Corporation and Private Property* (The Macmillan Company, New York, 1932); Adolf A Berle and Gardiner C Means *The Modern Corporation and Private Property* (Revised ed, Harcourt, Brace & World, New York, 1968) at 312-313; Ross Grantham and Charles Rickett *Company and Securities Law Commentary and Law* (Brookers Ltd, Wellington, 2002) at 54-55; Brian Cheffins *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997) 31-41; John Parkinson *Corporate Power and Responsibility* (Clarendon Press, Oxford, 1993) at 54-56 and at 97-132.

<sup>39</sup> Paul Halpern Michael Trebilcock and Stuart Turnbull “ An Economic Analysis of Limited Liability in Corporation Law” (1980) 30 *Uni. Toronto L.J* 117 at 139-142; Frank H Easterbrook and Daniel R. Fischel “The Corporate Contract” (1989) 89 *Columbia LR* 1416 at 1426-1434; Frank H Easterbrook and Daniel R. Fischel “Limited Liability and the Corporation” (1985) 52 *Uni. Chi L.Rev* 89 at 103-109 [“Limited Liability”]; Ian M Ramsay above n29 at 535-537; Eugene F Fama “ Agency Problems and the Theory of the Firm” (1980) 88 *J. Polit. Economy* 288 at 290-292.

<sup>40</sup> *Ibid*; Edwin M Dodd :“For Whom are Corporate Managers Trustees?” (1932) 45 *Harv LR* 1145 at 1153.

<sup>41</sup> *Ibid*.

Shareholders who have to incur high agency costs will most probably respond by selling off their shares.<sup>42</sup> The price at which shareholders can sell will reflect the value of the firm and there is a possibility for other investors to obtain shares in an inefficient company at a discount.<sup>43</sup> The accessibility of one market price in the share market facilitates free share transfer and management is compelled to act efficiently or face the possibility of being replaced.<sup>44</sup> It permits large block transfer and if the shareholder is dissatisfied with the management's performance, he could vote for replacement.<sup>45</sup> This also reduces the prospect of shirking on the part of directors and managers.<sup>46</sup>

### **5.2.3 Lifting of Corporate Veil in Relation to Creditors' Protection**

Economists have argued that limited liability and separate legal entity boost efficiency in company management, but courts do concede that the principles sometimes have adverse consequences on creditors, especially on small creditors.<sup>47</sup> To balance the interests of both shareholders and creditors, courts are prepared to ignore the principles in certain circumstances. In doing so, the courts have inadvertently made new law, a function reserved for the parliament.<sup>48</sup> Cases on the lifting of the corporate veil highlight the courts' willingness to abrogate the principle in order to prevent injustice to parties involved. Although writers regard courts as

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<sup>42</sup> Halpern, Trebilcock and Turnbull above n 39 at 139-142; Easterbrook and Fischel "Limited Liability" above n39 at 103-109; Ramsay above n29 at 535-53; Edwin M Dodd: "For Whom are Corporate Managers Trustees?" above n 40 at 1153.

<sup>43</sup> Ibid.

<sup>44</sup> Ibid.

<sup>45</sup> Ibid.

<sup>46</sup> Ibid.

<sup>47</sup> Ramsay above n29 at 523.

<sup>48</sup> Parker above n17 at 144-149.

inconsistent when lifting the veil, some see that the underlying principle in doing so is in the interests of justice, particularly when it involves fraud.<sup>49</sup>

However, Berle and Means theory of dispersion of ownership and control resulted in the weaker control exercised by shareholders on the management.<sup>50</sup> Without any effective control by the shareholders, coupled with the courts' reluctance to lift the corporate veil to hold them liable, directors have to certain extent a free rein to run the company as they see fit.<sup>51</sup> This situation may lead to the abuse of their position at the expense of creditors, especially when the company's financial position is unhealthy.<sup>52</sup> Creditors whose interests have been affected have no direct action against the company or the errant directors. Such action lies with the liquidator only if the company is wound up, and even then the liquidator's duty is to act in the best interests of the company rather than that of the creditors.

### **5.2.3.1 Court's Approach to Lifting of Corporate Veil in Relation to Directors' Duties**

In discharging the directors' duty as part of the company's management, the focus has always been on the shareholders as residual claimants of the company. Directors have a duty at common law to act in the best interests of the company. Courts have interpreted 'company' to mean the interests of shareholders, and directors who fail to take these interests into consideration breach their duty.<sup>53</sup> The courts' decisions are consistent with the shareholders' supremacy theory and directors must act in the best

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<sup>49</sup> Ibid.

<sup>50</sup> Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property* (The Macmillan Company, New York, 1932); Adolf A Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Revised ed, Harcourt, Brace & World, New York, 1968).

<sup>51</sup> Ramsay above n29 at 523-525; Farrar 'Frankenstein above 11 at 159.

<sup>52</sup> Ramsay above n29 at 522

<sup>53</sup> *Re Smith and Fawcett Ltd* [1942] 1 All ER 542; *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286.

interests of shareholders by maximising their wealth. Shareholders are perceived as owners of the company because of their contribution towards the capital of the company as well as their rights to appoint directors, hence the duty owed to them. In contrast, other key players in the company, particularly the creditors, cannot claim that such duties are owed to them because businesses have always been associated with risks. Creditors can avoid or protect themselves by either refusing to contract or negotiating favourable terms.

The position changes if the company is insolvent because at this stage shareholders' priority to the company's profit is replaced by the right of creditors to be paid. As such, creditors are seen as the beneficiaries to the company's benefit and cases have indicated courts' willingness to acknowledge there is a duty to consider the interests of creditors when making decisions.

In *Walker v Wimborne*,<sup>54</sup> the High Court of Australia regarded directors as having breached their duty for failure to take into account the interests of shareholders and creditors. Mason J asserted directors' failure to consider the creditors' interests would have adverse consequences for both the company and the directors.<sup>55</sup> The effects of such failure would be the company's insolvent condition and the liability imposed on the directors.

In the UK, the courts' inclination towards favouring creditors' interests was first shown in the case of *Lonrho Ltd v Shell Petroleum*<sup>56</sup> although the decision in

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<sup>54</sup> (1976) 3 ACLR 529 at 531.

<sup>55</sup> (1976) 3 ACLR 529 at 531.

<sup>56</sup> [1980] 1 WLR 627; Lord Diplock stated at 634 "the best interests of the company are not necessarily those of the shareholders but may include those of the creditors". However, His Lordship did not indicate whether the statements made were in connection of director's duty to creditors. See also *Re Horsley & Weight Ltd* [1982] 3 All E.R. 1045 where Templeman LJ concluded interests of the company could include the rights of creditors, hence directors have an indirect duty to consider the interests of creditors.

*Multinational Gas & Petrochemical Co v National Gas and Petrochemical Services Ltd*<sup>57</sup> stated it differently. Dillon L.J. in that case held that:

An individual trader who is solvent is free to make stupid, but honest commercial decisions in the conduct of his own business. He owes no duty of care to future creditors. The same applies to a partnership of individuals. A company, as it seems to me, likewise owes no duty of care to future creditors. The directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders: A company owes no duty of care to future creditors... *so long as the company is solvent the shareholders are in substance the company.*<sup>58</sup> (Emphasis added)

The same judge decided in *West Mercia Safety Ltd (in liq) v Dodd*<sup>59</sup> that once insolvency intrudes, the interests of the creditors overrode those of shareholders, because in a practical sense the company's assets belonged to those who could displace the power of shareholders and directors to deal with them. Dillon LJ clarified his earlier remarks because at the time the directors made decisions relating to the transaction in question, the company was amply solvent and directors were acting in good faith while in *West Mercia Safety Ltd (in liq) v Dodd*<sup>60</sup> at the relevant time the directors knew that the company was insolvent.

The House of Lords in *Winkworth v Edward Baron Development Co Ltd*<sup>61</sup> acknowledged the duty owed to creditors when the company is insolvent. In that

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<sup>57</sup> [1983] 2 All E.R. 563.

<sup>58</sup> [1983] 2 All E.R. 563 at 585.

<sup>59</sup> (1988) BCLC 250 at 252-253.

<sup>60</sup> (1988) BCLC 250 at 252.

<sup>61</sup> [1986] 1 W.L.R. 1512 at 1517.

situation, directors have a duty to ensure that the property of the company is sufficient to meet its obligation to the creditors. The rationale for imposing a duty to the company and to creditors is to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.

From the speech of Lord Templeman in the case, it seems that a director has a duty to ensure the company must ensure at all time that it has enough assets to pay creditors. This duty has been suggested to be either merely reiterating the capital maintenance principle enunciated in *Re Exchange Banking Company*<sup>62</sup> (*Flitcroft's case*), or extending the said principle to a duty to guarantee the solvency of a company.<sup>63</sup>

Likewise, Street J in *Kinsela v Russell Kinsela Pty Ltd*<sup>64</sup> recognised creditors' interests when the company is insolvent and that any breach by directors in such circumstances could not be ratified by shareholders.<sup>65</sup> Nevertheless, the judge did not devise any test to determine the extent of the degree of financial instability which would trigger the duty. This question was answered and deliberated further in *Nicholson v Permakraft (N.Z.) Ltd.*<sup>66</sup> Cooke J in his judgment<sup>67</sup> held that directors owed a duty to the company, but if the company is insolvent, near insolvent or of

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<sup>62</sup> (1882) 21 Ch D 519.

<sup>63</sup> See comments made by Professor Farrar in John Farrar "The Responsibility of Directors and Shareholders for a Company's Debts" (1989) 4 Cant. LR 12 at 14; and also Irene Trethowan in "Directors' Personal Liability to Creditors for a Company Debts" (1992) 20 ABLR 41 at 46.

<sup>64</sup> (1986) 10 ACLR 395; (1986) 4 ACLC 215 at 223.

<sup>65</sup> See also *Re Horsley & Weight Ltd* [1982] 1 Ch 442; *Re DKG Contractors Ltd* [1990] BCC 903; where the court held that shareholders could not ratify the breach in cases where the company is insolvent and they would clearly benefit at the expense of creditors.

<sup>66</sup> [1985] 1 NZLR 243.

<sup>67</sup> [1985] 1 NZLR 243 at 249-250.

doubtful insolvency or if payment or action would jeopardise solvency, creditors' interests should also be considered.

The judge went on to state that in considering whether the company is insolvent the test to be applied is whether the directors' action would prejudice the company's ability to discharge its debts to current and likely continuing creditors.<sup>68</sup> Accordingly, future creditors did not warrant protection and must take precautions on their own unless there was fraud.<sup>69</sup> In discharging the directors' duty, the test used is objective; whether at the time of the payment the directors should have appreciated or ought to have known that it was likely to cause loss to creditors or threatened the continuing existence of the company.<sup>70</sup>

Until recently in the case of *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong*,<sup>71</sup> courts in Malaysia have not included creditors as one of the parties that directors should consider when discharging their duty to act in the best interests of the company. In *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong*,<sup>72</sup> the liquidator took action against the director who had caused an amount of money to be paid to himself instead of paying off the creditor. Consequent to the director's action, a judgment sum has been entered against the company for failure to pay the creditor. The court had to consider whether there was a breach of fiduciary duty by the director and whether he acted in the interests of the company.

The court held that in exercising discretion, directors must act in accordance with what they perceived as bona fide for the interests of the company. Therefore, it

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<sup>68</sup> [1985] 1 NZLR 243 at 249.

<sup>69</sup> [1985] 1 NZLR 243 at 250.

<sup>70</sup> [1985] 1 NZLR 243 at 250.

<sup>71</sup> [2009] 1 MLJ 723.

<sup>72</sup> [2009] 1 MLJ 723.

concluded purchasing goods from third party when the company has ceased operation and insolvent could not be in the interest of the company. The court also made reference to the decision in *Winkworth v Edward Baron Development Co Ltd*<sup>73</sup> and acknowledged directors owe duty to creditors not to act in their own interests to the prejudice of creditors when the company is insolvent.

Although the case did not elaborate further on the issue, it shows that the Malaysian courts, albeit later than in the UK, New Zealand and Australia, have begun to acknowledge the interests of creditors during insolvency. The Malaysian Corporate Law Reform Committee (CLRC) in its Consultative Document when reviewing and reformulating directors' duties proceeds on the premise that the duty is owed to the company whilst taking into account the interests of other stakeholders.<sup>74</sup> Despite acknowledging the need to foster good relations with other stakeholders in order to improve governance, the CLRC did not regard it necessary to be incorporated into the statute.<sup>75</sup>

The decisions of the courts in all jurisdictions indicate similar characteristics; the duty is owed by directors primarily to the company. Directors have a duty to consider the interest of shareholders in making decisions when the company is solvent but the duty shifts to creditors in insolvency of the company. The duty of directors in this situation is to consider whether his or her action will prejudice the likelihood of creditors being paid. It should be noted, however, the duty should not be construed to mean that a company could not take any risks at all, but that directors must weigh all relevant factors available to them at the time to determine the chance of success. In doing so, the court would look at whether a reasonable man in the similar circumstances would have taken such risks.

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<sup>73</sup> [1986] 1 W.L.R. 1512.

<sup>74</sup> Malaysia Corporate Law Reform Committee "A Consultative Document on Clarifying and Reformulating the Directors' Role Duties" (2006) at [4.4]. [CLRC Clarifying and Reformulating the Directors' Role Duties ].

<sup>75</sup> Ibid, at [4.7].

The recent trend shows that courts begin to recognise the duty to consider creditors' interests and are willing to lift the corporate veil in order to hold that the directors had breached their duty, and hence are liable for their actions. This does not connote that courts have abrogated the principle in *Salomon v A. Salomon Co Ltd*,<sup>76</sup> because of the exception allowed in the case.

It would be worthwhile to look at the development in the USA on this issue, particularly the constituency statutes. The statute provides directors discretion to consider the interest of creditors, employees and others in making business decision. By allowing directors to do so, the statute may be seen as a revolution in corporate law,<sup>77</sup> a view which was shared by the Steering Committee<sup>78</sup> when refusing to adopt the stakeholders approach. For this reason, the American Bar Association Committee on Corporate Laws decided not to include such provision in the Revised Model Business Corporation Act.<sup>79</sup>

The Constituency Statutes provide the same concept as in the Corporation legislation by expressing the duty in the most general terms possible.<sup>80</sup> As such, the statute

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<sup>76</sup> [1897] A.C 22. Lord Halsbury L.C stated at page 30 “I am simply dealing with the provisions of the statute, and it seems to me to be essential to the artificial creation that the law should recognize only that artificial existence - quite apart from the motives or conduct of individual corporators. ...I do not at all mean to suggest that if it could be established that this provision of the statute to which I am adverting had not been complied with, you could not go behind the certificate of incorporation to show that a fraud has been committed... .But short of such proof it seems to me impossible to dispute that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself....”

<sup>77</sup> Marleen A O’ Connor Corporate Malaise –“Stakeholder Statutes: Cause or Cure” [1991] Stetson LR 4.

<sup>78</sup> See Company Law Review Steering Group “Modern Company Law For a Competitive Economy: The Strategic Framework” A Consultation Document (DTI, London, 1999) <<http://www.bis.gov.uk/files/file23279.pdf>> at June 2010 and also remedy codified for breach of directors’ duties.

<sup>79</sup> O’ Connor above n77 at 4; See also John Farrar, *Corporate Governance Theories, Principles and Practice* (3<sup>rd</sup> Ed., Oxford University Press, South Melbourne, 2008) at 31 [“Corporate Governance”].

<sup>80</sup> Morey W. McDaniel “Stockholders and Stakeholders” [1991] Stetson LR 121 at 126; see also Farrar *Corporate Governance* above n79 at 31.

stipulates directors “may consider the interest” of other stakeholders.<sup>81</sup> It is left to the court then to develop the standard and determine the parameter of the director’s discretion.<sup>82</sup> Only Connecticut enacts a mandatory provision that requires directors to consider the interest of other constituencies while the majority adopt the permissive approach which authorizes but does not require directors to have regard to interests other than shareholders.<sup>83</sup>

In this aspect, the UK has moved towards the same direction as the USA by passing the provision in section 172 of the Companies Act 2006 while New Zealand, Australia and Malaysia are still relying on the courts to provide for interests of other constituencies.<sup>84</sup> However, the provision does not make any changes to the corporate law because the core duty remains to the company. Other constituencies, like creditors for example, are protected only in the event the company is insolvent in both common law and as discussed above and statutes on areas relating to liquidation and insolvent trading.

### **5.2.3.2 Statutory Duty of Directors in Relation to Groups of Companies**

The principle of separate legal personality enunciated in Salomon’s case is seen today as not reflecting the commercial entity of the companies. When the case was decided in 1897, the economic circumstances were different, the principle of laissez faire ruled supreme and the fostering of business enterprises demanded that the

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<sup>81</sup> Ibid.

<sup>82</sup> Ibid.

<sup>83</sup> James Hanks Jr. “Playing with Fire: Non Shareholder Constituency Statutes in the 1990s” [1991] Stetson LR 96 at 103-105.

<sup>84</sup> See chapter 6 for further discussions.

principle of limited liability be rigidly maintained.<sup>85</sup> In the modern corporate world, a large single entity public limited company is almost non-existent; companies usually operate their businesses through conglomerates with different subsidiaries in different fields and locations.<sup>86</sup> Thus, the principle of separate legal entity no longer represents the commercial reality of the corporate structure.

The governing role in the organisation may come from the shareholders who have the power to vote at the general meetings or through banks or financial institutions which have sufficient leverage to influence a board's decisions.<sup>87</sup> This is often done through the creation of charges over the company's assets in favour of the bank. In addition, governance may also take the form of economic dependence where one dominant party is able to exert compliance from the other.<sup>88</sup>

The current legal standing which separates companies within a group does not reflect the commercial reality and when one of the companies collapses, creditors are at a disadvantageous position because, in most cases, they will find the company they concluded the contract with does not possess any valuable assets.<sup>89</sup> The parent company and other subsidiaries do not owe any liability to creditors of the insolvent

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<sup>85</sup> Roger AJA in *Briggs v James Hardie & Co Pty Ltd and Others* (1989) 16 NSWLR 549 at 567-568.

<sup>86</sup> Tom Haddon, "The Regulation of Corporate Groups in Australia" (1992) 15 UNSW LJ 61; Phillip Blumberg, *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality* (Oxford University Press, New York, 1993) at ch 3.

<sup>87</sup> David Millman "Priority Rights on Corporate Insolvency" in Clarke A. (Ed.) *Current Issues in Insolvency Law* (Stevens and Sons, London, 1991) 57.

<sup>88</sup> Hugh Collins "Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration" (1990) 53 MLR 731 at 734.

<sup>89</sup> See judgment by Justice Rogers in *Qintex Australia Finance Ltd v Schroders Australia Ltd* (1990) 3 ACSR 267 "It may be desirable for Parliament to consider whether this distinction between the law and the commercial practice should be maintained. This is especially the case today when the many collapses of conglomerates occasion many disputes...creditors of failed companies encounter difficulty when they have to select from among the moving targets the company with which they concluded a contract. The result has been unproductive expenditure on legal costs, a reduction in the amount available to creditors, a windfall for some, and an unfair loss to others. Fairness or equity seems to have very little role to play."

subsidiary and may continue to prosper to the joy of shareholders.<sup>90</sup> This is despite the fact all subsidiaries within the group are controlled either directly or indirectly by shareholders of the parent company. The strict application of the law in this situation may lead to injustice and may not give any sensible application to commercial life which then demands either basic change to the law or the practice.<sup>91</sup>

There is one aspect in which groups of companies are acknowledged as one entity; in relation to the preparation of group accounts.<sup>92</sup> The requirement to disclose accounts fair and true view should be sufficient to protect creditors because they can assess creditworthiness of a company based on the information.<sup>93</sup> If creditors suffer loss as a result of reliance on the information, then action should be taken under the existing law or against auditors for breach of duties.<sup>94</sup> However, as long as creditors only have claims against a particular company within a group, the law on disclosure is largely irrelevant.<sup>95</sup> The separateness of these companies is acknowledged even in

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<sup>90</sup> Lord Templeman in *Re Southard & Co Ltd*[1979] 1 W.L.R 1198 at 1208 summed up the situation as; “English company law possesses some curious features, which may generate curious results. A parent company may spawn a number of subsidiary companies; all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies... turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and other subsidiaries companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent companies.”

<sup>91</sup> Robert Baxt “The need to review rule in Salomon’s case as it applies to groups of companies” (1991) 9 C& SLJ 185 at 186-187; see also Robert P Austin “Problems for Directors Within Corporate Groups” in Michael Gillooly (Ed.), *Law Relating to Corporate Groups* at Ch 6.

<sup>92</sup> Section 399 of the UK Companies Act 2006; section 211 (2) of the New Zealand Companies Act 1993; sections 302(2)(b) and 306 of the Australian Corporations Act 2001; section 169 of the Malaysian Companies Act 1965.

<sup>93</sup> Gower above n4 at ch 17; See also Saul Fridman, “Removal of the Corporate Veil” (1991) 19 ABLR 211 at 213-214 .

<sup>94</sup> Fridman above n93 at 213-214 .

<sup>95</sup> Gower above n4 at ch 17.

the preparation of group accounts, because it does not substitute the requirement of preparing accounts of the holding company itself.<sup>96</sup>

The existence of an economic organisation has placed considerable stress on the legal principle; on the one hand, the economic reality requires the law to recognise these entities as one group, while the courts, on the other hand, are reluctant to depart from the principle enunciated by *Salomon v Salomon & Co Ltd*<sup>97</sup> over a century ago. The question now is how the law will reconcile this dilemma and to what extent the separate legal entity rule must be adhered to.

#### **5.2.3.2.1 Common Abuses in Groups of Companies<sup>98</sup>**

The structures of companies within the group make it possible for action prejudicial to creditors to be committed. A subsidiary company, for instance, can be used to act in accordance with the holding company's wishes even to its own detriment.<sup>99</sup> The subservient nature of the subsidiary makes it possible for the holding company to manipulate its assets through commingling, shuttling and draining the assets.<sup>100</sup> A subsidiary can also be used to be as a 'banker' to the holding company without any reciprocal benefits.<sup>101</sup>

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<sup>96</sup> *Industrial Equity Ltd v Blackburn* (1977) 17 ALR 575, per Mason J at 584 " The Companies Act does not, in the case of holding companies, substitute the requirement for the group accounts for the old requirements of accounts of the holding company itself. Group accounts are additional requirement; the holding company is still obliged to lay before its shareholders in general meeting its profit and loss account and balance sheet...."

<sup>97</sup> (1897) AC 22.

<sup>98</sup> For details see Andrew Muscat *The Liability of Holding for the Debts of its Insolvent Subsidiaries* (Dartmouth, 1996).

<sup>99</sup> *Ibid.*, at 65-84.

<sup>100</sup> *Ibid.*

<sup>101</sup> *Ibid.*

A holding company may use a subsidiary to minimize risks by transferring all risky projects for the latter to handle.<sup>102</sup> This subsidiary is often undercapitalized and if the venture fails, creditors of the subsidiary are left without any compensation because it lacks funding.<sup>103</sup> The holding company is free of liability and could set up another company to carry on similar activity.

The other type of activity within the group which is tantamount to abuse is the integrated economic enterprise in which all companies in the group are controlled by a holding company.<sup>104</sup> In this group of companies, each subsidiary will have its own commercial function which connects and complements the others.<sup>105</sup> The holding company often controls the finance of these subsidiaries and creditors may be prejudiced in the event of default because it is highly probable that the subsidiary does not have the capacity to pay.<sup>106</sup>

#### **5.2.3.2.2 Duty of Directors of Wholly-Owned Subsidiaries**

In *Walker v Wimborne*,<sup>107</sup> Mason J stressed the principle of separate legal entity and held that directors of each company within the group should act in its interests and its interest alone in deciding whether payment should be made to another company.<sup>108</sup>

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<sup>102</sup> Ibid, at 84-92.

<sup>103</sup> Ibid.

<sup>104</sup> Ibid, at 92-95.

<sup>105</sup> Ibid.

<sup>106</sup> Ibid.

<sup>107</sup> (1976) 3 ACLR 529.

<sup>108</sup> See also *Industrial Equity Ltd v Blackburn* (1977) 17 ALR 575 where the court upheld the separate legal personality principle and held that dividends can only be declared from profits made by it and not from any other companies within the group.

The difficulty of maintaining separate entity is evident when the particular subsidiary transaction benefits the whole group.<sup>109</sup>

In *Charterbridge Corporations v Lloyds Bank Ltd*,<sup>110</sup> Pennycuik J applied a standard of a reasonable director in the same position while in *Equiticorp Finance Ltd (in liq) v Bank of New Zealand*,<sup>111</sup> the judges preferred the traditional approach on directors' duty that if the directors fail to consider the interests of a relevant company, then they have acted in breach of their duty. However, if the transaction is seen to be in the interests of the company if objectively viewed, then no consequence will flow from that breach.

In *Pascoe Ltd (in liq) v Lucas*,<sup>112</sup> the court decided that the principle in *Walker v Wimborne*<sup>113</sup> did not apply in circumstances where the shareholders unanimously decided that the company should act in certain ways. In other words, a director of a wholly-owned subsidiary can act on the demand of the parent company provided that the subsidiary company in question is solvent and the shareholders are acting *intra vires* and in good faith.<sup>114</sup> The decision of the case is similar to the provisions in

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<sup>109</sup> *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 11 ACSR 642; *Charterbridge Corporations v Lloyds Bank Ltd* (1969) 2 All ER 1185; In *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465, the court applied the test in *Charterbridge* and held that even if the directors have failed to consider the interests of a particular company's creditors, there would be no breach of duty if other companies in the group have obtained derivative benefits from the directors' act.

<sup>110</sup> (1969) 2 All ER 1185.

<sup>111</sup> (1993) 11 ACSR 642.

<sup>112</sup> (1993) 11 ACSR 642 at 387.

<sup>113</sup> (1976) 3 ACLR 529.

<sup>114</sup> Robert Baxt "The South Australian Full Court confirms the ability of directors of wholly-owned subsidiaries to act in the interests of their holding company: do we need section 187 of the Corporations Law?" (2000) 18 C&SLJ 223 at 224.

section 187 of the Australian Corporations Act 2001, which deals specifically with a director's duty in a wholly-owned subsidiary.<sup>115</sup>

Likewise, New Zealand also has similar provisions which allow a director of a wholly-owned subsidiary to act in the best interests of a parent company even though the act may not be in the best interest of the subsidiary. Section 131(2) of the Companies Act 1993 provides a director of a wholly-owned subsidiary may, when exercising powers or performing duties as a director, act in a manner he or she believes is in the best interests of its holding company even though it may not be in the best interests of the subsidiary.

Australia has adopted the provision of section 131(2) into its Corporations Act 2001; however, it is stricter when compared to section 131(2) of the New Zealand Companies Act 1993.<sup>116</sup> In Australia, a director is allowed to act in the best interests of the parent company as long as the act is also in the best interests of the subsidiary. The act is taken to be in the interests of the subsidiary if the subsidiary is not insolvent and does not become insolvent as a result of the director's act. Hence, only when the company is solvent can the director consider the interest of the parent company, and even then the director must ensure that his action will not affect the solvency of the company. If the company is insolvent at the time of his action or insolvency ensues from his action, then the director is not acting in good faith in the interest of the subsidiary, thus he has breached his duty.

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<sup>115</sup> Section 187 of the Australian Corporations Act 2001 provides that a director of a corporation that is a wholly-owned subsidiary of a body corporate is taken to act in good faith in the best interests of the subsidiary if:

- (a) the constitution of the subsidiary expressly authorises the director to act in the best interest of the holding company; and
- (b) the directors acts in good faith in the best interests of the holding company; and
- (c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

<sup>116</sup> Farrar *Corporate Governance* above n79 at 269.

The directors in New Zealand, however, are not subject to the same restriction as directors in Australia. They are free to act in the best interests of the parent company even if the act may not be in the best interests of the subsidiary, so long as the act is permitted by the company's constitution. The requirement that a director will act in good faith only if the act is in the interests of a subsidiary means that the director must consider the interests of both parent and subsidiary.

Sections 131(2) and (3) of the New Zealand Companies Act 1993 impose a subjective test on a director as to what he perceived to be in the interests of a parent company. This standard is lower than the standard in section 187 of the Australian Corporations Act 2001 where the provision imposes an objective test on what are the best interests of the parent company. The absence of the phrase 'even though it may not be in the interests of the company' means that the duty for Australian directors is more difficult to fulfil. The purpose of this section is to assist external lenders to wholly-owned corporate groups.<sup>117</sup> A guarantee or third party mortgage that is not in the best interests of a wholly-owned subsidiary may be unenforceable, and the lender may be liable as a constructive trustee for any benefit it obtains from that guarantee or mortgage if the directors of the subsidiary have breached their duty by entering into it when it was not in the interests of the subsidiary.<sup>118</sup>

#### **5.2.3.2.3 Duty of Directors of Subsidiaries not Wholly-Owned**

Only New Zealand has a statutory provision in respect of director's duty in a subsidiary not wholly-owned. Section 131(3) provides that a director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with prior agreement of the shareholders (other than

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<sup>117</sup> Robert P Austin and Ian M Ramsay Ford's Principles of Corporation Law (14<sup>th</sup> ed, Lexis Nexis, Butterworths, 2010) at [8.020].

<sup>118</sup> Ibid.

its holding company), act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the interests of the company.

A director of a partly owned subsidiary may also contract out of the separate legal principle to consider the interests of the company he serves, if the constitution allows him to do so and there is an agreement that shareholders, other than the parent company agreed to such an arrangement. The wording in the section differs slightly from sub-section (2), for in the former, the requirement of agreement from shareholders other than the holding company is essential. This is because in the partly owned subsidiary the problem of abuse of minority shareholders is more acute; as such, in order to prevent minority shareholders from being oppressed their agreement is necessary.

There is no equivalent provision to section 131(3) in Australia.

### **5.2.3.3 Lifting of the Corporate Veil in Groups of Companies**

New Zealand and Australia have taken radical steps by making provisions in their laws to permit courts to make orders as if the companies in a group are one entity. Professor Farrar pointed out that the provision in section 271(1) is similar to the position in the United States and suggested the possibilities of the US cases being accepted in New Zealand's courts.<sup>119</sup> This trend has emerged in the case of *Mountfort v Tasman Pacific Airlines of NZ Limited*<sup>120</sup> where the court has made references to the United States cases in deciding whether it is just and equitable to make orders under section 271.

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<sup>119</sup> Farrar *Corporate Governance* above n79 at 277-278; see also Lynne Taylor "Liquidation" in John Farrar (Ed.) *Company and Securities Law in New Zealand* (Brookers, Wellington, 2008) 799 at [30.7.1]; Gehan Gunasekara and Alan Toy "Lifting the Veil on Pooling Orders under Section 271 of the Companies Act 1993" (2007) 13 NZBLQ 18; John Farrar "Legal Issues Involving Corporate Groups" (1998) 16 C&SLJ184.

<sup>120</sup> [2006] 1 NZLR 104.

Malaysia and the United Kingdom do not have any equivalent statutory provision and thus reliance on case law remains. The courts in the UK remain staunch in upholding the separate legal entity principle and have become stricter since the decision of *Adams v Cape Industries plc*.<sup>121</sup> The Malaysian courts have adopted the same position as in the UK and are reluctant to lift the corporate veil unless circumstances justify it.

#### **5.2.3.3.1 New Zealand Approach**

The Companies Act 1993 allows the court to make an order to any company which is related to the company in liquidation to pay for the debts of the latter,<sup>122</sup> and if two or more related companies are in liquidation, the court may order the liquidation of these companies as if they were one company.<sup>123</sup> A liquidator, a creditor or a shareholder can make an application under section 271 of the Act. This section differs from section 588V of the Australian Corporations Act 2001 because it allows creditors and shareholders to make direct application to the court and not necessarily through a liquidator. The court has the power to make such orders if the court is satisfied that it is just and equitable to do so.<sup>124</sup>

##### **5.2.3.3.1.1 Contributions and Pooling Orders**

A contribution order is governed by section 271(1)(a) of the Companies Act 1993 which allows a court to order a company related to a company in liquidation to contribute towards the claim in liquidation if it is satisfied that it is just and equitable to do so. Section 271(1)(b) of the same Act permits the court, if it is satisfied that it

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<sup>121</sup> [1990] Ch. 433.

<sup>122</sup> Section 271(1)(a) of the New Zealand Companies Act 1993.

<sup>123</sup> Section 271(1)(b) of the New Zealand Companies Act 1993.

<sup>124</sup> Section 271(1) of the New Zealand Companies Act 1993.

is just and equitable, to make an order that liquidations in respect of each company must proceed together as if they were one company and assets must be pooled for distribution.

A contribution order is an order in which a company related to a company<sup>125</sup> in liquidation is required to contribute towards the settlement of claim against the latter. A pooling order, on the other hand, is a court's order that a liquidation of two related companies must proceed together as if they are one entity and their assets to be combined for distribution. An application for a contribution order can be made if one of the related companies is in liquidation whereas the pooling order can be granted if two or more companies are in liquidation.

When a contribution order is made, the liquidated company's creditors will be in a better position because the contribution made by the other company which is not liquidated may increase the availability of assets for distribution, thus increasing their chances of getting their payments. However, if the contribution order might lead to the insolvency of the related company, Justice Tipping in *Lewis v Poultry Processors (Holdings) Limited*<sup>126</sup> commented in such a case, claims of bona fide unsecured creditors of the related should be satisfied first.<sup>127</sup>

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<sup>125</sup> Section 2(3) of the New Zealand Companies Act 1993 defines related companies as:

“ A company is related to another if:

- (a) The other company is its holding or subsidiary; or
- (b) More than half of the issued shares of the company, other than shares that carry no right to participate beyond a specified amount in distribution of either profits or capital, is held by the other company and companies related to that other company (whether directly or indirectly, but other than in a fiduciary capacity); or
- (c) More than half of the issued shares of the company, other than shares that carry no right to participate beyond a specified amount in distribution of either profits or capital, is held by members of the other (whether directly or indirectly, but other than in a fiduciary capacity); or
- (d) The business of the companies has been so carried on that the separate business of each company, or a substantial part of it, is not readily identifiable; or
- (e) There is another company to which both companies are related; and ‘related company’ has a corresponding meaning.”

<sup>126</sup> (1988) 4 NZCLC 64,508.

<sup>127</sup> See also *Re Liardet Holdings Ltd* (1993) BCR 604.

Likewise a pooling order may benefit creditors of a liquidated company which has fewer assets because they will receive more than what they would have had no order been made. However, a pooling order may prejudice creditors of the company with greater assets because they will now receive less than what they would have received.<sup>128</sup>

It is unclear, due to inconsistencies in the courts' decisions, whether in making a pooling order, the court can pool both the assets and liabilities of the companies. In *Re Dalhoff and King Limited (in liq)*,<sup>129</sup> the court allowed assets and liabilities, including to unsecured creditors of the companies, to be pooled. The court, however, rejected an application by the creditor who obtained a guarantee from one of the related companies to maintain right to take action. This is because the pooling order had the effect of merging both assets and liabilities and to allow the creditor the right to action against both companies would defeat the purpose of making the order.

The position, however, differs in *Re Stewart Timber & Hardware (Whangarei) Limited (in liq)*<sup>130</sup> where Justice Doogue disagreed that the pooling of assets also has the consequence of pooling liabilities of companies. The same position is taken in *Mountfort*,<sup>131</sup> where the pooling order is made so that creditors of both related companies are treated alike. In *Re Grazing & Export Meat Company Ltd*,<sup>132</sup> the court interpreted similar phrase "to be wound up as one company under the Companies Special Investigation Act" to mean to form a common pool of all assets of related companies in order to meet claims by unsecured creditors. The judge in *Re Pacific*

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<sup>128</sup> Jonathan Landers "A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy" (1975) 42 *Uni Chi L Rev* 589 at 630.

<sup>129</sup> [1991] NZLR 296.

<sup>130</sup> (1991) 5 NZCLC 67,137.

<sup>131</sup> *Mountfort v Tasman Pacific Airlines of NZ Limited* [2006] 1 NZLR 104.

<sup>132</sup> (1984) 1 NZCLC 99,226.

*Syndicates (NZ) Limited (in liq)*<sup>133</sup> held that section 315B should be subjected to broad interpretation because it is a remedial measure designed to facilitate the task of liquidation and general interest of those involved. Otherwise, it would have frustrated the intention of the legislature for wide usage of the section.

In *Mountfort v Tasman Pacific Airlines of NZ Limited*,<sup>134</sup> the court considered the consistency between the limited liability principle enunciated in section 15 of the Act and the pooling order under section 271(1)(b) of the Act. In spite of the wide discretion conferred by section 272(2)(e), it is not the intention of the Parliament to allow judges to use section 272 to dilute the separate legal principle.<sup>135</sup> The court would still have to consider whether, on facts, it is appropriate to lift the corporate veil when making a pooling order.

Since solvency is the requirement of the statute which enables the holding company to remain separate from its subsidiaries, the court should be aware of any actions which would affect the company's solvency. Any actions by the former which will cause the latter to trade whilst insolvent, or to jeopardise its independent existence, is relevant in a decision as to whether the corporate veil should be lifted.

#### **5.2.3.3.1.1.1 Just and Equitable**

The court acknowledged that there are not many authorities to guide it in the interpretation of the words 'just and equitable.' Nevertheless, Justice Casey in *Re Home Loans Fund (NZ) Ltd (in group liq)*<sup>136</sup> held that the court has wide discretions to interpret the phrase to effect a result which accords with common notions of

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<sup>133</sup> (1989) 4 NZCLC 64,757.

<sup>134</sup> [2006] 1 NZLR 104.

<sup>135</sup> [2006] 1 NZLR 104 at 125.

<sup>136</sup> (1983) 1 NZCLC 98,581.

fairness in all circumstances, while at the same time it needs to pay attention to the principle of *pari passu* among creditors of equal standing.<sup>137</sup>

To assist the court in deciding what is tantamount to just and equitable for the purpose of contribution order, section 272(1) provides as follows:

- (a) The extent to which the related company took part in the management of the company in liquidation.
- (b) The conduct of the related company towards the creditors of the company in liquidation.
- (c) The extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company.
- (d) Such other matters as the court thinks fit.

Section 272(2) which deals with guidelines for pooling order has similar conditions to section 272(1)<sup>138</sup> to determine just and equitable. The only difference is that under a pooling order there is an additional requirement that the court has to consider the extent to which the businesses of the companies have intermingled. Courts have to interpret whether it is just and equitable to make such orders in the light of the fundamental principle of the legislations; the separate legal entity principle.<sup>140</sup>

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<sup>137</sup> (1983) 1 NZCLC 98,581 at 98,583-98,584.

<sup>138</sup> See also *Lewis v Poultry Processors (Holdings) Limited* (1988) 4 NZCLC 64,508 the court made a distinction between what constitutes just and equitable under section 315A and section 315B (the old provisions equivalent to section 271(1) (a) and (b) in the Companies Act 1955), and held that the extent to which the businesses of the companies have been intermingled was relevant in the latter but not in the former.

<sup>140</sup> *Mountford v Tasman Pacific Airlines of NZ Limited* [2006] [2006] 1 NZLR 104 at 125. The judge expressed the opinion that it was not the intention of the Parliament to allow judges to use the said provision to disapply or to dilute the separate legal entity principle.

### **a) Extent to which the Related Company took part in Management<sup>141</sup>**

The degree of involvement in the management of one company by another must be substantial before a contribution or pooling order can be made by the court. The example of substantial involvement includes when the management had been operating inter-related groups of companies as one entity.<sup>142</sup> Hence, mere participation by the holding company in the subsidiary is not enough to justify the making of the order; the facts must show an element of control exercised by the holding company over the subsidiary.<sup>143</sup> In other words, courts will scrutinize both the operational and policy level to determine whether the holding company is pulling the strings in the subsidiary.<sup>144</sup>

In *Rea v Barker*,<sup>145</sup> the liquidator was required to allege that the companies were related and that it was just and equitable for the court to make a contribution order. The court would refer to the conduct by related companies either directly or indirectly, which would affect the creditors of the wound up company when making the order.

### **b) Conduct of Related Company towards Creditors<sup>146</sup>**

There must be a clear distinction between the creditors of one company and those of another. Creditors of companies within the same group must be clear who they are dealing with and the circumstances involved. If it was established that the nature of

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<sup>141</sup> Section 272(2)(a).

<sup>142</sup> *Re Dalhoff and King Holdings Ltd (in liq)* [1991] NZLR 296 at 302.

<sup>143</sup> See also arguments by Gunasekara and Toy above n99 at 23-24.

<sup>144</sup> *Mountford v Tasman Pacific Airlines of NZ Limited* [2006] 1 NZLR 104 at 127.

<sup>145</sup> (1988) 4 NZCLC 64,312.

<sup>146</sup> Section 272(2)(b).

the business had led to confusion as to which companies are involved, then it would be just and equitable to treat the company as one entity.<sup>147</sup>

**c) Extent of the Related Company's Conduct Attribute to Liquidation of the Company<sup>148</sup>**

The court will also look at the related company's contribution towards the liquidation of the other companies in the group. The facts which are relevant for this purpose would be the holding company providing bad debts to its subsidiary, compelling it to trade whilst insolvent.<sup>149</sup> Moreover, the court will consider any evidence which will illustrate that the companies are one entity and dependent on each other such as fusions of accounting systems, financial arrangements and managements.<sup>150</sup> Due to the dependency on one another, any conduct by the related company which led to insolvency would have an impact on the others.<sup>151</sup>

**d) Extent to which the Businesses of the Companies have been Intermingled<sup>152</sup>**

The difficulty of separating the activities of each company due to the use of a common name for all inter-related companies is another relevant consideration. The court pointed out that confusion of ownership in respect of particular assets is a further illustration that those responsible for management of the companies treated the companies as one and did not differentiate between the activities carefully.

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<sup>147</sup> *Re Dalhoff and King Holdings Ltd (in liq)* [1991] NZLR 296 at 302-305.

<sup>148</sup> Section 272(2)(c).

<sup>149</sup> *Mountford v Tasman Pacific Airlines of NZ Limited* [2006] 1 NZLR 104 at 127.

<sup>150</sup> *Ibid.*

<sup>151</sup> *Re Dalhoff and King Holdings Ltd (in liq)* [1991] NZLR 296 at 305.

<sup>152</sup> Section 272(2)(d).

That the management did not differentiate between the companies and did not maintain proper documentation between the companies made it difficult to ascertain the validity of certain inter-loans or inter-payments. The court concluded that the companies were sub-divided into separate groups, but for convenience purposes the activities were not, and there was no indication to suggest that one set of shareholders was preferred over the others. It should be noted that the companies' actions must be observed as a whole in order for them to be of any significance, and not in isolation.<sup>153</sup>

**e) Other Matters the Court deems Fit<sup>154</sup>**

The courts have wide discretion to determine features worth contemplation before granting the order. In *Mountford v Tasman Pacific Airlines of NZ Limited*,<sup>155</sup> the court found that as a result of the subsidiary directors' breach of duty, the holding company improved its financial position. The subsidiary, meanwhile, was left with substantial bad debts and its unsecured creditors were left without compensation. The court granted the order because to do otherwise would have been to permit the holding company to take advantage of its own wrongdoing.

In addition to considering whether directors had breached their duty, the judge also considered the solvency test as the relevant factor. The court held that engaging in insolvent trading justified the departure from the separate legal entity and the making of the pooling order. Baragwanath J, however, set the limitations on the use of insolvency as justifying the making of the order; firstly by permitting the pooling order to the extent required to restore the solvency of the subsidiary;<sup>157</sup> secondly,

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<sup>153</sup> *Re Dalhoff and King Holdings Ltd (in liq)* [1991] NZLR 296 at 305-306.

<sup>154</sup> Section 272(2)(e).

<sup>155</sup> [2006] 1 NZLR 104 at 118.

<sup>157</sup> *Mountford v Tasman Pacific Airlines of NZ Limited* [2006] 1 NZLR 104 114; see also Gunasekara and Toy above n99 at 25.

because the creditors of the subsidiary could not expect to receive more than they would have done, had the directors complied with their statutory duties.<sup>158</sup>

In *Re Dalhoff and King Limited (in liq)*,<sup>159</sup> the court considered the existence of inter-company debts which were not properly documented. If the pooling order was not granted, there would need to be legal actions to determine the validity and amount of those debts and this could deplete the available funds. Further, the court noted in insolvency, creditors' interests will prevail over shareholders and the creditors will be better off if the order is granted. The court also acknowledged from the facts that management had treated these companies as an entity and to refuse the order would belatedly recognising the principle, which the companies had never operated.

The availability of these orders would assist the management to set the standard of care required from them. This is because the management of the solvent company must also be aware when the court will find the situation just and equitable to make a contribution or pooling order.<sup>160</sup> This also imposes an additional duty on directors to be vigilant not only on the affairs of their company but also other companies within the group.

Baragwanath J in *Mountfort* also explained the relationship between section 131(2) and section 272 of the Act. The judge was of the view that the application of section 131(2) is narrow and provides little defence to a director. Section 131(2) allows a director of a wholly-owned subsidiary to act in the interests of parent, even if it is not in the subsidiary's best interests, provided the constitutions of the subsidiary contain provisions to that effect. The section, however, is ancillary to the fundamental

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<sup>158</sup> Ibid.

<sup>159</sup> [1991] 2 NZLR 296 at 306-309.

<sup>160</sup> Farrar *Corporate Governance* above n79 at 280.

requirement of insolvency and it does not relieve directors of their obligation to cease trading upon insolvency.<sup>161</sup>

### **5.2.3.3.2 Australian Approach**

#### **5.2.3.3.2.1 Liability of a Holding Company for Insolvent Trading by a Subsidiary<sup>162</sup>**

Section 588V of the Corporations Act 2001 imposes civil liability on the holding company for the debt of its subsidiary if the subsidiary is insolvent or becomes insolvent as a result of incurring the debt. The provision imposes liability in circumstances where the holding company or its directors has reasonable grounds to suspect that the company is insolvent or becomes insolvent; or having regard to the holding company's control over the subsidiary, it is reasonable to expect that the holding company or its directors would be aware that the subsidiary is insolvent or becomes insolvent by incurring the debt.

#### **5.2.3.3.2.2 Defences<sup>163</sup>**

The holding company will escape liability under section 588V if the holding company or any of its directors can show that there are reasonable grounds to expect, and did expect, that the subsidiary was solvent and would remain so at the time the debt was incurred.<sup>164</sup> It is also a defence if the holding company or any of its directors can display reasonable grounds to believe, and did believe, on a competent

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<sup>161</sup> *Mountford v Tasman Pacific Airlines of NZ Limited* [2006] 1 NZLR 104 at 128; see also Gunasekara and Toy above n157 at 29; Taylor above n157 at [30.1.7(3)]

<sup>162</sup> See Chapters 11 and 12 for further discussion.

<sup>163</sup> See Chapter 11 for detailed discussions on this topic.

<sup>164</sup> Section 588X(2) of the Australian Corporations Act 2001.

and reliable third party's opinion, that the company was solvent and would remain as such at the time the debt was incurred.<sup>165</sup>

The liability on the holding company is imposed only in respect of the knowledge of its directors who are actively involved in its management. Thus, the holding company will escape liability if the directors who have knowledge of the insolvency of the subsidiary are those who are not actively involved in the management of the company due to illness or any other good reasons.<sup>166</sup> Finally, if the holding company has proven that it has taken all reasonable steps to prevent the subsidiary from incurring debts, then it will not be liable for the debts of its subsidiary.<sup>167</sup>

#### 5.2.3.3.3 Common Law Approach

In the absence of statutory provisions expressly dealing with the liability of holding company/directors in group of companies, reliance on the courts to provide guidelines continues. Courts grapple with the reality of the issue while at the same time trying to uphold the separate legal entity principle.<sup>168</sup> The courts have been inconsistent as to the circumstances when veil will be lifted, though fraud and business reality of the groups seem to be the most used. In *D.H.N. Food Distributions Ltd v Tower Hamlets L.B.C.*,<sup>169</sup> the Court of Appeal looked at the structures and the business reality of the group and decided they should be treated as one.<sup>170</sup>

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<sup>165</sup> Section 588X(3) of the Australian Corporations Act 2001.

<sup>166</sup> Section 588X(4) of the Australian Corporations Act 2001.

<sup>167</sup> Section 588X(5) of the Australian Corporations Act 2001.

<sup>168</sup> *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 2 All E.R 563.

<sup>169</sup> [1976] 1 W.L.R. 852.

<sup>170</sup> Lord Denning M.R. stated at 860 "This group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point...They should not be deprived of the compensation which should justly be

The House of Lords in *Woolfson v Strathclyde Regional Council*,<sup>171</sup> expressed doubt as to the decision in D.H.N. and refused to lift the veil unless the corporate form was "a mere façade concealing true facts."<sup>172</sup> The courts, however, indicated their willingness to pierce the veil in cases where it was necessary to achieve justice for parties.<sup>173</sup>

This decision, however, was rejected in *Adams v Cape Industries plc*<sup>174</sup> in which the Court of Appeal concluded that doing justice to parties and the use of the corporate structure in order to ensure that legal liability will fall on another member of the group is not sufficient to lift the veil. There must be an element of control by the parent company of the subsidiary and the subsidiary must not be independent in making its decision, before an agency relationship can be established within members of the groups. The fact that the companies within the group operate as one single company is not sufficient. *Adams v Cape Industries plc*<sup>175</sup> was followed and approved in subsequent cases<sup>176</sup> where the courts held that in the absence of fraud or mere façade concealing true facts, justice to parties does not justify the departure from the Salomon's principle.

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payable for disturbance. The three companies should, for present purposes, be treated as one and the parent company, D.H.N., should be treated as that one."

<sup>171</sup> 1978 S.L.T. 159.

<sup>172</sup> Lord Keith of Kinkel stated at 161 "I have some doubts whether...the Court of Appeal properly applied the principle that it is appropriate to pierce the corporate veil only where special circumstances exist indicating that it is a mere façade concealing the true facts." Lord Wilberforce, Frazer of Tullybelton and Russell of Killowen concurred with the statements. The House of Lords, however, did not overrule the decision in D.H.N. thus it remains good law.

<sup>173</sup> *Re A Company* (1985) 1 BCC 99 at 421 the Court of Appeal held that "In our view the cases...show that the court will use its power to pierce the corporate veil if it is necessary to achieve justice irrespective of the legal efficacy of the corporate structure..."

<sup>174</sup> [1990] Ch. 433.

<sup>175</sup> [1990] Ch. 433.

<sup>176</sup> *Ultraframe (UK) v Fielding & Ors* [2005] EWHC 1638; *Dadourian Group v Simms* [2006] EWHC 2973.

It would seem that the English courts are still leaning towards the separate legal entity doctrine and refusing to lift the veil in the absence of fraud. Since the decision in *Adams v Cape Industries*,<sup>177</sup> it seems that the courts in England are restricting circumstances to lift the corporate veil. By insisting on special circumstances in addition to creating justice, the courts have placed a burden on parties who wish to lift the veil to show elements of fraud or a mere façade concealing true facts. Lord Wedderburn wrote "is it not time to know just when a company is a 'sham' and when the veil of corporate personality can be torn aside?"<sup>178</sup> and until today, more than twenty years later, the answers remain uncertain.

#### 5.2.3.3.4 Malaysian Approach

In Malaysia, the principle of separate legal entity is found in section 16(5) of the Companies Act 1965<sup>179</sup> and the courts are reluctant to alter the principle. The courts in Malaysia have been influenced by the English decisions on this matter. This is evident from the courts' reluctance to lift the corporate veil on a group of companies except in limited circumstances. The courts are prepared to lift the veil in cases where fraud is alleged and also in circumstances where justices demand such an action.

In *Tay Tian Liang v Hong Say Tee & Ors*,<sup>180</sup> the court considered whether it was necessary to lift the corporate veil to unveil the existence of a wholly-owned

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<sup>177</sup> [1990] Ch. 433

<sup>178</sup> Wedderburn "Multinationals and the Antiquities of Company Law" (1984) 47 MLR 87 at 90.

<sup>179</sup> Section 16(5) of the Malaysian Companies Act 1965 provides that: "On and from the date of incorporation specified in the certificate of incorporation but subject to this Act the subscribers to the memorandum together with such other persons as may from time to time become members of the company shall be a body corporate by the name contained in the memorandum capable forthwith of exercising all functions of an incorporated company and of suing and being sued and having perpetual succession and a common seal with power to hold land but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as is provided by this Act"

<sup>180</sup> [1995] 4 MLJ 529 at 541.

subsidiary. Abdul Malik J held that in the interests of justice it was necessary to lift the corporate veil even though there was no fraud involved. From this decision, it appeared that the court lifted the veil in order to determine whether the subsidiary was under the absolute control of the parent company.

In the case of *Golden Vale Golf Range & Country Club Sdn Bhd v Hong Huat Enterprises Sdn Bhd (Airport Auto Centre Sdn Bhd & Anor as third party)*,<sup>181</sup> the managing director of the plaintiff company and her bankrupt husband were alleged to have used the company as an extension of themselves to commit fraud on the defendant. In this situation, the High Court lifted the corporate veil and found that the managing director had been in effective control of the company and was therefore liable.<sup>182</sup>

In another case,<sup>183</sup> an appeal from the Industrial Court involved a dispute between the Union representing the workers of Hotel, Bar and Restaurant and the Jaya Puri Chinese Garden Restaurant which employed the workers. The workers were retrenched due to business closure owing to losses. The restaurant was operating in the premises belonging to Hotel Jaya Puri Bhd, the plaintiff, and both the restaurant and the hotel, had the same managing director. The Union sought to have the Hotel joined as a party on the basis that the workers were the employees of the hotel and they were dismissed and not retrenched as alleged by the restaurant.

The court lifted the corporate veil and held they were the hotel's employees. The judge also made reference to several English cases<sup>184</sup> and noted that courts are quite

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<sup>181</sup> [2005] 5 MLJ 64.

<sup>182</sup> It should be noted that this case, however, is not the case where the holding company has to be liable for the debt of the subsidiary.

<sup>183</sup> *Hotel Jaya Puri Bhd v National Union of Hotel, Bar & Restaurant Workers & Anor* [1980] 1 MLJ 109.

<sup>184</sup> *Smith, Stone and Knight v Birmingham Corporation* [1938] 4 All ER 116; *Re FG (Films) Limited* [1955] 1 WLR 483; and *Firestone Tyre & Rubber Co v Llewelyn* [1957] 1 WLR 464.

willing to lift the veil of incorporation when the justice of the case so demands. In doing so, it was found that the hotel and the restaurant were functioning as one integral entity and in terms of management they also constituted a single unit.

Gopal Sri Ram JCA in *Law Kam Loy & Anor v Boltex Sdn Bhd*<sup>185</sup> declined to follow D.H.N. which is deemed no longer sustainable, and referred to Adams and Woolfson as guidance.<sup>186</sup> The judge opined that it is no longer desirable for the court to lift the veil in the interests of justice unless special circumstances have been established. Special circumstances include cases where there is either actual fraud at common law or some inequitable or unconscionable conduct amounting to fraud. In light of the later Court of Appeal decisions, it is no longer open to the court to lift the veil in the interest of justice per se. The court must insist on the evidence of fraud or mere façade is to be established first, only then the lifting is justified.

The court will scrutinise the capacity of a director who gives any undertaking on behalf of the holding company, namely whether he or she is acting in the capacity as director in the subsidiary of the holding company. If the undertaking is given in his or her capacity as director in a subsidiary, the court will not lift the veil to hold the holding company liable. Only when the undertakings are given on behalf of the parent will the veil be lifted.

This matter is illustrated in the case of *People's Insurance Co (M) Sdn Bhd v People's Insurance Co Ltd & Ors*.<sup>187</sup> The plaintiff was the subsidiary of the first defendant and the second, third, fourth and fifth defendant were on the board of directors in the plaintiff company. They were also senior officers of the first

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<sup>185</sup> [2005] 3 CLJ 355.

<sup>186</sup> See also decisions in *Perman Sdn Bhd & Ors v European Commodities Sdn Bhd & Anor* [2006] 1 MLJ 97.

<sup>187</sup> [1986] 1 MLJ 68.

defendant company. During a meeting of the board of directors of the plaintiff company, in which the second, third, fourth and fifth defendants were present, the auditor expressed the view that the plaintiff's account might not be sufficient to meet all claims in respect of policies issued by the plaintiff.

The second, third, fourth and fifth defendants then gave an undertaking to be responsible for any shortfall and when the sum was not enough to meet all the claims, the plaintiff claimed from the defendant company for the shortfall. The defendant company denied any liability. Zakaria Yatim J decided that the parent and subsidiary companies are two separate entities and that officers of the parent company, when giving the undertaking, are not representing the parent company, but they sit as directors or agents of the subsidiary. Thus the parent was held not to be liable to pay for any shortfall of the subsidiary.

The court is also reluctant to depart from the principle of separate legal entity where the subsidiary company is partly owned by the holding company. In *JH Rayner (Mincing Lane) Ltd & Ors v Manilal & Sons (M) Sdn Bhd & Anor*,<sup>188</sup> the plaintiffs, who were foreign companies, claimed that the defendants were indebted to them. The first defendant company wrote to the plaintiff admitting the debt and asking the plaintiff not to commence any legal action within 21 days from the date of the letter. The defendants also pledged in the same letter all the issued share capital of its subsidiary, the second defendant, in favour of the plaintiffs. The defendant further promised to procure the creation of a first fixed charge and floating charge over all assets of the second defendant as security for payment of the said debts.

When the defendants failed to comply, the plaintiffs commenced an action in London and obtained a Mareva injunction. Later, an action was filed in Kuala Lumpur and an injunction was obtained. The defendants then applied for an order dissolving an injunction granted against them. The second defendant argued that the plaintiff had

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<sup>188</sup> [1987] 1 MLJ 312.

no cause of action because there was no privity of contract between the plaintiffs and the second defendants.

The plaintiff's claim against the second defendant was based on the letters written by the first defendant to the plaintiffs and though one of the signatories was the director of both the first and the second defendant, he signed the letters in his capacity as the director of the first defendant. The defendant further contended that although 60 percent of the issued share capital was owned by the first defendant, the second defendant remained separate legal entity. The plaintiffs, on the other hand, argued that the court should lift the corporate veil since all the shares were owned by the defendant and another company which the defendant had controlled.

Zakaria Yatim J refused to lift the corporate veil on the basis that the first defendant did not fully own all shares in the second defendant to justify the pledge made to the plaintiff. The judge referred to his decision in *Bank Bumiputra Malaysia Sdn Bhd & Anor v Lorraine Osman & Ors*<sup>189</sup> and noted he refused to lift the veil in respect of five companies which were not fully owned by Lorraine.<sup>190</sup> The decisions of both cases indicate absolute control over the subsidiary is essential. In cases where there is an element of independence on part of the subsidiary, as illustrated in both cases discussed above, courts would not abrogate the principle of separate legal personality. The courts require the person who wishes to lift the veil to show evidence that a holding company exercises sufficient or absolute control over the subsidiary and the subsidiary is not independent in making its decisions. This can be seen in the case of

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<sup>189</sup> [1985] 2 MLJ 236.

<sup>190</sup> Zakaria Yatim J at 314 stated "It seems to me that the counsel is asking the court to lift the corporate veil of the second defendant. In *Bank Bumiputra Malaysia Sdn Bhd & Anor v Lorraine Osman & Ors*<sup>190</sup> I had the occasion to consider *Jones v Lipman & Anor* [1962]1 WLR 832...and in the present case, the situation is different from that in *Jones v Lipman*. From the evidence available, the first defendant does not fully own all the shares in the second defendant. In Lorraine's case, I refused to lift the corporate veil in respect of five companies which were not fully owned by Lorraine. The court will only lift the corporate veil of a company if the justice of the case so demands. In the instant case, there is no justification for the court to lift the corporate veil of the second defendant."

*Uniphoenix Corporation Bhd v Raymond Leong Ah Kat*<sup>191</sup> where the court emphasised that in order to lift the corporate veil, there must be sufficient evidence to prove that the holding company had absolute control over its subsidiaries and associate companies.

The claim that Uniphoenix and its subsidiaries were one entity was substantiated by a search in the registry of companies, which confirmed that Uniphoenix was the brain and mind of its subsidiaries and had total control over them. The court has also indicated the possibility that the principle in Salomon's case would not be applied to group of companies if the evidence is clear to show the wholly-owned subsidiary is bound hand and foot to the holding company and the facts have not been challenged.

This can be seen from the Federal Court decision in *Sunrise Sdn Bhd v First Profile (M) Sdn Bhd & Anor*<sup>192</sup> which stated that in the situation where it was an undisputed fact that the subsidiary was wholly-owned by the holding company, and it had not been challenged that the holding company by proxy or through its nominees managed the subsidiary, there was no need to lift the veil. This is because, the composition, type, shareholding and control of the subsidiary stood in front of the veil.

Likewise, in *Kwan Chew Holdings Sdn Bhd v Kwong Yik Bank Bhd*,<sup>193</sup> Gopal Sri Ram JCA decided that where the companies have been regarded as one entity from the beginning, it is not open for the defendant to change its stance and choose to treat each company in the group as a different entity. The judge went on to state that in these circumstances, it was not a question of lifting the veil or treating the companies in the group as one economic entity, but merely an example of equity in personam where the defendant was estopped from denying that companies in the group were

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<sup>191</sup> [2004] 6 MLJ 90.

<sup>192</sup> [1996] 3 MLJ 533 at 542.

<sup>193</sup> [2006] 6MLJ 544 at 559-560.

one entity. Instead of lifting the veil, the court in this case referred to the doctrine of estoppel in order to do justice to the parties.

These decisions, however, should not be seen as an abrogation of the principle of separate legal entity by the court. This is because in both cases it was never challenged that the subsidiary and the holding company were one entity and were controlled by the holding company. In *Sunrise*, the plaintiff made an application for interlocutory injunction to prevent the holding company from disposing of the assets belonging to the subsidiary. The court found that the fear was not without basis since there was an agreement between the holding company and the plaintiff which was purportedly for the acquisition of land belonging to the subsidiary by the plaintiff.

The holding company, however, terminated the contract three days before the cutoff date mentioned in the agreement. In *Kwan Chew Holdings*, it was undisputed that the defendant had always treated the companies in the group as one entity when dealing with them. Therefore, the defendant could not have relied on the separate legal entity in order to avoid liability.

From the facts of both cases, it is clear that the issue of who has control over the subsidiary and the extent of subsidiary's capacity to make decisions had already been determined without having to lift the corporate veil. Hence, the courts had only to decide whether the holding companies in these cases had breached the contract.

From the cases discussed above, it is clear that the courts are reluctant to lift the corporate veil in groups of companies. In situations where the veil is lifted, the courts have insisted on evidence of control exercised by the parent over the subsidiary, or whether the subsidiary is independent in making decisions or taking orders from the parent. It would seem that the courts were of the view that total control of the parent over the subsidiary is essential. In a partly owned subsidiary, the court will be reluctant to lift the veil for lack of the control element and will only do so if justice so demands. However, in the light of recent decisions, judges have demanded that

justice alone is not sufficient; there must be other elements, such as fraud, present before the veil will be lifted.

In cases where undertakings have been given by directors of both parent and subsidiary, the court will scrutinise on whose behalf they are acting. It is also interesting to note that recent decisions of the courts open the possibility that the separate legal entity principle will be ignored. The courts have relied on other principles, such as estoppel, in order to make the parent company liable for the debts of its subsidiary.

It is apparent that the courts in Malaysia have been influenced by the English courts and it is submitted that the trends will continue. As such, any developments in the area will have great impact on Malaysian corporate law. Parliament has been reluctant to intervene in the area of corporate personality and the matters have been left to judges to decide, as and when necessary, to depart from the separate legal entity doctrine. The courts, therefore, will have to look elsewhere for guidance, and any developments in common law jurisdictions have become their primary source of reference.

## CHAPTER 6 THE INTERESTS IN THE CORPORATION

### 6.1 Introduction

The word ‘interest’ cannot be assigned to any particular definition. It is one of those words, which not having any superior genus, cannot be defined in an ordinary way.<sup>1</sup> It can be measured according to Bentham in terms of pain and pleasure accorded to an individual. As such, a thing is said to promote the interests, or to be for the interest of an individual when it tends to increase the sum total of pleasure or to diminish the sum total of pain.<sup>2</sup> A person can be said to have an interest in any object if it tends to produce benefit or advantage or to prevent the happening of mischief or loss.<sup>3</sup>

Bentham’s concept of pain and pleasure can be translated into interests of various groups in a corporation. Shareholders whose interests are equated by the court to be the interests of the company have interests in exchange of capital injected into the corporations. By virtue of their contribution to the company, shareholders have been recognised as owners, though they do not own the assets of the company.<sup>4</sup> Shareholders’ interests in the corporation is said to be parallel with the corporation because both want profit maximization.

Over time, the company has come to be viewed as ‘sets of contracts’ where the company serves as the common party to contracts with managers, shareholders,

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<sup>1</sup> Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation* (University of London The Athlone Press 1970) at 12.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

<sup>4</sup> Paddy Ireland, Ian Grigg-Spall and Dave Kelly, “The Conceptual Foundations of Modern Company Law” (1987) 14 *JL& Soc’y* 149 at 152.

lenders, employees, suppliers and customers.<sup>5</sup> The theory known as nexus of contract perceived company as a legal device to facilitate contracting between these groups though the director's duty to shareholders remains.<sup>6</sup> Each group contracts with the company and is allowed to set terms on which it is prepared to supply the firm's input and it will be remunerated for so doing.<sup>7</sup>

Creditors' interests in the corporation take the form of repayment on time of a loan or for goods supplied. As long as the company has sufficient funds to pay, creditors normally are not concerned with the ways businesses are conducted. The interests of both shareholders and creditors are said to be in the same direction. However, when the company is insolvent, the measurement of pain increases because of the possibility of non-payment of debts.

Shareholders may try to advance their interests to maximise profits and pressurise the management to pursue risky investments or to withdraw assets from the company.<sup>8</sup> Creditors, on the other hand, want the management to avoid these types of investment for which there are no guarantees of success, thus increasing their chances of not getting paid.<sup>9</sup> In this situation, creditors become the residual claimants since the shareholders' conduct has exposed them to unanticipated risks, i.e. risks not

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<sup>5</sup> Gavin Kelly and John Parkinson "The Conceptual Foundations of the Company: A Pluralist Approach" in John Parkinson, Andrew Gamble and Gavin Kelly (Eds) *The Political Economy of the Company* (Hart Publishing, Oxford and Portland (Oregon), 2000) 113 at 115-116.

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> Brian Cheffins *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997) at 78-79.

<sup>9</sup> Ibid, at 79.

covered under the contract,<sup>10</sup> and therefore they are entitled to the company's assets.<sup>11</sup>

The law as it stands at the moment has imposed on directors a duty to consider the interests of creditors when making the decision of when the company is insolvent; failure to do so will result in personal liability. Likewise, the law also imposes a duty on directors to prevent the company from engaging in trading when the company is insolvent. It is deemed sufficient to protect the interests of creditors because that is the only time when creditors' interests are prejudiced.

Recently, there has been some inkling that directors should also consider various other stakeholders in the company in addition to shareholders. The existing law is deemed inadequate because it only considers the interests of shareholders and does not have any regard for other stakeholders in the company. This is because every party in the corporation contributes to the success of the company and therefore the law should recognize this.

This chapter will provide views on both the shareholders and stakeholders theory. It will provide the outline of the theory and focus will be made particularly to creditors.

## **6.2 Development of Shareholders' Primacy Theory**

Shareholders' supremacy endorses the view of directors as agents of shareholders, who are employed to run the business exclusively for the shareholders' wealth maximization.<sup>12</sup> This right is based on property rights; shareholders own the

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<sup>10</sup> Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law*, (Harvard University Press, Cambridge (Mass), 1991) at 68.

<sup>11</sup> In the event of winding up, creditors are the residual claimant and entitled to the assets of the company. They have the priority. The law has also acknowledged the creditors' rights when the company is insolvent/in financial difficulty by shifting the duty to creditors-see Chapter 5.

<sup>12</sup> Cheffins above n 8 at 54

company and as the residual claimant have the greatest stake in the outcome of the company's business.<sup>13</sup>

The premise that shareholders are owners of a corporation can be drawn from historical perspectives.<sup>14</sup> When the joint stock companies emerged during the end of the eighteenth and early nineteenth centuries, the structures of these companies were not much different from partnerships.<sup>15</sup> The concept of corporate personality and separate legal personality were foreign at the time and the shareholders were the company. During those times companies were managed by managers who were also shareholders. In managing those companies, director-owners would control all decision-making in the companies and the primary concern was to maximize profits, making as much possible.

Through time, the structures of companies began to change and so did the nature of shareholding in the company. The changes were prompted by the need to seek funds to finance public projects such as railways.<sup>16</sup> These high fixed assets companies were managed by directors who were merely agents of the shareholders. Companies continue to evolve from then on and with the concentration of economic power and wealth, the increasing size of corporations created a dispersion of ownership of shares. This, in turn, caused a weaker control over the company because share ownership was not concentrated in one person or group.

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<sup>13</sup> Ibid.

<sup>14</sup> See Chapter 4 of the thesis for the historical aspects of the corporations.

<sup>15</sup> David Millon "New directions in corporate law: Communitarians, contractarians and the crisis in corporate law" (1993) 50 Washington & Lee LR 1373 at 1379.

<sup>16</sup> Cheffins above n 8 at 541; Len Sealy 'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Monash U.L Rev 164 at 181; Thomas Telfer 'Risk and Insolvent Trading' in Ross Grantham and Charles Rickett (eds), *Corporate Personality in the 20th Century* (Hart Publishing Oxford, 1998) at 127- 128.

An empirical research study conducted in the United States and published by Berle and Means in 1932 highlighted amongst others, that shareholders' control over companies had weakened.<sup>17</sup> The study questioned the traditional logic of property; whether owners who had surrendered control to managers were entitled to the same benefits as owners who fully controlled their wealth. The findings indicated the concentration of economic power, i.e. economic activities, were mostly carried out by large enterprises resulting in a wide spread of stock ownership. As ownership becomes widely dispersed, the ownership of wealth and control lies less and less in the same hands. The ownership of wealth lies in the hands of shareholders who invest their money (wealth) in the company, while control is in the hands of the management who makes decisions on how this wealth should be managed.

In the research, Berle and Means divided control of companies into five categories ranging from total control through complete ownership which is usual in the family-controlled private companies, to the total management control due to widely scattered shareholdings so that none holds a minority control.<sup>18</sup> In between these two types of control in the management, there are majority control which deals with individual/small groups/companies who own a majority of shares in the corporation,<sup>19</sup> a control through legal device without a majority ownership<sup>20</sup> and a minority control.<sup>21</sup>

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<sup>17</sup> Adolf A Berle and Gardiner C. Means *The Modern Corporation and Private Property* (The Macmillan Company, New York, 1932); Adolf A Berle and Gardiner C. Means *The Modern Corporation and Private Property* (Revised ed., Harcourt, Brace & World, 1968).

<sup>18</sup> Ibid, at 67-84.

<sup>19</sup> Berle and Means regarded it as the first indication of separation of ownership and control. Most matters require a simple majority (51%) of votes to decide although some matters, such as alteration of the company's constitution, require a special resolution (75%) of votes. Hence, the majority shareholders will have no difficulty in voting in favour of their interests. See *ibid*, at 67-68.

<sup>20</sup> This type of control by using legal devices such as pyramiding, non-voting stock and voting trust are more suitable to the US systems than to the British Commonwealth.<sup>20</sup> It involves the usage of various methods to gain control in the company without having to own a majority of shares in it. Pyramiding is the majority shareholders in a corporation who own a majority of shares in another corporation and this process is repeated for a few times. This system gives the authority to the

The claim that shareholders' rights to exercise control stem from the ownership of shares<sup>22</sup> in the company has been subjected to dispute.<sup>23</sup> The rights accrued to shareholders on the basis that they have the proprietary interests in the company through ownership of shares though they are not the owners of the company's assets.<sup>24</sup> Gower described the usage of the word 'shares' as a misnomer since acquiring them in the company does not entitle shareholders to an interest in the company's assets.<sup>25</sup> However, he emphasised that owning shares in the company entitled them to become members of the company.<sup>26</sup>

Despite changes in the structures of the shareholding in the companies, the law remains the same; the management are required to ensure that shareholders' investments are managed to their advantage. Shareholders are entitled to the benefits of the increase in value of their investments and through distributions made by the

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corporation to control the other company though it does not own any shares in it. Voting trust is the creation of a group of trustees who have complete powers to vote for all shares placed in the trust without having them to own the shares. This legal mechanism illustrates the complete separation of ownership and control envisaged by Berle and Means. Non-voting stock involves arranging rights attached to different classes of shares and only a very small class or a class representing a very small investment is allowed to vote. Hence, a small ownership of this privileged class of shares is sufficient to control the company. See *ibid*, at 69-75.

<sup>21</sup> The shares in the company are widely dispersed so that none of the shareholders own a majority in the company. In order to acquire control over the company, a shareholder must be able to attract various owners to garner sufficient majority votes at the general meeting.

<sup>22</sup> John Farrar *Corporate Governance Theories, Principles and Practice* (3rd ed., Oxford University Press, South Melbourne, 2008) at 305 ["Corporate Governance"].

<sup>23</sup> Paddy Ireland *Company Law and the Myth of Shareholder Ownership* [1999] 62 MLR 32.

<sup>24</sup> This assertion is based on the historical reason where the early joint stock companies were viewed as a partnership where partners are also owners of the property. However, after the corporate personality principle was adopted, the company now owns the property and not the shareholders - see *Macaura v Northern Assurance Co Ltd* [1925] AC 619.

<sup>25</sup> Paul L. Davies Gower and Davies' *Principles of Modern Company Law* (8<sup>th</sup> ed., Sweet & Maxwell, London, 2008) at [23-2].

<sup>26</sup> *Ibid*.

company, normally in the form of dividend.<sup>27</sup> This misconception lies in the failure of company law to appreciate the full implications of separate legal entity.<sup>28</sup> The law fails to consider that the company is an entity of its own and is separate from its shareholders.<sup>29</sup> Hence, the interpretation that the company's interest is equivalent to the shareholders has totally ignored this fundamental principle in company law.

The law also imposes duties on directors to act honestly according to their judgment for the interests of the company. The interests of the company have long been decided as being the shareholders' interests since directors are managing the company on behalf of shareholders. In addition, directors are subjected to fiduciary duties such as the duty to exercise their powers for proper purpose as well as using their care, skills and experiences. Directors have to exercise these duties for the purpose of advancing the interests of shareholders and failure to do so will result in liability.<sup>30</sup>

Shareholders can exercise rights to vote and can replace directors if they are not satisfied with director's performances, although in reality, directors' market power,

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<sup>27</sup> Company Law Review Steering Group "Modern Company Law For a Competitive Economy: The Strategic Framework" A Consultation Document (DTI, London, 1999) <<http://www.bis.gov.uk/files/file23279.pdf>> at June 2010 at [5.1.5].

<sup>28</sup> Ireland above n23 at 48. The writer argued that the concept of shareholders ownership dated from the early emergence of the joint stock company which was similar to partnership. At the time, shareholders and companies were identified as one with the company and shareholders shared property in common as partners in partnership. However, as a result of separate legal entity, shareholders no longer retain that rights to property and their interests in the company "are simply bundles of contractual and statutory rights which the shareholder has against the company" - Robert Pennington *Company Law* (6<sup>th</sup> ed., Butterworths, London,1990) at 56. The shareholders' positions in these circumstances are similar to the creditors.

<sup>29</sup> John Farrar "Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance" (1998) 10 Bond LR 142 at 147 [Frankenstein]; Otto Kahn-Freund "Some Reflections on Company Law Reform" (1944) 7 MLR 54 at 55.

<sup>30</sup> See *Re Smith & Fawcett Ltd* [1942] 1 All ER 542; *Heron International Ltd v Lord Grade* [1983] BCLC 244; *Foss v Harbottle* (1843) 2 Hare 461; however, different considerations apply when the company is insolvent or near insolvent in which case, directors owe duty to creditors- see *Walker v Wimborne & Ors* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722.

particularly lack of effective management skills on the part of shareholders and the influence management has over information may inhibit shareholders from enforcing remedies provided by the law.<sup>31</sup> Further, dispersal of ownership weakens shareholders voting power which causes problems for them in co-ordinating the use of voting rights.<sup>32</sup>

Dispersal of ownership can also lead to the possibility of directors engaging in opportunistic behaviour at the expense of the corporation and shareholders.<sup>33</sup> To avoid this, shareholders will need to monitor the directors and this is known as the agency costs.<sup>34</sup> The existence of the duty to act in the interests of shareholders and other fiduciary duties will compel directors to be accountable for their actions and reduce the agency costs.<sup>35</sup>

Fama, however, reasoned that dispersed ownership and control can lead to corporate efficiency.<sup>36</sup> Instead of being disciplined by shareholders, he explained that competition with other companies in the market will self regulate the management teams' performance.<sup>37</sup>

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<sup>31</sup> The Steering Report above n27 at [5.1.5].

<sup>32</sup> Ibid.

<sup>33</sup> Cheffins above n8 at 106-107.

<sup>34</sup> Eugene F. Fama "Agency Problems and Theory of the Firm" (1980) 88 J. Polit. Economy 288 at 290-292; ; Ian M Ramsay "Holding Company Liability for the Debts of an Insolvent Company: A Law and Economic Perspective" (1994) 17 UNSWLJ 520 at 535-537; [Corporate Objective]; Michael Jensen and William Meckling "Theory of the firm: Managerial behaviour, agency costs and ownership structure" (1976) 3 J Finan.Econ 305 at 308-310.

<sup>35</sup> Ibid; Farrar 'Frankenstein' above n29 at 154.

<sup>36</sup> Fama above n 34 at 308-310.

<sup>37</sup> Ibid.

The theory is based on the premise that shareholders are vulnerable compared to other parties in the company. Creditors for example, can safeguard their interests by adjusting interest rates according to the risks involved, while employees<sup>38</sup> can negotiate terms in their favour in the contracts of employment.<sup>39</sup> Maximising shareholders' wealth would encourage efficient allocation of resources and avoid wastage. By concentrating on the interests of one particular group in the company, directors would be able to discharge their duty effectively and it would be easier for the courts to monitor and review management conduct.<sup>40</sup> Other stakeholders would eventually benefit from this principle because maximising the profits of the company would result in the company's financial stability.<sup>41</sup> It reduces the risks of creditors not being paid; employees will benefit from the continuing operations and this will inevitably benefit the community as well as the economy as a whole.<sup>42</sup>

The law has provided that creditors' interests override those of shareholders when the company is insolvent<sup>43</sup> and there are other provisions which are intended to protect creditors under insolvency law<sup>44</sup> and under the law of distribution. However, these laws do not provide any direct access for creditors to take part in the

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<sup>38</sup> See Katherine van Wezel Stone "Policing Employment Contracts within Nexus-of-Contracts Firm" (1993) 43 *Uni. Toronto LJ* 353. The writer challenged the theory that have employees an ability to protect themselves through contracts; see also Jeffrey G. MacIntosh "Designing an Efficient Fiduciary Law" (1993) 43 *Uni. Toronto LJ* 425.

<sup>39</sup> *Ibid.*

<sup>40</sup> Key "Ascertaining the Corporate Objective : an Entity Model and Sustainability Model" (2008) 71 *MLR* 663 at 668-669 ['Corporate Objective'].

<sup>41</sup> *Ibid.*, at 669.

<sup>42</sup> *Ibid.*; see also Andrew Key "Enlightened Shareholder value, the reform of the duties of company directors and corporate objectives" (2006) *LMCLQ* 335.

<sup>43</sup> *Walker v Wimborne & Ors* (1976) 137 *CLR* 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 *NSWLR* 722; see also chapter 5.

<sup>44</sup> For examples of provisions relating to antecedent transaction in the statute- see Chapter 11 of the thesis.

management of the companies. Creditors could not restrain companies or directors from any actions even if they fear these would lead to the company's failure. Even when the company is in liquidation, generally the right to take action against the company or directors is not conferred on creditors but on the liquidator.

### **6.2.1 Limitations of the Theory**

The shareholder supremacy theory concentrates on the objective of increasing the shareholders' value. However, it does not provide a clear explanation as to what constitutes shareholders' value.<sup>45</sup> It is unclear whether directors should focus on generating short term profits for shareholders or on the company's long term profitability. The absence of exact definition causes difficulty to creditors in assessing whether they have fulfilled the said objectives, especially when shareholders themselves may not have homogenous interests in the company.

The theory has also been regarded as restricted in two ways. First it does not acknowledge investors' ability to diversify.<sup>46</sup> In other words, the theory does not take into account the possibility of shareholders having multiple roles; it only considers their interests as shareholders alone.<sup>47</sup> Second, the theory may discourage those other than shareholders to invest in the company since they know that their interests will be subordinate to shareholders'.<sup>48</sup>

Under the theory, shareholders are motivated to monitor the directors in order to protect their investment, but shareholders seldom exercise effective control over

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<sup>45</sup> Keay, "Corporate Objective" above n40 at 670.

<sup>46</sup> Ibid.

<sup>47</sup> Ibid.

<sup>48</sup> Ibid.

management due to dispersed ownership.<sup>49</sup> In addition, the theory only benefits shareholders and does not increase social wealth as a whole.<sup>50</sup> For example, in order to increase shareholders' wealth, the company may decide to invest in a project which may endanger the ecosystem or may result in the business' closure.<sup>51</sup> In addition, shareholders are not the only group affected by the company's fate, for others such as creditors, employees, customers and communities have also invested in the company's well-being. As such, it defeats the proposition that shareholders' interests merit protection because they are residual claimants.

### 6.3 Stakeholders Theory

Over time, various factors such as the development of new production processes, new technologies, demographic factors, and social and political forces have resulted in changes in corporate structures.<sup>52</sup> These changes caused other players, apart from shareholders, to become an integral part of the companies and have become more influential than their traditional role.<sup>53</sup>

Traditionally, these stakeholders are considered as outsiders and would be able to negotiate favourable terms in contracts in order to protect themselves.<sup>54</sup> These

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<sup>49</sup> Berle and Means above n10 at 67.

<sup>50</sup> John Parkinson *Corporate Power and Responsibility* (Clarendon Press, Oxford, 1993) at 272.

<sup>51</sup> Ibid.

<sup>52</sup> R. Edward Freeman *Strategic Management: A Stakeholder Approach* (Pitman, Boston, 1984) at 5.

<sup>53</sup> Ibid.

<sup>54</sup> See Paul Halpern, Michael Trebilcock and Stuart Turnbull "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 *Uni. Toronto LJ* 117 at 139-145; Frank H. Easterbrook and Daniel R. Fischel "The Corporate Contract" (1989) 89 *Columbia LR* 1416 at 1428-1434; Frank H. Easterbrook and Daniel R. Fischel "Limited Liability and the Corporation" (1985) 52 *Uni. Chi.L.R* 89 at 104-107; Ramsay above n34 at 522-523.

players' interests intertwine with one another with each contributing to the success of the company. In order to ensure the overall success of the company, the management should take into consideration the interests of various key players in the company, and not concentrate on a particular group, hence the emergence of the stakeholders' theory. In other words, directors are allowed to prioritise the interests of one group of stakeholders over the others as long as it is for the long term benefit of the company.<sup>55</sup>

The stakeholders' theory rests on the theory of organizational management and ethics requiring management to reflect the interests of those whose contribution results in either promoting or frustrating the company's objectives.<sup>56</sup> It asserts that maximising shareholders' wealth is no longer suitable in the modern corporate structure since shareholders are not the only bearers of residual risks.<sup>57</sup> Discussion on this issue has intensified with the current development of industrial relations, as well as economic theories.<sup>58</sup> Moreover, it also reflects the progressive and effective means of corporate governance, since it involves considering the interests of various groups which form part of the company as well as the benefits that accrue to society as a whole.

Freeman refers to stakeholders as groups of constituents who have legitimate claims on the firm, established through the existence of an exchange relationship and each can be seen as supplying the corporation with critical resources.<sup>59</sup> They are

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<sup>55</sup> Helen Anderson "Creditors' Rights of Recovery: Economic Theory, Corporate Jurisprudence and the Role of Fairness" (2006) MULR 1 at 24.

<sup>56</sup> Robert Phillips *Stakeholder Theory and Organizational Ethics* (Barret-Koehler, San Francisco, 2003) at 15-16.

<sup>57</sup> Kelly and Parkinson above n5 at 122.

<sup>58</sup> Andrea Corfield "The Stakeholder Theory and its Future in Australian Corporate Governance: A Preliminary Analysis" (1998) 10 Bond L.R 213 at 213.

<sup>59</sup> Freeman above n52 at 25; Charles W.L. Hill and Thomas M. Jones "Stakeholder-Agency Theory" (1992) *J. Manage Studies* 131 at 133.

considered as stakeholders based on the stakes they have put into the corporation. Shareholders provide capital, and in exchange expect the return of their investment.<sup>60</sup> Creditors lend finances or supply goods, hoping for payment to be made on time.<sup>61</sup> Employees contribute human capital to the company in exchange for remuneration and safe working conditions.<sup>62</sup> Consumers' interests are vested in the products of the company which they expect to be safe and to provide value for money. The local community's interests in the company would include the possibility of employment, developing the local area and ensuring that the local environment is protected. Each of these groups has a different magnitude of claims in the company, depending on the costs in producing their inputs.<sup>63</sup>

The UK incorporated into the Companies Act 2006 the duty on directors to act in good faith in a way he or she considers would likely to promote the success of the companies. The duty to promote the success of the company is translated by the Act as acts which will benefit its members as a whole. Therefore, the duty under section 172 of the Companies Act 2006 does not differ from the common law principle which equates the interests of company to the interests of shareholders.

The section also includes the need for directors to have regard to other factors listed in the section; the employees, suppliers, customers, environment and others.<sup>64</sup> It is

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<sup>60</sup> Hill and Jones *ibid.*

<sup>61</sup> *Ibid.*

<sup>62</sup> *Ibid.*

<sup>63</sup> *Ibid.*

<sup>64</sup> Section 172(1) of the UK Companies Act 2006 provides "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- (a) the likely consequences of any decision in the long term;
- (b) the interests of the company's employees;
- (c) the need to foster the company's business relationships with suppliers, customers and others;

important for directors to build long-term and trusting relationships with these other stakeholders in order to secure the long term success of the company.

The duty under the section nevertheless does not create any rights for the persons listed, other than the shareholders and the company, to bring action for breach of the provisions. The law still operates within the confines of fiduciary duty, namely duty to act in the interests of the company. Section 172 only requires directors to consider their wider role in discharging their duty to act in good faith for the interests of the company.

Directors are obliged to consider the interests of other stakeholders under the Act but this does not mean they have to include every interest in the decision-making. The paramount duty is still to the long term success of the company and not to any other parties. The section, in fact, may be used by directors as defence against claims by shareholders for breach of duty. Directors can argue if shareholders take action that the action taken is made after considering the interest of other stakeholders and in their honest belief it is for the benefit of the company.

### **6.3.1 Creditors**

The duty to consider the interests of creditors is not a new concept and has been accepted by courts in situations where a company's financial stability is in doubt.<sup>65</sup> There is voluminous literature both for and against the duty to consider the interests

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- (d) the impact of the company's operations on the community and the environment;
  - (e) the desirability of the company maintaining a reputation for high standards of business conduct; and;
  - (f) the need to act fairly as between members of the company.

<sup>65</sup> See cases in Chapter 5.

of creditors, and both arguments are based on the economic analysis of efficiency and fairness.<sup>66</sup> Those supporting the duty argued that creditors are vulnerable, like shareholders, and require protection from the law. On the other hand, those who are against the imposition of this duty insisted that such duty is redundant since creditors can rely on the market and are well able to negotiate favourable terms with the company.<sup>67</sup>

Among the mechanisms available for creditors to safeguard their interests are a) negotiating favourable terms in the contracts; b) insisting on guarantee or security, and c) other self help mechanisms.

a) negotiating favourable terms in the contracts

Creditors can protect themselves by negotiating with the company and because they have better access to information, they will be able to gauge the risks entailed. Hence they can adjust the interest rate so that lending is proportionate to risks incurred. Any changes in the company will be of importance to creditors and they can include in the contracts restrictions on the company's activities to ensure the availability of the assets in the event of winding up.<sup>68</sup> Creditors can also include in the contracts a requirement for the company to furnish them with frequent financial information.<sup>69</sup> Creditors are also aware of the possibility of directors increasing the level of riskiness after the contract has been made and will prepare against such occurrence by adjusting the interest rate.<sup>70</sup>

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<sup>66</sup> See; Vanessa Finch "The Measures of Insolvency law" (1997) 17 OJLS 227 ["Measures"]; Roy Goode "Is the Law too Favourable to Secured Creditors? (1983-1984) Can. Bus LJ 53; Rizwaan Mokal "On Fairness and Efficiency" (2003) 66 MLR.

<sup>67</sup> See David Wishart "Models and Theories of Directors' Duties to Creditors" (1999) 14 NZULR 323.

<sup>68</sup> Halpern, Trebilcock and Turnbull above n54 at135.

<sup>69</sup> Ibid.

<sup>70</sup> Ibid.

Despite having included favourable terms in the contract, creditors cannot foresee all contingencies and there are bound to be lacunae in the contracts. In addition, not all creditors have access to information and can dictate terms of contracts in their favour, small creditors often do not have the choice.<sup>71</sup> For small creditors, the costs of negotiating and drafting the contract may exceed the value of the contract itself and therefore it may not be worthwhile to pursue it.<sup>72</sup>

b) insisting on guarantee or security

Since contractual terms used by creditors are limited by unforeseeable risks, and the monitoring of costs is only effective if the benefit is greater than costs incurred, security is used as device to reduce costs.<sup>73</sup> Security is perceived to be more cost effective than the costs of investigating the creditworthiness of debtors as well as costs of monitoring them.<sup>74</sup> Creditors prefer the use of security because they are not subject to the *pari passu* principle<sup>75</sup> in the event the company is wound up. The assets which are subjected to security are not part of the general assets of the company to be distributed among the general creditors by the liquidator. Unsecured creditors may be discouraged from filing a winding petition if most of the company's assets are subject to security and thus will avoid premature liquidation. Creditors can also threaten to realize the security if the company fails to supply relevant information in order for them to make an accurate assessment of the company's

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<sup>71</sup> Ramsay above n34 at 523

<sup>72</sup> Ibid; see also Cheffins above n8 at 503.

<sup>73</sup> Vanessa Finch "Security, Insolvency and Risk: Who Pays the Price?" (1999) 62 MLR 633 at 641 ["Security"].

<sup>74</sup> Ibid.

<sup>75</sup> *Pari passu* is one of the insolvency principles in which proceeds of realisation is to be paid to creditors in proportion according to the quantity of debts owed. See Finch "Security" above n73 at 634; Roy Goode *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London, 2005) at [7-01]-[7-04].

financial position. They can also demand to have a representative on the company's board of directors.

In spite of the advantages of using security, not many creditors resort to it. This is because the creation of security in favour of one creditor will increase the risks faced by other creditors because the expected value of the assets have been reduced.<sup>76</sup> Creditors who are aware of this arrangement can minimize the risks by insisting on their own security or by adjusting the rate accordingly<sup>77</sup>. However, the ability to fix such provisions would only be achieved if all creditors were equal. In reality, creditors are not equal, large creditors such as banks and other financial institutions may be able to dictate their terms of credit to the debtor company, but other small creditors may lack necessary information to enable them to do so.<sup>78</sup> The insufficiency of resources, expertise and time to evaluate the risks may deter them from demanding security.<sup>79</sup> Moreover, the nature of their products and business arrangements<sup>80</sup> may not allow them to make appropriate adjustments.

c) other self help mechanisms.

Other options available to creditors are to utilize self help remedies such as the retention of title clause<sup>81</sup> in the contract of supply. This self help remedy or quasi-security is, however, a difficult and complex subject which involves insolvency law

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<sup>76</sup> Finch "Security" above n73 at 641.

<sup>77</sup> Ibid, at 644- 645.

<sup>78</sup> Ibid, at 638-639.

<sup>79</sup> Ibid.

<sup>80</sup> Vanessa Finch "Directors' Duties: Insolvency and the Unsecured Creditors" in Alison Clarke (Ed.) *Current Issues in Insolvency Law* (Sweet & Maxwell, London, 1999) 87 at 90 the writer gave example of the feasibility of newsagent to negotiate for security for every paper delivery.

<sup>81</sup> Retention of title clause is a stipulation that ownership in goods will not pass until full payment been made. See the case of *Aluminium Industries Vaasen BV v Romalpa Aluminium Limited* [1976] 1 WLR 676. See also Report of the Review Committee on Insolvency Law and Practice (Cmd 8558, 1982) at [1618] [Cock Report].

at the intersection of a number of different areas of law. The effect of this device is to transfer assets covered under such clause out of the reach of small creditors. Therefore, the same defects mentioned above still exist at the expense of small creditors who remain unsecured.

Contractarians who disagree with the additional duty imposed on directors to take into account creditors' interests, insist that it will restrict directors from the risk-taking which is commonly associated with businesses.<sup>82</sup> Their arguments are mostly founded on the law and economic perspectives. They argue that directors will be pressured to adopt defensive measures in order to protect themselves from liability.<sup>83</sup> They will not be willing to venture into new, risky projects for fear that they will be liable in the event such venture fails to materialize.<sup>84</sup> In addition, the imposition of an additional duty on directors will encourage directors to put the company into premature liquidation rather than face the possibility of personal liability, and would certainly change the role from active management to passive assets preservation.<sup>85</sup> Thus, it will reduce the net value of the corporation because of the directors' decision not to invest in the projects which would have a positive net value to the firm.<sup>86</sup>

The Contractarian assumes a perfect market scenario and that creditors have equal bargaining power.<sup>87</sup> Creditors can negotiate with the company and adjust the interest rate in accordance with the risks involved.<sup>88</sup> Creditors can also insist on guarantees

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<sup>82</sup> Cheffins above n8 at 541; Andrew Keay *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish, London, 2007) at 310-311 ["Company Directors"].

<sup>83</sup> Keay "Company Directors" above n82 at 310.

<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.*

<sup>86</sup> *Ibid.*

<sup>87</sup> Cheffins above n8 at 81-82; Finch "Measures" above n66 at 233.

<sup>88</sup> *Ibid.*

or additional security or other self help remedies<sup>89</sup> in order to protect them further when extending credit to the firm. There are also existing statutory provisions<sup>90</sup> in the Companies Acts as well in the Insolvency legislation which are deemed sufficient to protect creditors. Common law cases have also provided ample protection to creditors when the company is on the brink of insolvency. Communitarians, on the other hand, reason that when the company is insolvent, creditors' rights are transformed into equity-like rights and they become the major stakeholders in the company.<sup>91</sup>

The creation of an additional duty to include considering creditors' interests does not mean that the directors' hands are tied and cannot in any circumstances involve risks in decision-making. To do so would undermine the basic foundation of a corporation to create wealth, and directors make decisions on commercial activities associated with risk on a daily basis. On the other hand, directors should not be given a free rein to engage in excessively risky investments if the company's financial position does not allow them to do so. What is required from the directors is for them to be prudent and to acquire information in order to consider various interests before making any decisions.

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<sup>89</sup>These refer to arrangements creating security devices such as reservation of title, hire purchase agreements or lien. The key aspect of these agreements is to enable the company to raise funds while titles remain with creditors. This allows creditors to avoid the having to compete with other creditors in the event company is subjected to insolvency proceedings (Vanessa Finch *Corporate Insolvency Law Perspective and Principles* (2<sup>nd</sup> ed., Cambridge University Press, Cambridge, 2009 at 77-79).

<sup>90</sup> See for example see section 127 of the UK Insolvency Act 1986; section 292 of the New Zealand Companies Act 1993; sections 223 & 292 of the Malaysian Companies Act 1965; section 588FJ of Australian Corporations Act 2001.

<sup>91</sup> Key "Company Directors" above n82 at 338-340.

Directors must weigh any particular decisions in good faith and belief that any action taken is in the furtherance of the company's interests in the future.<sup>92</sup> If they do so, it will be very difficult for the court to find them liable for failure to consider creditors' interests. Case law has suggested that as long as directors have acted in good faith they will be protected from liability even when their decisions are not in the shareholders' best interests.<sup>93</sup> When making decisions on the issue of whether directors have breached the duty to consider creditors interests, courts would have to look at various aspects and balance them accordingly before making any judgment.

The courts' function to decide whether directors have breached their duty has also been subjected to scrutiny. The concern is whether courts are the appropriate forum to decide on risk-taking since judges do not have expertise in commercial matters.<sup>94</sup> Some decided cases,<sup>95</sup> however, have proved otherwise, with judges giving thought to various considerations before making decisions. In *Facia Footwear Ltd (in administration) v Hinchliffe*,<sup>96</sup> the court emphasized that there has not always been a clear perimeter between acceptable risks and non-acceptable risks, hence careful consideration is important. These cases have demonstrated that despite having to consider various competing interests, judges are able to make fair and competent

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<sup>92</sup> Gregory V. Varallo and Jesse A. Finkelstein "Fiduciary Obligations of Directors of the Financially Troubled Company" (1992) 48 Bus Law 239 at 243.

<sup>93</sup> *Re W & M Roith Ltd* [1967] 1 WLR 432; *Punt v Symons & Co Ltd* [1903] 2 CH 506; *Hoggs v Cramphorn Ltd & Ors* [1967] Ch 254.

<sup>94</sup> Cheffins above n8 at 543.

<sup>95</sup> See decisions in *Nicholson v Permakraft (NZ)* (1985) 3 ACLC 453; *Re Welfab Engineers Ltd* [1990] BCC 600; *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465; *Brady v Brady* (1988) 3 BCC 535 where court have considered various factors and decided in favour of the directors.

<sup>96</sup> [1998] 1 BCLC 218 at 228.

assessments on directors' conduct.<sup>97</sup> Thus it is ill-founded to assume that because of their legal background judges will make decisions based on their hindsight.<sup>98</sup>

The introduction of an additional duty on directors may also encourage them to take out insurance policies in order to protect themselves against possible liability.<sup>99</sup> The utilization of insurance could increase moral hazard because payment will now be made from the insurance funds and not from the directors' personal wealth.<sup>100</sup> Therefore, it could undermine the very purpose of the introduction of additional duty which is to ensure that the directors' action would not prejudice the creditors' interests.<sup>101</sup> There is also a possibility that directors will enter into highly risky projects at the expense of both creditors and shareholders since any liability incurred will be paid by the insurance company.<sup>102</sup>

Another aspect which concerned contractarians is the increased monitoring and agency costs which would result in less efficient allocation of resources.<sup>103</sup> Directors would engage in extra monitoring of the decisions made in order to minimize the risks.<sup>104</sup> Directors will take precautions in order to protect themselves by making investigations in order to determine whether their action will actuate insolvency.<sup>105</sup>

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<sup>97</sup> Key "Company Directors" above n82 at 314.

<sup>98</sup> Ibid.

<sup>99</sup> Vanessa Finch "Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance" (1994) 57 MLR 880 at 887-892; Halpern, Trebilcock and Turnbull above n54 at 138-145; Key "Company Directors" above n82 at 327-328.

<sup>100</sup> Ibid.

<sup>101</sup> Ibid.

<sup>102</sup> Ibid.

<sup>103</sup> Key "Company Directors" above n82 at 315.

<sup>104</sup> Ibid.

<sup>105</sup> Ibid.

Directors will also enlist the service of expert opinion before deciding, and the time taken in deliberating will increase the costs.<sup>106</sup> The rise in the agency costs is a matter of concern to shareholders because the growth in costs does not coincide with the degree of profit making.<sup>107</sup>

It should be noted that monitoring is one of the most useful mechanisms in corporate governance and can be used in order to improve the management as well as the company's operations as a whole.<sup>108</sup> Monitoring would involve directors deliberating, investigating, analysing, interpreting and reviewing every decision they make.<sup>109</sup> Directors will be able to identify any shortcomings and to ameliorate any weaknesses identified. Consequently, it promotes good management ethics and all stakeholders in the company will benefit.<sup>110</sup>

### **6.3.2 Employees**

Employees' interest was not mentioned in any earlier companies' legislation due to various factors. Firstly, unlike shareholders who risked their investment, employees were not seen as risk providers.<sup>111</sup> Since employees did not risk anything in the business operation, they should not be allowed to claim the residual benefits from such transactions. Secondly, they were perceived as having no legitimate interests in

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<sup>106</sup> Ibid, at 316.

<sup>107</sup> Ibid.

<sup>108</sup> Ibid.

<sup>109</sup> Ibid.

<sup>110</sup> Ibid.

<sup>111</sup> David Milman "From Servant to Stakeholder: Protecting the Employee Interest in Company Law" in David Feldman and Frank Meisel (Eds) *Corporate and Commercial Law: Modern Development* (Lloyd's of London Press, London, 1996) 147 at 149.

the company or were seen as outsiders rather than an integral part of the company.<sup>112</sup> In *Hampson v Price's Patent Candle Co*,<sup>113</sup> the court allowed employees' interests to be considered as long as it was in accordance with the shareholders' interests. The Court of Appeal in *Hutton v West Cork Rly Co Ltd*<sup>114</sup> held that the company had acted *ultra vires* in making gratuitous provisions for past and present employees. The majority however, were of the view that management could consider employees' interests as long as they benefited the company.<sup>115</sup>

In the case of *Parke v Daily News Ltd*,<sup>116</sup> the company sold one of its two newspapers in order to avoid insolvency. The proceeds from the sale of such assets were to be paid to employees by way of compensation for dismissal. Shareholders objected and brought an action against the directors on the ground that such move was *ultra vires*. The court held that the payment was not made in furtherance of the company's interests. It also found that such action was detrimental to shareholders and to the company as a whole. In normal circumstances, payment to employees can be regarded as in the company's interests since it provides motivation to increase productivity and improve labour relations. However, such an issue did not arise in the case since the company was on the verge of insolvency and the employees had been made redundant. Generally, directors have no duty to consider employees' interests, apart from those stated in the employment legislation, such as their safety and health while at work.

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<sup>112</sup> Ibid at 148.

<sup>113</sup> (1876) 45 LJ Ch 437.

<sup>114</sup> (1883) 23 Ch D 654.

<sup>115</sup> 1883) 23 Ch D 654 at 672.

<sup>116</sup> [1962] Ch 927.

Contractarians regard employees in terms of costs of production, and therefore for the purpose of efficiency, these need to be minimized.<sup>117</sup> The stakeholder approach, on the other hand, treats employees as assets that need to be preserved and protected.<sup>118</sup> Common law has been reluctant to consider such an approach, despite criticisms being made for such an unfriendly attitude towards employees.<sup>119</sup> It was not until the UK Companies Act 1985 that employees' interests finally came into the picture. Directors, when discharging their duty, were required under Section 309 to consider the interests of employees, apart from shareholders' interests.<sup>120</sup>

However, their duty remained to the company and only shareholders would have the right of action against any wrongdoing committed by the directors.<sup>121</sup> Hence, despite having their interests well written in the legislation, employees did not have the right to enforce such provision unless they happened to own shares in the company. Section 172(1)(b) of the Companies Act 2006 which replaces section 309(1) requires a director to have regard to the interests of the employees in discharging his duty under the Act.<sup>122</sup> The right to take action against directors who failed to adhere to

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<sup>117</sup> Milman above n111 at156.

<sup>118</sup> Ibid.

<sup>119</sup> Ibid.

<sup>120</sup> Section 309(1) of the UK Companies Act 1985 provided "The matters to which the directors of the company are to have regard in the performance of their function include the interests of the company's employees in general, as well as the interests of its members." See also section 132 of the New Zealand Companies Act 1993.

<sup>121</sup> Section 309(1) of the UK Companies Act 1985 provided "Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors."

<sup>122</sup> Section 172(1) of the UK Companies Act 2006 provides "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers and others,

such provision, however, remains with shareholders.<sup>123</sup> The Malaysian Companies Act 1965 empowers directors to establish and support various resources calculated to be for the benefit of present and past employees and their dependents.<sup>124</sup> In light of this, the Corporate Law Reform Committee (CLRC) viewed the existing provision as sufficient to protect the interests of creditors.<sup>125</sup>

In reality, employees are as vulnerable as shareholders for they will be affected by the outcome of the company's operation. They may be subjected to redundancy, unpaid wages, unfair dismissal, industrial accidents and other incidents.<sup>126</sup> Further, employees cannot diversify their risks like shareholders who can do so by investing in many companies.

Though some of the incidents are external factors out of the company's control, the fact remains that employees are vulnerable. While shareholders can rely on law to protect them, employees are not privy to such protection. Like creditors, employees are expected to protect themselves through negotiation processes which are incorporated in the terms of contracts. The principle used here is again freedom of contract where both parties are free to bargain terms in their favour and to reach a compromise. In reality, employees do not have the bargaining power to demand

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- (d) the impact of the company's operations on the community and the environment,
  - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
  - (f) the need to act fairly as between members of the company."

<sup>123</sup> See section 178(2) of the UK Companies Act 2006: "The duties in those sections (with the exception of section 174 (duty to exercise reasonable care, skill and diligence) ) are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors."

<sup>124</sup> See para 7 of Third Schedule of the Malaysian Companies Act 1965.

<sup>125</sup> Malaysia Company Law Reform Committee "A Consultative Document on Clarifying and Reformulating the Directors' Role Duties, Corporate Law Reform Committee" (2006) at [4.7]. [CLRC Clarifying and Reformulating the Directors' Role Duties]

<sup>126</sup> Cheffins above n8 at 91.

terms to their liking, they either have to accept what has been offered or leave the employment.

Employees' rights include the right to information and consideration in decision-making, rights to financial interest including salary and rights to enjoy continuing employment opportunity.<sup>127</sup> While the company is a going concern, employees expect to be consulted and informed on matters affecting their interests. In cases where employees have been informed and consulted, for example on investments or relocation decisions, the economic well-being of the local community is better served compared to when decisions are made by a distant board or dispersed and remote investors.<sup>128</sup> Employees' participation in decision-making will promote greater efficiency by producing better teamwork and at the same time increasing productivity.<sup>129</sup> High productivity and motivation on the part of employees will certainly benefit the company as a whole.

Employees sometimes find themselves being thrust into the creditors' role for claims of unpaid wages. Insolvency legislation has given employees priority status in respect of some portion of unpaid wages.<sup>130</sup> The priority status is given only to amounts mentioned in the statute; employees will be considered as unsecured creditors for claims above the specified sums. The preferential status conferred by the legislation, however, is not of much assistance to employees since they are ranked after fixed charge holders. Creditors can resort to other measures in order to defeat the employees' claim, for example the creation of automatic crystallisation of floating charges which gives the floating charge holder priority over employees'

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<sup>127</sup> Milman above n101 at 147.

<sup>128</sup> Parkinson above n50 at 398.

<sup>129</sup> Ibid.

<sup>130</sup> Section 292(1)(b) of the Malaysian Companies Act 1965; Schedule C Category 4 of the UK Insolvency Act 1986; section 556(1)(e)-(h) of the Australian Corporations Act 2001; Schedule 7 (2) (a) and also section 312 of the New Zealand Companies Act 1993.

claims. In addition, the usage of self remedies such as retention of title clauses, lien and hire purchase will result in the assets being taken out of the pool for distribution to creditors. Hence, despite the priority status, employees may not be able to claim the benefits because the assets of the company are no longer available for distribution.

Employees will also be vulnerable when the company is in the stage of closure of business where they will face the uncertainty of termination of employment. Contractarians argue that the company has no duty to ensure continuance of employment and employees are free to seek employment elsewhere. When the economy is vibrant and there is full employment, it may be relatively easier to find an alternative. Otherwise, it might be difficult for employees to seek other work, especially when it involves highly specialized skilled workers.

### **6.3.3 Other Stakeholders**

#### **6.3.3.1 Consumers<sup>131</sup>**

Other stakeholders who may be affected by the company's action include consumers and local communities. When the management is making decisions on the company's future investments, customers' interests will have to be one of the paramount concerns.<sup>132</sup> This is because customers would expect to receive safe and reliable products from the company.<sup>133</sup> In addition, they anticipate that they will receive fair exchange and value for money. Failure on the part of the management to take into account consumers' interests will cause them to go to competitors or even

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<sup>131</sup> See section 172(1)(c) of the UK Companies Act 2006 which requires a director to consider the need to foster the company's business relationships with suppliers, customers and others.

<sup>132</sup> Parkinson above n50 at 261

<sup>133</sup> Freeman above n52 at 25.

to boycott the company.<sup>134</sup> The company may, as a result of consumer reaction, be forced out of business.

### **6.3.3.2 Local Communities<sup>135</sup>**

Though their action may not be immediate and direct, the local community may influence the government by lobbying for regulation of the company's policies in respect of the use of land and disposal.<sup>136</sup> Further, they can also influence the government's decision on tax policy which could affect the company's business.<sup>137</sup> Without good relations with the local communities, it will be difficult for the company to maintain its goodwill.<sup>138</sup> Hence, the current trend is for the company to be involved with the local community as part of its social responsibility. Many large corporations are involved with education and environmental programmes as part of their contribution to the communities.

### **6.3.3 Limitations of the Stakeholders Theory**

Despite continuing recognition, there are many criticisms of the theory that have been discussed in the literature. Firstly, by serving the interests of many groups, the theory resurrects the agency problem because it provides better opportunity for unscrupulous directors to act in their own interests.<sup>139</sup> Directors have wide

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<sup>134</sup> Ibid.

<sup>135</sup> See section 172(1) (d) of the UK Companies Act 2006 which requires a director to consider the impact of the company's operations on the community and the environment.

<sup>136</sup> Freeman above n52 at 25.

<sup>137</sup> Ibid.

<sup>138</sup> Parkinson above n50 at 267.

<sup>139</sup> Hill and Jones above n59 at 145; Phillips above n 56 at 19-20; Keay "Corporate Objective" above n40 at 677.

discretionary powers and are able to play groups against one another by claiming that their actions benefit some groups. The problem of granting discretion to directors was emphasised by the Company Law Review Steering Group, which stated:

in particular that this would impose a distributive economic role on directors in allocating the benefits and burdens of management of the company's resources; that this role would be uncontrolled if left to directors in the form of a power or discretion; and that a similarly broad role would be imposed on the judges if the new arrangement took the form of an enforceable obligation conferring rights on all the interested parties to argue for their interests in court.<sup>140</sup>

In addition, the Hampel Report accentuated the limitation of the theory when it stated:

To redefine the directors' responsibilities in terms of the stakeholders would mean identifying all the various stakeholder groups; and deciding the extent and nature of the directors' responsibility to each. The result would be that the directors were not effectively accountable to anyone since there would be no clear yardsticks for judging their performance. This is a recipe neither for good governance nor for corporate success.<sup>141</sup>

Nevertheless the Report acknowledged that in order to successfully pursue the long term objectives of shareholder value, it is essential to foster and maintain good relationships with all stakeholders.<sup>142</sup>

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<sup>140</sup> The Steering Report above n27 at [2.12].

<sup>141</sup> Final Report of the Committee on Corporate Governance (London, January 1998) at [1.17]. <[http://www.ecgi.org/codes/documents/hampel\\_index.htm](http://www.ecgi.org/codes/documents/hampel_index.htm)> at 1 March 2009 [Hampel Report].

<sup>142</sup> Ibid at [1.18].

On the other hand, the duty owed to many stakeholders can also lead to directors being more accountable because they will be answerable to one group or the other who is not satisfied with their action.<sup>143</sup> Hence, directors will have to take precautions to reassure all groups or be able to provide satisfactory explanations for their actions.<sup>144</sup> The possibility of being questioned by one of the stakeholder groups will certainly reduce the likelihood of directors acting dishonestly. In addition, directors are not serving the interests of various groups because due to separate legal entity, there remains only one master, i.e. the company.

Secondly, the right of enforcement of breach by directors remains with shareholders.<sup>145</sup> Other stakeholders do not have the right to take action against directors unless they own shares in the company. Shareholders who have the derivative actions against the directors may not feel inclined to do so because they will incur the litigation's costs without any benefit accruing to them.

Thirdly, directors will have to balance the interests of divergent groups each time decisions need to be made.<sup>146</sup> Directors will need time to consider their actions so that various groups will be satisfied. Directors may not be cognizant of what constitutes benefits to stakeholders and further, even within the same group stakeholders' interests vary.<sup>147</sup> Directors do not have clear guidelines on how these competing interests should be addressed and how stakeholders should be informed of the decision-making. One of the possible solutions is to allow various stakeholders to

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<sup>143</sup> Hill and Jones above n59 at 145; Phillips above n56 at 22.

<sup>144</sup> Ibid.

<sup>145</sup> Keay "Corporate Objective" above n40 at 676.

<sup>146</sup> Ibid.

<sup>147</sup> Ibid, at 677.

have representatives on the board, a model which is more predominant in Germany and Japan.<sup>148</sup>

#### **6.4 Conclusion**

The debate between shareholder supremacy theory and stakeholder theory is not new and the law remains unchanged, namely the duty is owed to the company. It was evident from the report by the Steering Committee in the UK which rejected the suggestions to incorporate extensive reform of duties to include other stakeholders into the Companies legislation. The reforms put forward included having representative from creditors and employees in the decision-making process in order to safeguard their interests. The proposal was rejected because it would involve radical changes to British corporate jurisprudence and culture.<sup>149</sup>

Section 172 of the UK Companies Act 2006 illustrates a form of compromise between the two theories; namely the primary duty is to the company but in fulfilling that duty, the interests of various stakeholders should be considered. In any event of conflict, directors should act in good faith for what they consider in the best interests of the company alone. Directors have to consider various interests, especially the effect of their actions on the company in the long run. This is because there is a possibility they will be liable under the law if the company should become insolvent as a result of their action. It is settled law in insolvency where creditors' interests are most affected, the duty shifts to creditors.

New Zealand, Australia and Malaysia do not have provisions like the UK section 172, but the framework of director's duty is similar to the UK. The duty revolves around action in the interests of the company and directors are to use the care, skills

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<sup>148</sup> Farrar "Corporate Governance" above n22 at 34-35.

<sup>149</sup> The same sentiment is echoed by the CLRC in Malaysia when reviewing director's duty; see [CLRC Clarifying and Reformulating the Directors' Role Duties] above n125 at [4.1-4.9].

and experiences in order to discharge that duty. The objective standard imposed by the law on directors when exercising their skills, care and experience is provided as protection to stakeholders from actions which are deemed as unreasonable.

In this instance, the court's role as guardian of interests for all parties is important to determine whether the act is reasonable. However, stakeholders who feel that the action is not in the interests of the company, for example where directors have breached their fiduciary duty, do not have direct access to the remedy. The remedy is exclusively for the company and shareholders in a derivative action. Further, shareholders can ratify the action at the general meeting.

Company law is not seen as part of mechanism to protect stakeholders because their interests have been dealt with by specific statutes, for example, consumer protection law environmental legislation and labour law. Creditors have always been regarded as superior to the debtors and hence have the ability to protect their own interests. They are expected to arrange for security and the law should not intervene to regulate their interests for them. This argument, however, only works in perfect markets where parties are assumed to have equal bargaining power. In reality, there are many creditors, especially small creditors, could not demand security and will be most affected if the company is having difficulty.

The duty not to trade when the company is insolvent confers protection to creditors in addition to insolvency law. In New Zealand, Australia and Malaysia, the law gives rights to creditors to bring action against directors for breach of duty for trading whilst the company is insolvent. In the UK the right to bring action remains with the liquidator because the right to bring action for wrongful trading is only available during liquidation. (The issues will be discussed further in Chapter 7). The insolvency law also granted employees a position as preferential creditors in respect of certain amounts of unpaid wages.

The imposition of duty on directors to creditors provides protection to creditors because directors have to be cautious in their decisions not to cause the company to become insolvent or else they will be personally liable. It is most appropriate to impose an obligation on directors to consider creditors' rights at that time because they are most affected when the company is insolvent.

This means creditors' rights are protected only after the company is already in financial difficulty; hence, the likelihood of being paid in full is doubtful. This has been argued by the pluralists or communitarians as inadequate because creditors' interests are better protected if they have the right to restrain the company from taking actions. Due to the structures of corporate law in common law countries, it seems very unlikely that the law will change in the near future because it will involve amendment to the whole corporate culture and jurisprudence, particularly to the current concept of directors' duties.<sup>150</sup>

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<sup>150</sup> See Lucian Arye Bebchuk and Mark J. Roe "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 Stanford LR 127.

## **CHAPTER 7: A CONCEPTUAL ANALYSIS OF CAPITAL AND CORPORATION**

### **7.1 Introduction**

This chapter will explore the relationship between share capital and creditors' protection and the concept of the corporation. The relationship between a company and its creditors has changed from personal to impersonal with the evolution of companies from partnership to joint stock companies to the existing structures. Hence, creditors are relying on the company's share capital as the benchmark of the company's capability to make loan repayments. To this extent, the capital is the corporation, as Jessel MR recognised in *Re Exchange Banking Co, Flitcroft's Case*<sup>1</sup>

The chapter will be arranged in two sections: the first section will examine the definitions of share capital and the effects of companies' evolution on share capital and creditors; the second section will briefly examine the common law doctrine of capital maintenance as well as statutory provisions which aim to provide a cushion against creditors' claims. The section will also investigate the extent to which protection is accorded to creditors by the doctrine, as well as the weaknesses of the law in this area. It will also identify any differences in the laws in the UK, New Zealand, Australia and Malaysia.

### **7.2 Definition of Capital**

The term 'capital' originally referred to loans of money and later expanded to include other assets. These funds were the used to engage in the company's trade.<sup>2</sup>

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<sup>1</sup> (1882) 21 ChD 519.

<sup>2</sup> John Farrar and Brenda Hannigan *Farrar's Company Law* (4th ed., Butterworths, London 1998) at 155.

The emergence of funds as capital was closely connected with the growth of the capitalist class in the sixteenth century as opposed to the earlier guild system.<sup>3</sup>

In modern company law, capital deals with share capital contributed by shareholders and debt capital advanced by creditors.<sup>4</sup> Share capital confers rights in the company to the shareholders, while debt capital concerns a set of rights against a company arising from a contractual relationship between a debtor and a creditor.<sup>5</sup> Share capital funds are made up of either wholly-paid or partly paid shares which represent the legal measure and the actual amount subscribed by shareholders.<sup>6</sup>

Capital, under company law, refers to contributions in money or money's worth by shareholders in exchange for shares.<sup>7</sup> The company then utilises the earnings for its commercial activities and any gains from these constitutes the company's true capital.<sup>8</sup> The money fund is then invested in assets of the company for the business of the company.<sup>9</sup> Although share capital has been used to pay for real assets in the company, the share value is not reflected in the value of net assets.<sup>10</sup> Instead, it depends on the supply and demand for shares.

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<sup>3</sup> In the guild system, the principal assets were the skill and connection of tradesman. (John Farrar "The Concept of Capital and the Financing of Companies" in John Farrar (Ed.) *Companies and Securities Law* (Brookers, Wellington, 2008) ch 23 at [23.1] ["The Concept of Capital"]).

<sup>4</sup> Farrar and Hannigan above n2 at 156-158.

<sup>5</sup> LCB Gower *Modern Company Law* (6<sup>th</sup> ed., Stevens, London, 1997) at 321.

<sup>6</sup> David Waiman *Company Structures: Law, Tax and accounting for Companies and Groups Growing and Evolving* (Sweet & Maxwell, London, 1995) at 107-108.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid; see also Farrar and Hannigan above n2 at 156.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

Economists divided real capital which is invested using both share capital and debt capital into fixed and circulating capital.<sup>11</sup> Fixed capital is assets which a company retains which either produce income themselves or are made use of to produce income.<sup>12</sup> Circulating capital is a portion of subscribed capital intended to be used by being parted temporarily and circulated in the business.<sup>13</sup>

A company's business activities comprise abstract relationships which in economic terms are expressed by words such as prices, profits, interests, rents and wages.<sup>14</sup> A company which fails to generate sufficient profits from these relationships may lay off masses of workers and this action may create chain reactions which may affect the economy as a whole.<sup>15</sup>

A company was initially an extension of a partnership and identified with its owners.<sup>16</sup> Creditors extended credit to the company, based on personal relationship with owners who would be personally liable for the debts.<sup>17</sup> However, through time, the company has become impersonal and detached from shareholders and the final severance eventuated when separate legal personality doctrine was enunciated in the case of Salomon.<sup>18</sup>

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<sup>11</sup> Farrar and Hannigan above n2 at 158.

<sup>12</sup> *Ammonia Soda Co v Chamberlain* [1918] 1 Ch 266.

<sup>13</sup> *Ammonia Soda Co v Chamberlain* [1918] 1 Ch 266.

<sup>14</sup> Paddy Ireland, Ian Grigg-Spall and Dave Kelly, "The Conceptual Foundations of Modern Company Law" (1987) 14 *JL& Soc'y* 149 at 162.

<sup>15</sup> *Ibid.*

<sup>16</sup> *Ibid.*, at 152.

<sup>17</sup> Farrar and Hannigan above n2 at 156.

<sup>18</sup> Ireland, Grigg-Spall and Kelly above n14 at 153

The concept of limited liability is closely connected to the division of company's capital into shares.<sup>19</sup> Limited liability is achieved through shares when what shareholders are required to contribute towards the assets of the company is limited to the amount shareholders agree to pay.<sup>20</sup> Since the company is now the debtor and with limited liability, creditors seek to rely on the amount of share capital contributed in order to estimate shareholders' liabilities.<sup>21</sup> In other words, decisions to give credit are made based on the representation of share capital in the Constitution. As such, the amount contributed by shareholders signifies the company's capability to make repayment. The decision in *Re Exchange Banking Co, Flitcroft's Case*<sup>22</sup> accentuated this point when Jessel MR explained:

The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders, though it may be a right which he cannot enforce otherwise than on a winding up.<sup>23</sup>

Meanwhile, the concept of property began to change to include abstract intangible rights such as shares.<sup>24</sup> The emergence of a share capital market helped to accelerate

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<sup>19</sup> Ibid.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid, at 156.

<sup>22</sup> (1882) 21 Ch D 519.

<sup>23</sup> (1882) 21 ChD 519 at 533.

<sup>24</sup> Ireland, Grigg-Spall and Kelly above n14 at 153; Crawford Brough Macpherson "Capitalism and the Changing Concept of Property" in Eugene Kamenka and Ronald Stanley Neale (Eds) *Feudalism, Capitalism and Beyond* (Australian National University Press, Canberra, 1975) 104 at 110.

the transformation of shares as readily marketable commodities and liquid assets.<sup>25</sup> As owners of the shares, shareholders are also the owner of the company although separate legal entity precludes ownership of assets which belong to the company.<sup>26</sup> Subsequently, shareholders' control over the company decreased, and finally, they are perceived to be in the similar position as creditors; outsiders who advance loans to the company in exchange for company's profits.<sup>27</sup>

### 7.3 Doctrine of Capital Maintenance

The purpose of this doctrine is to balance the scale which tends to tip in favour of shareholders due to the separate legal entity principle. This doctrine does not imply that capital funds will remain throughout the life of the company because to do so would require the company to guarantee the company's solvency which is quite impossible since there is always likelihood for the company to lose in trading; a risk which creditors are well aware of.<sup>28</sup> Creditors, however, have the right to expect that the company will not utilise money for purposes contrary to its objects.<sup>29</sup>

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<sup>25</sup> Paddy Ireland "Company Law and the Myth of Shareholder Ownership" (1992) 62 MLR 32 at 41.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid, at 43; Adolf A Berle and Gardiner C. Means *The Modern Corporation and Private Property* (The Macmillan Company, New York, 1932); Adolf A Berle and Gardiner C. Means *The Modern Corporation and Private Property* (Revised ed., Harcourt, Brace & World, 1968) at 244.

<sup>28</sup> *Trevor v Whitworth* (1887) 12 App Cas 409.

<sup>29</sup> *Trevor v Whitworth* (1887) 12 App Cas 409 at 423-424 when Lord Watson stated "Paid up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid...and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of business".

### 7.3.1 Rules Concerning Capital Maintenance

The capital maintenance doctrine relates to the rule which restricts the company from returning to members, monies which have been received for payment of shares.<sup>30</sup> A company may not reduce its share capital since it affects shareholders' liabilities to contribute in liquidation, consequently affecting creditors' likelihood to be paid.<sup>31</sup> This doctrine raises questions on the freedom of the company to deal with its assets in terms of distribution to its members as well as the right to reduce the amount of share capital below the initial amount relied on by creditors.<sup>32</sup> The prohibition may prevent the company from undertaking any beneficial form of reorganisation which may benefit shareholders without affecting the interest of creditors.<sup>33</sup> To overcome this, the company is authorised to reduce its capital subject to conditions laid down in the statute.

The law generally requires shareholders' approval through special resolution.<sup>34</sup> The amendment in the UK in 2006 removed the requirement of court's confirmation in relation to private limited company, and replaced it with the directors' solvency declaration.<sup>35</sup> Section 256B of the Australian Corporations Act 2001 specifically provided the reduction should be authorised only if it does not materially prejudice

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<sup>30</sup> Farrar and Hannigan above n2 at 172.

<sup>31</sup> Robert P Austin and Ian M Ramsay *Ford's Principles of Corporations Law* (14<sup>th</sup> ed., Lexis Nexis Butterworth, NSW, 2010) at [24-530].

<sup>32</sup> Paul L. Davies Gower and Davies' *Principles of Modern Company Law* (8<sup>th</sup> ed., Sweet & Maxwell, London, 2008) at [13-1].

<sup>33</sup> Austin and Ramsay above n31 at [24-530].

<sup>34</sup> Section 256B(1) of the Australian Corporations Act 2001- shareholders' approval subject to procedures laid down in Part 2J.1 Div 1; section 64(1) of the Malaysian Act 1965; section 641(1)(b) of the UK Companies Act 2006.

<sup>35</sup> See section 641(1)(a) of the UK Companies Act 2006 and see also sections 642-645 of the same Act.

the company's ability to pay its creditors.<sup>36</sup> The Act also provides that, if as a result of the reduction, the company is insolvent, directors could be subjected to personal liability for insolvent trading under section 588G of the Corporations Act 2001.

To protect creditors, the Malaysian Companies Act 1965 gives the right to every creditor whose debt is admissible in proof to object to the reduction.<sup>37</sup> The same position applies in the UK prior to the amendment in 2006 and now in addition to proof of debt, the creditor has the burden to show the proposed reduction will put the discharge of due debt at risk.<sup>38</sup> The company then has to apply to the court for confirmation which provides further protection to creditors.<sup>39</sup>

Prior to the amendment in 2006, creditors in the UK were in a better position than they would have been had the reduction not been made. This is due to the law in Companies Act 1985 which required the company to discharge or secure all creditors' outstanding claims at the time of reduction.

The prohibition on the company on returning share capital to its members is expressed in various forms in the statutes. The company must not directly or indirectly purchase its own shares; give financial assistance for the purpose of or in connection with the acquisition of its shares or shares of its holding company; or distribute its capital to members.

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<sup>36</sup> The section also provides that the reduction should be fair and reasonable to shareholders as a whole and consent from shareholders is required. See section 256B of the Australian Corporations Act 2001.

<sup>37</sup> See section 64(2) of the Malaysian Companies Act 1965.

<sup>38</sup> See section 646(1)(b) of the UK Companies Act 2006.

<sup>39</sup> See section 645(1) of the UK Companies Act 2006; see section 64 of the Malaysian Companies Act 1965.

### 7.3.3.1 Directly or Indirectly purchase Its Own Shares

The common law position is very strict, and a company is prohibited from purchasing its own shares even if it is allowed to do so in its Constitution or authorised by shareholders in the general meeting.<sup>40</sup> The underlying principle for such prohibition is that by purchasing its own shares a company is using its own financial resources and it is equivalent to reducing its own capital.<sup>41</sup> Lord Hershell commented that the stringent procedures required in order to reduce share capital would be futile if companies were allowed to purchase their own shares.<sup>42</sup>

The common law position is incorporated in the statute and a company is prohibited from purchasing its own shares except otherwise provided for in the statute.<sup>43</sup> Since purchasing its own shares amounted to depleting the company's assets, the law has laid down strict procedures that need to be complied with.<sup>44</sup> Section 257A of the Australian Corporations Act 2001 permits the purchase if it does not *materially prejudice the company's ability to pay its creditors*. (Emphasis added).

The requirement is related to the company's solvency and directors may be subjected to personal liability under section 588G if conditions stated therewith have been fulfilled. In Malaysia, in addition to the stringent procedures, there must be a solvency declaration by the directors that the company is solvent at the time of

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<sup>40</sup> *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 ChD 519 at 533.

<sup>41</sup> *Trevor v Whitworth* (1887) 12 App Cas 409.

<sup>42</sup> *Trevor v Whitworth* (1887) 12 App Cas 409 at 416.

<sup>43</sup> See section 658(1) of the UK Companies Act 2006; section 67A of the Malaysian Companies Act 1965; section 257A of the Australian Corporations Act 2001.

<sup>44</sup> Section 690 of the UK Companies Act 2006; the procedures are laid down in Chapter 4 of the Act; Part 2J.1 Division 2 of the Australian Corporations Act 2001.

purchase or will not become insolvent as a consequence of it.<sup>45</sup> The purchase must also be made in good faith and in the interest of the company.<sup>46</sup>

### **7.3.3.2 Give Financial Assistance for the Purpose of or in Connection with the Acquisition of its Shares or Shares of its Holding Company**

The rule against financial assistance was a product of a statutory reform recommended by the Greene Committee and was introduced in the UK Companies Act 1929.<sup>47</sup> The restriction on the company providing finance in order to assist another in purchasing its shares is akin to the company purchasing its own shares, hence depleting the company's capital.<sup>48</sup>

However, in reality, it does not directly reduce the company's share capital and creditors will only be affected when assistance is given when the company's solvency is doubtful.<sup>49</sup> Shareholders, on the other hand, will be more affected since their shareholding will be diluted. In such a situation, when the company is on the verge of insolvency, there are other provisions deemed to be material to protect creditors such as directors' duties and insolvent and wrongful trading.<sup>50</sup>

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<sup>45</sup> Section 67(2)(a) of the Malaysian Companies Act 1965.

<sup>46</sup> Section 67(2)(c) of the Malaysian Companies Act 1965.

<sup>47</sup> Davies above n32 at [13-26]. For historical background of the rule see also at [13-26]- [13-27].

<sup>48</sup> Section 67 of the Malaysian Companies Act 1965; Section 256A of the Australian Corporations Act 2001 and Part 18 of the UK Companies Act 2006. The Greene Committee considered the assistance offended against the spirit if not the letter of the rule in *Trevor v Whitworth* (1887) 12 App Cas 409.

<sup>49</sup> Company Law Reform Modern Company Law for a Competitive Economy Company Formation and Capital Maintenance (1999, DTI, London) at [3.41].  
<<http://www.berr.gov.uk/files/file23277.pdf>> at 20 March 2009. [The Company Law Review Steering Group Company Formation and Capital Maintenance].

<sup>50</sup> Ibid.

The law prohibits a company from giving financial assistance to another person for the purpose of acquiring shares in the company or its subsidiary.<sup>51</sup> Under the UK Companies Act 2006, financial assistance is prohibited in the case of public companies only<sup>52</sup> and the rule does not now apply to a private company. The UK Companies Act 2006 also prohibits assistance if as a result of the acquisition of shares in the company, a person incurs liability and assistance is then given in order to reduce or discharge that liability.<sup>53</sup>

The law recognises some commercial reasons which justify the company giving financial assistance such as to facilitate venture capital investment, to promote wider ownership of the company's shares or to facilitate a management buy-out which otherwise cannot be undertaken.<sup>54</sup> Therefore, the strict prohibition is amended to give the company some leeway, subject to certain safeguards.

A company is permitted to give financial assistance to a person if it is not for the purpose of acquiring shares in the company or its subsidiary.<sup>55</sup> In addition, the law ensures protection to creditors by requiring that the assistance has to be done in good faith in the interests of the company.<sup>56</sup> In Australia, a similar condition is stated in the Corporations Act 2001 in that the assistance does not materially prejudice interests of company or company's ability to pay. Financial assistance is also

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<sup>51</sup> See section 678(1) of the UK Companies Act 2006; Part 2J.3 of the Australian Corporations Act 2001 and section 67(1) of the Malaysian Companies Act 1965.

<sup>52</sup> See section 678 of the UK Companies Act 2006.

<sup>53</sup> See section 678(3) of the UK Companies Act 2006.

<sup>54</sup> The Company Law Review Steering Group Company Formation and Capital Maintenance above n49 at [3.42].

<sup>55</sup> See section 678(2) of the UK Companies Act 2006; see also section 678(3) where it is stated if the principal purpose is not to reduce or discharge liability or if the reduction or discharge of any liability is incidental of some larger purpose; and the assistance is given in good faith for the interests of the company, the financial assistance is not prohibited.

<sup>56</sup> See section 678(2) of the UK Companies Act 2006; see also 678(4) of the same Act.

available where special resolution is passed by shareholders or in situations exempted by statute in section 206C of the Corporations Act 2001.<sup>57</sup>

In Malaysia, financial assistance is strictly prohibited unless it falls under the exceptions under section 67(2). Due to this, the CLRC in its report in 2007 suggested amendments to be made to relax the existing law. The proposal includes a special resolution by shareholders and a solvency test need to be satisfied.<sup>58</sup> Nevertheless, the CLRC did not suggest all directors but it is sufficient for a majority of directors to make solvency declaration.<sup>59</sup> The CLRC also proposed personal liability to directors who made solvency declaration without reasonable grounds.<sup>60</sup> To date, the proposals have not been adopted.

### **7.3.3.3 Distribute its Capital to Members**

One of the fundamental propositions generated by the doctrine is that distribution could not be made out of the capital and the company can only declare dividends from its trading profits.<sup>61</sup> The common law rule on distributions rule has been incorporated into provisions in the statute.<sup>62</sup> Creditors are concerned whether they will be paid on time, and in the event of insolvency, unsecured creditors, particularly, are concerned whether there are enough assets to meet their claims.<sup>63</sup> Problems with

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<sup>57</sup> Malaysian Corporate Law Reform Committee “A Consultative Document on Capital Maintenance and Share Capital: Simplifying and Streamlining Provisions Applicable to the Reduction of Capital, Share Buy Back and Financial Assistance” (2007) at [3.7]-[3.8]. [CLRC Capital Maintenance and Share Capital].

<sup>58</sup> Ibid.

<sup>59</sup> Ibid.

<sup>60</sup> Ibid.

<sup>61</sup> *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 ChD 519 at 533; see section 254T Australian Corporations Act 2001; section 365 of the Malaysian Companies Act 1965.

<sup>62</sup> See section 365(1) of the Malaysian Companies Act 1965 and also section 60(3)(c); section 830 of the UK Companies Act 2006; section 254T of the Australian Corporations Act 2001.

<sup>63</sup> Austin and Ramsay above n 31 at [20-160].

capital maintenance materialise when the court allows distribution to be made out of current trading profit but prohibit distribution out of capital.<sup>64</sup> The amounts stated as capital funds are historical figures and the value can depreciate either through inflation or through trading losses.<sup>65</sup> Companies are not obliged to replace any trading loss from previous years with profits made in the current years before declaring dividends.<sup>66</sup> Hence the values of assets could have diminished despite generating profits in the current year.

### 7.3.2 Reforms of the Doctrine - A Shift towards a Solvency Test

The doctrine of capital maintenance was developed to balance the effect of limited liability which was made widely available to any person who wanted to register a company. The law sought to protect creditors by controlling what a limited liability company could do with their share capital.

The beneficial effect of restriction upon share capital could be understood in the light of assumptions in the nineteenth century.<sup>67</sup> The assumption was that a registered company would be like a deed of settlement company with a large membership.<sup>68</sup> It was assumed that incorporators, when forming new companies, would arrange for a large number of subscribers for membership to undertake to pay in for shares with a high issue price, in most cases, much of issue price remained as uncalled capital.<sup>69</sup>

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<sup>64</sup> Ibid; Davies above n32 at 227; Mike Ross *Directors' Liability and Company Solvency: the new Companies Act* (CCH New Zealand, Auckland, 1994) at 6.

<sup>65</sup> Len Sealy Cases and Materials in Company Law (7<sup>th</sup> ed., Butterworths, London, 2001) at 396, Ross, *ibid*.

<sup>66</sup> Ross, *ibid*.

<sup>67</sup> Austin and Ramsay above n31 at [20-160].

<sup>68</sup> *Ibid*.

<sup>69</sup> *Ibid*.

The idea that maintaining share capital would suffice to protect creditors was based on an assumption that a limited company would have adequate capital to run a business.<sup>70</sup> However, the emergence of a one-person company makes it possible for a company to operate with a small capital and in this situation, the doctrine is inadequate to protect creditors.<sup>71</sup> Creditors themselves are not mainly concerned with the level of the company's share capital. Their main concern will be the company's ability to pay its debts as and when they fall due.

The creditors' concern in the company's flow of funds instead of on the level of share capital caused legislators to shift their focus on the persons who directed the company.<sup>72</sup> The law has imposed a strict duty on directors to cease trading if the company is insolvent or will become one as a consequence.

New Zealand abolished the capital maintenance doctrine and replaced it with a statutory solvency test<sup>73</sup> which must be satisfied when a company enters into transactions that involve a distribution of funds or property to shareholders.<sup>74</sup> The rationale for adopting this concept can be found in the decision of Heath J *Re DML Resources (in liq)*<sup>75</sup> which is related to the shareholders' position as residual claimants in winding up.<sup>76</sup> Prior to 1993, the insolvency test was applied in *Hilton International Ltd v Hilton*<sup>77</sup> in addition to the capital maintenance test.

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<sup>70</sup> Ibid.

<sup>71</sup> Ibid.

<sup>72</sup> Austin and Ramsay above n31 at [20-160].

<sup>73</sup> The solvency test will be discussed in Chapter 8.

<sup>74</sup> Matthew Berkahn and Lindsay Trotman "Equity Finance" in John Farrar (Ed.) "Companies and Securities Law in New Zealand" (Brookers Ltd, Wellington, 2008) ch 24 at [24.6.3].

<sup>75</sup> [2004] 3 NZLR 490.

<sup>76</sup> [2004] 3 NZLR 490 at 492; Heath J explained "The Act requires the board of directors of a company to determine whether it is solvent before returning wealth to its shareholders. As shareholders stand behind creditors in the priorities in which they are paid on insolvency, it is inappropriate for a shareholder to receive benefits, ahead of creditors, at a time when the company is insolvent. The need for a company to be solvent before distributions are made to shareholders is

Section 52(1) of the Companies Act 1993 allows a company to make distributions if it is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the solvency test. Directors who vote in favour of distribution must sign a certificate stating that in their opinion the company will satisfy the solvency test and their grounds for that opinion.<sup>78</sup> A distribution which has been authorised but has not been made will no longer be deemed authorised if there is a change in circumstance that results in the company not being able to satisfy the solvency test after the distribution is made.<sup>79</sup>

Under the Companies Act 1993, a company is permitted to buy its own shares provided it is expressly authorised by the constitution.<sup>80</sup> The protection in *Trevor v Whitworth*<sup>81</sup> for creditors is achieved by applying the solvency test.<sup>82</sup> In addition, directors must be subjected to duty of good faith for the best interests of the company and for proper purpose.<sup>83</sup>

The Companies Act 1993 also permits the company to provide financial assistance to purchase its own shares or those of its holding company.<sup>84</sup> The same solvency test<sup>85</sup>

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underscored by provisions in the Act by which a company may seek recovery of amounts distributed from shareholders and directors: see sections 56(1), (2) and (4) of the Act.”

<sup>77</sup> [1989] 1 NZLR 442 at 475-476.

<sup>78</sup> See section 52(2) of the New Zealand Companies Act 1993.

<sup>79</sup> See section 52(3) of the New Zealand Companies Act 1993. See also *Kitchener Nominees Ltd v James Products Ltd* (2002) NZCLC 262,882 and *Ordeal Enterprises Ltd v Calan Healthcare Properties Ltd* (2003) 9 NZCLC 263,184.

<sup>80</sup> See section 59(1) of the New Zealand Companies Act 1993.

<sup>81</sup> (1887) 12 App Cas 409.

<sup>82</sup> See section 59(1) of the New Zealand Companies Act 1993 which states the company may purchase its own shares if it is permitted to do so by the constitution and subject to section 52 of the Act. Section 52 requires the board to satisfy the solvency test.

<sup>83</sup> *Mounfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 112.

<sup>84</sup> See section 76 of the New Zealand Companies Act 1993.

<sup>85</sup> See section 77 of the New Zealand Companies Act 1993.

must be satisfied by the company in addition to the requirement that the board must resolve that the assistance is in the best interests of the company.<sup>86</sup>

The statute replaces the doctrine and provides that when a company trades whilst insolvent, it loses the right to rely on the limited liability.<sup>87</sup> The company, therefore, is compelled to maintain the company's solvency although the obligation to do so is not absolute due to inevitable risks of trading.<sup>88</sup> The right, however, is forfeited when the company exposes assets and capital to risks at the creditors' expense.<sup>89</sup> The courts have been very cautious in deciding whether the risks are legitimate and have applied an analogy equivalent to medical negligence cases.<sup>90</sup>

In Malaysia, the requirement of solvency has been incorporated in section 67A in relation to share buy back/ purchasing its own shares in 1997. The provision allows a company to buy its own shares provided the company is solvent at the date of purchase and will not become insolvent as a result of the purchase.<sup>91</sup> The requirement was made during the financial crisis, at the time when many companies were in financial difficulties. The purpose of allowing a company to purchase its own shares is to stabilise the supply and demand as well as the share prices traded in Stock Exchange due to the circumstances at the time.<sup>92</sup> At the same time, creditors

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<sup>86</sup> See section 76(2)(b) of the New Zealand Companies Act 1993.

<sup>87</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 112.

<sup>88</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104.

<sup>89</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 113.

<sup>90</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 114; in medical negligence cases enunciated in *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582, the court looked at whether acceptable professional standards have been complied with unless such standards are shown to be wholly unreasonable.

<sup>91</sup> See section 67A(2) "A company shall not purchase its own shares unless-  
(a) it is solvent at the date of the purchase and will not become insolvent by incurring the debts involved in the obligation to pay for the share purchased;

<sup>92</sup> Ben Chan Chong Choon, Phillip Koh Tong Ngee and Peter SW Ling, *Chan & Koh on Malaysian Company Law principles & Practice* (Sweet & Maxwell, Malaysia, 2006) at 338.

are also at their most vulnerable position and to allow company to purchase its own shares will further worsen their position, hence the requirement of company solvency to be declared. In addition, directors are required to make declaration that the purchase is in good faith and in the interests of company.<sup>93</sup>

The provision in section 67A seems to balance the interests of creditors on one hand and the shareholders on the other. Creditors' rights are duly protected when directors are required to consider the solvency of the company before a decision is made. Shareholders' rights are also protected when directors have to state in their declaration that the act is done in good faith and in the interests of the company because of the courts' tendency to equate interests of the company and that of shareholders.

Another aspect of the doctrine of capital maintenance concerns payment for shares at their nominal value, this must be paid in full and the company is not allowed to make a gratuitous allotment or at a discount.<sup>94</sup> This is to ensure that the initial share capital funds stated in the Memorandum of Association is truly reflected and provided as a cushion of solvency.<sup>95</sup> However, it does not grant any protection to creditors against insolvency because there is usually no link between initial share capital and capital employed by company.<sup>96</sup> Consideration for share capital can be in money or money's worth or both, though the latter cannot be less in value than the value of a nominal share or else it will constitute a discount. Likewise, payment made in non-monetary consideration may also infringe creditors' interests, since the amounts are not represented with cash reserve.<sup>97</sup>

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<sup>93</sup> See section 67A(2)- A company shall not purchase its own shares unless-  
(c ) the purchase is in good faith and in the interests of the company.

<sup>94</sup> Farrar and Hannigan above n2 at 172.

<sup>95</sup> Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [376].

<sup>96</sup> *Ibid*, at [378]. In addition, the concept also provided confusion to accounting practice.

<sup>97</sup> Ross above n 64 at 9.

## 7.4 Conclusion

The doctrine of capital maintenance has been criticised because it is seen to be inadequate to protect creditors. This is because the share capital fund raised from members of the public does not represent the company's actual value and ability to trade. The funds collected have been used to invest in the company's assets as well as the company's business operation; thus the funds deemed to protect creditors merely exist on paper. There is also likelihood that the funds could be lost in trading, reducing the effectiveness of the doctrine to protect creditors to mere rhetoric.

The duty to preserve the capital fund is not absolute because the law allows for exceptions, provided the conditions are fulfilled. The law grants protection to creditors in these situations through stringent procedures and the court acting as guidance of justice. The existence of exceptions proves that rigid application of capital maintenance is not possible because it may restrict the company to restructure or reorganise, for example. In Malaysia, for example, the law provides leeway for a company to purchase its own shares in order to stabilise share prices which plummeted significantly due to financial crisis.

This has allowed the solvency concept to penetrate the doctrine of capital maintenance either through requirement for directors to make a solvency declaration as in the UK and in Malaysia<sup>98</sup> or, alternatively as in Australia where the court is required to consider whether the act would not materially prejudice the company's ability to pay its creditors and also impose personal liability on directors if the company became insolvent under section 588G as a result of the act.

In Malaysia, the importance of this concept to replace the old doctrine of capital maintenance can be seen from the proposals by the Corporate Law Reform Committee (CLRC).<sup>99</sup> The CLRC proposed the tests to be applied in section 67A are

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<sup>98</sup> In Malaysia, the requirement to make a solvency declaration is only applicable in relation to share buy back.

<sup>99</sup> [CLRC Capital Maintenance and Share Capital] above n 57 at [1.4].

both the balance sheet and cash flow test.<sup>100</sup> In addition to the current legal framework, CLRC recommended a solvency declaration by a majority of directors to be adopted.<sup>101</sup> For reduction of capital, the CLRC recommended all directors to make a declaration of solvency as an alternative to the current regime which requires court's approval.<sup>102</sup> The CLRC also proposes for directors to be subjected to criminal liability if they fail to make a true declaration. This would also apply to shareholders for the amount they receive as a result of the reduction unless they do so in good faith.<sup>103</sup> It illustrates the committee's seriousness in implementing the solvency requirement as well as the importance of this requirement being strictly adhered to. To date, the proposals have yet to be implemented and, therefore, the reliance on the old law remains.

Other jurisdictions also acknowledge that company's solvency is more befitting to protect creditors but have not gone so far as to abolish the capital maintenance doctrine. The UK<sup>104</sup> retained the statutory provisions<sup>105</sup> which protect creditors' interests, with an additional requirement of directors' solvency declaration/statements. It combines both the solvency requirement and capital maintenance doctrine. The statute requires directors to make a solvency statement<sup>106</sup>

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<sup>100</sup> Ibid, at [1.20], currently the test applicable is the cash flow test - see Regulation 18A(2)(a) of the Companies Regulation 1966 which states: "A company shall be deemed to be solvent if it is able to continue to meet its obligations as and when they become due without any substantial disposition of its assets outside the ordinary course of its business, restructuring its debts, externally forced revisions of its operations or other similar actions."

<sup>101</sup> Ibid, at [1.9], In share buy back, declaration of solvency by a majority of directors is sufficient because there is no other alternative procedure a company can opt for, therefore the CLRC viewed that the procedures should be lenient compared to reduction of capital situation see at [2.4].

<sup>102</sup> Ibid, at [1.5]. The CLRC also proposed that court's approval to reduce company's capital is necessary to be retained because it provides certainty and legality to the process.

<sup>103</sup> Ibid, at [1.20(g)-(h)].

<sup>104</sup> The UK must also comply with the EU Directives on these matters.

<sup>105</sup> Refers to reduction of capital, share buy back, financial assistance and dividend payments.

<sup>106</sup> The solvency statement requires each director's opinion in regard to the company's situation at the date of the statement and that if the company is wound up within a year from the date of the

and once a resolution is passed, to obtain court's confirmation.<sup>107</sup> These dual requirements provide a check and balance in the sense that reliance is not placed totally on directors but also on the court as the guardian of justice.<sup>108</sup> The Malaysian Corporate Law Reform Committee (CLRC) has also recommended the same approach which maintains the existing statutory provisions on capital maintenance and requires directors' to make a solvency declaration. The CLRC is also of the view that court procedures should be preserved since they provide legality and certainty to the proceedings.

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statement, the company would be able to discharge its debts in full. In addition, the company is required to submit audited accounts confirmed by external auditors.

<sup>107</sup> See sections 645-648 of the UK Companies Act 2006 in respect of reduction of capital.

<sup>108</sup> Justice refers to protection to various parties affected including creditors, shareholders and the company itself.

## **CHAPTER 8 THE CONCEPTS OF SOLVENCY AND INSOLVENCY**

### **8.1 Introduction**

In the previous chapter, the relationship between the corporation, capital maintenance and creditors' protection was explored. This chapter will delve into the relationship between solvency, insolvency and creditors' protection and will be divided into two sections. The first section will discuss the link between creditors' protection and solvency. The discussion will focus on risks faced by creditors when the company trades with their money and how maintaining solvency will assist in protecting them. There are two tests which are incorporated into statute, the balance sheet and cash flow under the common law. The second section will examine the tests used to determine solvency, difficulties of applying the tests and, where necessary, suggestions for improvements will be made.

### **8.2 Insolvency Concepts in Company Law**

The creditors' main concern after making a loan to the company is whether they will be paid on time.<sup>1</sup> Insolvency is the state of a company's inability to pay its debts as they fall due, and therefore it will be in the creditors' interests for the company to remain solvent. Once insolvency encroaches, the company is technically trading with creditors' money; money which should be used to pay off its debts. Common law has now recognised the duty of directors to consider the interests of creditors when the company is insolvent. Directors should be careful when dealing with money which does not belong to the company and should consider the repercussions to creditors before making any decisions.

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<sup>1</sup> Robert P Austin and Ian M Ramsay *Ford's Principles of Corporations Law* (14<sup>th</sup> ed., Lexis Nexis Butterworth, NSW, 2010) at [ 20-160].

The term 'insolvency' has also long been associated with winding up. Thus, when the company is insolvent, it can be subjected to formal legal proceedings<sup>2</sup> which will confer retrospective legal significance to an earlier state of insolvency which at the time it first arose had no impact in law.<sup>3</sup> Once an order has been made in respect of winding up, the liquidator will scrutinize the directors' past activities and ascertain any action which can be declared void by the court. The purpose is to increase the company's pool of assets for distribution among creditors.

The solvency concept has been acknowledged as a relevant concept in protecting creditors' interests and has begun to seep into companies legislation as evidenced in the area of capital maintenance.<sup>4</sup> The law which prohibits distributions being made to shareholders if the company could not maintain its solvency thereafter is to prevent misallocation of wealth from the company to shareholders, since such act will not benefit the company.<sup>5</sup> Creditors, on the other hand, will be in a precarious position. There is a possibility for the company to be subjected to winding up for failure to maintain its solvency. In such situations, payment to unsecured creditors will be based on the *pari passu* principle and the chance of being paid in full is doubtful.

Another area in which the solvency notion has left its trail is directors' duties, particularly in relation to trading whilst the company is insolvent. Directors often claim that they have the interests of the company as well as creditors in mind when deciding to trade when the company's finances are in a risky position.<sup>6</sup> The directors' goal by continuing to trade when the company's finances are unstable is to turn the company back into profitability and so as to be able to save the company. However,

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<sup>2</sup> Legal proceedings here refer to the winding up procedures both voluntary and by the court's order, receivership and administrative order.

<sup>3</sup>Roy Goode *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London, 2005) at 83.

<sup>4</sup> Austin and Ramsay above n1 at [20-160].

<sup>5</sup> Mike Ross *Corporate Reconstructions Strategies for Directors* (CCH, Auckland, 1999) at 71.

<sup>6</sup>*Ibid.*

there is no guarantee that the company will be able to generate adequate profits and continue as going concern, hence the risks lie with creditors who may not get paid.

The principle of separate legal entity enshrined in New Zealand in section 15 of the Companies Act 1993 shields directors from personal liability. The privilege, however, is revoked when the company trades whilst insolvent and directors can be held personally liable for any loss incurred by creditors. The underlying principle for such liability is when the company is insolvent the company is technically exposing assets and capital belonging to creditors at risk.

In the context of maintaining solvency, the duty is not a perfect duty because failure to do so does not attract liability unless the company trades while insolvent and exposes creditors to risks.<sup>7</sup> Up until that point, the company may lawfully expose its capital and assets to the risks of trade. In addition, directors could not be held liable for any loss resulting from trading loss which is an integral part of business activities.<sup>8</sup>

Thus, there should be a distinction between loss due to trading and loss due to director's misconduct.<sup>9</sup> The law has imposed liability on directors who have exposed companies to illegitimate risks.<sup>10</sup> In attempting to define what is illegitimate risk, the law must recognise that assessment of the company's ability to survive is a matter of judgment and a substantial margin of tolerance must be allowed to directors to perform their function of taking legitimate risks.<sup>11</sup> The courts have applied a standard

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<sup>7</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 113-114.

<sup>8</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 113-114.

<sup>9</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 113-114.

<sup>10</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 113-114.

<sup>11</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 113-114.

equivalent to medical negligence cases;<sup>12</sup> what a reasonable director believes to be a reasonable business prospect. This is also consistent with the aim of the Law Commission when proposing reform to section 320 because it inhibited the use of company as a vehicle for taking risks.<sup>13</sup> The Law Commission conceded in certain circumstances it is legitimate for the company to take risks and in that case no liability should be imposed on directors should it fail.<sup>14</sup> (This area of law will be explored in detail in the next two chapters.)

### 8.3 Liquidity

When a company is having financial difficulties, it is not necessary that it will end up in insolvency. This is because the company may be facing a temporary illiquidity which is a normal occurrence for any businesses. The New Zealand courts make a distinction between risks directors are allowed to take for the purpose of restoring the company's liquidity, and those which are likely to lead to insolvency. Directors will only be liable if the risks they have taken are deemed to be illegitimate.<sup>15</sup> Risks which are deemed to be legitimate signify the right of the company to continue to trade and take risks for the purpose of restoring liquidity.<sup>16</sup>

In deciding whether a company is insolvent under the Australian Corporations Act 2001, the court has to refer to the facts of each case and based on the company's

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<sup>12</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 114; in medical negligence cases enunciated in *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582 the court looked at whether acceptable professional standards have been complied with unless such standards are shown to be wholly unreasonable.

<sup>13</sup> Law Commission *Company Law Reform and Restatement* (NZLC R9,1989) at [516].

<sup>14</sup> *Ibid.*

<sup>15</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104.

<sup>16</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104.

financial position as a whole.<sup>17</sup> To do so the court must have regard to commercial realities such as the resources available to the company to meet its liabilities as they fall due, whether resources other than cash are releasable by sale or borrowing upon securities and whether such realizations are achievable.<sup>18</sup>

To further distinguish whether the company is merely having temporary illiquidity or endemic illiquidity resulting in insolvency, the court must also have regard to the commercial reality that creditors do not always insist on payment being made strictly in accordance with the terms of the contract but allow some latitude in time for payment.<sup>19</sup> Such leeway, nevertheless, should not be concluded to mean that the debts are not payable at the time stipulated in the contract and only become payable when demand is made by creditors.<sup>20</sup> Consequently, it should be implied that the company has cash or credit resource which can be taken into consideration in ascertaining its solvency.<sup>21</sup>

#### **8.4 Definitions of Insolvency**

It is necessary to have an accurate definition of the term ‘solvent’ and also definite guidelines on the components of each test, given that many consequences hinge on the satisfaction of the tests. All insolvency legislation shares the core concept of the

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<sup>17</sup> See *Southern Cross Interiors Pty Ltd and Anor v Deputy Commissioner of Taxation and ors* [2001] NSWSC 621 at [54] and cases discussed therein.

<sup>18</sup> *Southern Cross Interiors Pty Ltd and Anor v Deputy Commissioner of Taxation and ors* [2001] NSWSC 621 at [54].

<sup>19</sup> *Southern Cross Interiors Pty Ltd and Anor v Deputy Commissioner of Taxation and ors* [2001] NSWSC 621 at [54].

<sup>20</sup> *Southern Cross Interiors Pty Ltd and Anor v Deputy Commissioner of Taxation and ors* [2001] NSWSC 621 at [54].

<sup>21</sup> *Southern Cross Interiors Pty Ltd and Anor v Deputy Commissioner of Taxation and ors* [2001] NSWSC 621 at [54].

meaning of inability to pay debts.<sup>22</sup> For the purpose of winding up, the company is insolvent if it fails to pay its debts when they fall due (also known as the cash flow test) or if the liabilities of the company exceed its assets (also known as the balance sheet test). A company is also deemed to be unable to pay its debts for the purpose of winding up if it fails to comply within stipulated time to the written demand, or if judgment in favour of creditors remains unsatisfied in whole or in part.<sup>23</sup>

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<sup>22</sup> See section 123 of the UK Insolvency Act 1986; section 287 of the New Zealand Companies Act 1993; section 95A of the Australian Corporations Act 2001; section 218(2) of the Malaysian Companies Act 1965.

<sup>23</sup> However, there are slight differences as to the exact wording of these provisions.

Section 123(1) of the UK Insolvency Act 1986 defines inability to pay debts to cover situations such as:

- a) if the company neglected to pay to the creditors demand for a sum exceeding £750 after three weeks a written demand has been served;
- b) if execution or other process judgment in favour of creditors is returned unsatisfied in whole or in part;
- c) (provision applicable to (Scotland);
- d) (provision applicable to (Northern Ireland);
- e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.

Section 123(2) of the same Act also deemed a company to be unable to pay its debts if the court is satisfied that the value of the company's assets is less than the amount of its liabilities taking into account its contingent and prospective liabilities.

The New Zealand provisions in section 287 provide that the company is deemed to be unable to pay its debts if the company has failed to comply with a statutory demand, or execution issued in respect of judgment debt has been returned unsatisfied, or a person entitled to a charge over all or substantially all of the company's property has appointed a receiver under the instrument creating the said charge, or a compromise between a company and its creditors has been voted for but is yet to be approved. Section 288 provides that in deciding whether the company is insolvent, its contingent and prospective liabilities may be taken into account.

The Malaysian Companies Act 1965 is still applying the definition used in section 223 of the UK Companies Act 1948. Section 218(2) states the company is deemed to be unable to pay its debts if; a company fails to comply with the creditors demand for a sum exceeding RM500 three weeks after notice has been served on the company in compliance with the said provision; execution or other process issued on a judgment in favour of creditors is returned unsatisfied in whole or in part;<sup>23</sup> or the court is satisfied that the company is unable to pay its debts taking into account its contingent and prospective liabilities.

The Australian Corporations Act 2001, on the other hand, defines it as a person is solvent if and only if, the person is able to pay all the person's debts as and when they become due. Subsection (2) then states that a person who is not solvent is insolvent. Under this section only the cash flow test is recognized.

The courts have employed two principal tests, the balance sheet test and the cash flow test, in order to determine whether the company is solvent. The tests have been prescribed in the insolvency legislations. The outcome of the company's solvency status depends on the tests used by the court. Sir Roy Goode observed that there is a close link between the two tests:

...there is a close link between cash flow insolvency and balance sheet insolvency in that where a company is a going concern and its business can be sold as such with its assets in use in the business, those assets will usually have a substantially higher value than if disposed of on a break-up basis, divorced from their previous business activity. So a company which is commercially solvent has a much greater chance of satisfying the balance sheet test of solvency, than one which is unable to pay its debts as they fall due.<sup>24</sup>

The New Zealand Companies Act 1993 requires compliance with both tests before a company can be held to be insolvent, while Australian Corporations Act 2001 only recognises the cash flow test. The UK and Malaysia legislation, however, recognise both tests but compliance with one of the tests is sufficient.

In addition to insolvency for the purpose of winding up described above, section 4(1) of New Zealand Companies Act 1993 lays down two tests that must be satisfied before a company is said to be insolvent. The aim of these statutory tests is to provide guidelines on corporate restructuring and replace the capital maintenance doctrine.<sup>25</sup> The section provides a company satisfies the solvency test if:

- (a) the company is able to pay its debts as they become due in the normal course of business; and
- (b) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities.

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<sup>24</sup> Goode above n3 at [4-06].

<sup>25</sup> Ross above n5 at 13.

It is important to distinguish as to when company liquidity is relevant for the purpose of winding up and also for the purpose of distribution envisaged in section 4 of the New Zealand Companies Act 1993. The consequences which depend on the winding up order mentioned above were based on directors' past action i.e. whether the transaction was made during the time the company was insolvent.<sup>26</sup> In contrast, section 4 places the burden on directors to forecast the company's solvency and to remain cautious in their decisions.<sup>27</sup> It is a difficult task for directors because there are many factors which may affect the company's solvency, both within and beyond their control.<sup>28</sup> As such, directors have referred to companies' current financial statements in order to project the company's solvency.<sup>29</sup>

## **8.5 Balance Sheet Test**

The balance sheet test provides that the company is insolvent if its liabilities exceed its assets or if its assets are insufficient to meet the liabilities and in doing so the company's contingent and prospective liabilities is to be taken into account.<sup>30</sup> The term liabilities is broader than the term debts and it includes all forms of liability, whether liquidated or unliquidated and whether arising in contract or in tort or by way of restitution or for damages for breach of statutory duty.<sup>31</sup>

Goode pointed out that, in order to give the phrase contingent liability any meaning, it must be restricted to liability or loss arising out of existing obligations which

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<sup>26</sup> Ibid, at 72.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid, at 72-76.

<sup>29</sup> Ibid.

<sup>30</sup> Goode above n3 at [4-24] 101. New Zealand, the UK and Malaysia share the same term in legislations.

<sup>31</sup> Ibid, at [4-25]; see also r13.12(4) of the UK Insolvency Rules 1985 for the purpose of winding up.

depend on the occurrence of events that may or may not happen.<sup>32</sup> Prospective liability is defined in the case of *Stonegate Securities Ltd v Gregory*<sup>33</sup> as "a debt which will certainly become due in the future, either on some date which has already been determined or on some date determinable by reference to future events." From the definition, prospective liability includes both liquidated sums due and unliquidated claims of future debts.<sup>34</sup> However, for the purpose of the test, potential liabilities are not to be included, as decided in the case of *Re European Life Society*.<sup>35</sup> It should be noted that unlike the UK and Malaysia, the New Zealand Companies Act 1993 only requires the contingent liabilities to be taken into consideration when ascertaining the company's net assets under the test.<sup>36</sup>

Under the test, the valuations of assets and liabilities are important because it requires a solvent company to have positive net assets.<sup>37</sup> While in most cases the company's solvency status is clear-cut, there are marginal situations where the ascertainment of the value of assets and liabilities is essential.<sup>38</sup> In this situation, the court has to decide on the balance of probabilities whether the company is or was at a particular point of time unable to pay its debts.<sup>39</sup> In addition, the company is free to choose from various methods available for valuation, depending on its business as

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<sup>32</sup> Ibid, at [4-28].

<sup>33</sup> [1980] 1 Ch 576, per Buckley LJ at 579.

<sup>34</sup> Goode above n3 at [4-29].

<sup>35</sup> (1869) LR 9 Eq 122 at 128.

<sup>36</sup> Section 4(1)(b) of the New Zealand Companies Act 1993; but see also section 188 of the Act which requires both prospective and contingent liabilities to be considered in order to determine the meaning of unable to pay its debts for the purpose of winding up.

<sup>37</sup> Ross above n5 at 79.

<sup>38</sup> Goode above n3 at [4-34].

<sup>39</sup> Ibid; see also Mike Ross "The Statutory Solvency Test" in Andrew Borrowdale, David Rowe and Lynne Taylor (Eds) *Company Law Writings: A New Zealand Collection* (Centre for Commercial and Corporate Law, Christchurch, 2002) 177 at 198 ["Company Law Writings"].

long as the accounts give true and fair view.<sup>40</sup> Thus, the outcome of the test would vary depending on the accounting methods used by the company. The company's balance sheet may also be of little assistance, since the value reflected in it represents historical costs<sup>41</sup>.

On the question of whether valuation<sup>42</sup> should be a break-up or going concern, it depends on the company's position at the relevant time, the court will have to decide whether it should continue to trade or otherwise.<sup>43</sup> Another difficulty associated with this test is the estimation of liabilities, particularly in relation to unquantified existing liabilities, contingent liabilities and the expense of liquidation.<sup>44</sup> Just as with the valuation of assets, the outcome of the test will vary depending on how liabilities are appraised.

For contingent liability, the question is not only on the amount but also on the existence of liability itself. This is because the possibility of its occurrence ranges from nil to near certainty.<sup>45</sup> In this case, the court will have to assess the probability of the occurrence of such contingency and it is difficult to do so with reasonable accuracy.<sup>46</sup>

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<sup>40</sup> Goode above n3 at [4-35].

<sup>41</sup> Goode above n3 at [4-34]; Ross "Company Law Writings" above n39 at 200.

<sup>42</sup> The New Zealand Companies Act 1993 provides guidelines in section 4(2) in which regard must be given to the company's recent financial statement, directors may also consider internal and external factors in order to determine whether necessary to make adjustment to the value of the assets and directors may adopt the valuation they consider as reasonable depending on the circumstances; see Ross above n3 at 87-88.

<sup>43</sup> Goode above n3 at [4-37]; the relevant time depends on the statutory provisions and circumstances the solvency test is required for.

<sup>44</sup> *Ibid.*, at [4-41].

<sup>45</sup> *Ibid.*

<sup>46</sup> *Ibid.*

The variation in the outcome depending on methods of assessment has raised the question of whether there should be one standard practice that must be adopted by the company. The existence of one standard practice may provide certainty in the outcome but it may be too rigid and may not be able to respond immediately to any contingencies. On the other hand, to leave to directors to decide may be flexible but will lead to uncertainty as well as being open to manipulation by directors.

In the absence of legal definition as to what amounts to assets and liabilities, reliance has been placed on directors' discretion and accounting practice. Directors are free to choose any accounting format they feel best suited for the company and the court will not intervene in their decisions unless there are elements of *mala fides*.

In Malaysia, the balance sheet test is contained in section 218(2)(c) of the Companies Act 1965, but unlike the UK Insolvency Act 1986 and New Zealand Companies Act 1993, the provision did not describe the test. In *Datuk Mohd Sari bin Datuk Hj Nuar v Idris Hydraulic (M) Bhd*<sup>47</sup> the petitioner relied on the respondent's balance sheet which showed current liabilities exceeded the current assets, to file a winding up petition.

The court asserted that under section 218(2), there are three ways in which the petitioner could prove that the respondent is unable to pay its debts and in the instance section 218(2)(c) is applicable since no statutory notice of demand was served. The court referred to the UK Companies Act 1948 and concluded that:

Section 218(2)(c) is very clear. To ascertain if a company is unable to pay its debt the court shall take into account the contingent and prospective liabilities of the company. In order to ascertain its liabilities, it is proper that its assets are also ascertained because only upon ensuring that there is insufficient assets to meet the debts can there be ascertained liabilities. Therefore the

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<sup>47</sup> [1997] 5 MLJ 377.

current assets must be taken stock of to see if after considering the total liabilities both contingent and prospective there is a surplus.<sup>48</sup>

The court, nevertheless, did not discuss the meaning of contingent and prospective liabilities in the case, instead only referred to the company's current liabilities and assets in determining whether the company was insolvent. The court went on to state that in order to satisfy the section, the overall assets and liabilities test was the proper test rather than the quick assets tests which the petitioner had relied on.

## **8.6 Cash Flow Test**

Under this test, a company is insolvent if it fails to pay its debts as and when they become due.<sup>49</sup> The test has been used more widely than the balance sheet test. The test has been described in the UK, New Zealand and Australian legislation while Malaysian Companies Act 1965 does not have similar provision. The cash flow test has been used by the company in order to rebut the presumption of inability to pay its debts which arose when the company failed to comply within 21 days as stated in the statute.<sup>50</sup> In addition, the courts have also applied the test in relation to section 223 for avoidance of disposition of property and section 293 for undue preference.

Although the cash flow test is not incorporated into the Malaysian Companies Act 1965, the test is still applicable in Malaysia through the common law. The High Court's decision in *Hotel Royal Ltd Bhd v Tina Travel & Agencies Sdn Bhd*<sup>51</sup> acknowledged that there are two tests, the cash flow and the balance sheet test which can be used in order to determine the phrase 'unable to pay its debts.' Since then, the

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<sup>48</sup> *Datuk Mohd Sari bin Datuk Hj Nuar v Idris Hydraulic (M) Bhd* [1997] 5 MLJ 377 at 390.

<sup>49</sup> See section 123((1) (e) of the UK Insolvency Act 1986; Section 4(1)(a) of the New Zealand Companies Act 1993; Section 95A of the Australia Corporations Act 2001.

<sup>50</sup> Section 218(2)(a) of the Malaysian Companies Act 1965.

<sup>51</sup> [1990] 1 MLJ 21.

cash flow test has been more widely used by the court than the balance sheet test. The balance sheet test has only been used if the creditors have filed the winding up petition without serving a statutory notice of demand as stated in section 218(2)(a).<sup>52</sup>

In *Sri Hartamas Development Sdn Bhd v MBF Finance Bhd*,<sup>53</sup> the court stated that “the presumption of insolvency arises when the requirements of section 218(2)(a) of the Act have been satisfied and it is for the company to prove that it is able to pay its debts.” In deciding whether the company was commercially insolvent, the Supreme Court applied the test used by the Privy Council in *Malayan Plant (Pte) Ltd v Moscow Narodny Bank Ltd*<sup>54</sup> and held that it did not matter if the company had assets available, if they could not be realized on time to meet its current liabilities, the company was insolvent.<sup>55</sup>

The court in *Lian Keow Sdn Bhd (In Liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors*,<sup>56</sup> a preference case under sections 223 and 293, held “the question is not whether the debtor’s assets exceed his liabilities as appeared in the books of the debtor, but whether there are moneys presently available to the debtor, or which he is able to realize in time, to meet the debts as they become due. It is not sufficient that the assets might be realizable at some future date after the debts have become due and payable.”<sup>57</sup> The court’s decisions seem to illustrate that a company is insolvent if it fails to pay within the stipulated time. It should be noted that in most

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<sup>52</sup> See *Datuk Mohd Sari bin Datuk Hj Nuar v Idris Hydraulic (M) Sdn Bhd* [1997] 5 MLJ 377.

<sup>53</sup> [1992] 1 MLJ 313 at 320.

<sup>54</sup> [1980] 2 MLJ 53.

<sup>55</sup> [1992] 1 MLJ 313 at 320; see also *Re Hong Huat Realty* [1987] 2 MLJ 502; *Hotel Royal Ltd Bhd v Tina Travel & Agencies Sdn Bhd* [1990] 1 MLJ 21; *Pioneer Concrete (M) Sdn Bhd v Celini Corp Sdn Bhd* [1998] 3 MLJ 810; *HSBC Bank Malaysia Bhd v CS Metal Industries (M) Sdn Bhd* [2006] 2 MLJ 578; *Yew Chye Heng & Anor v Venice Hill Living Resort Sdn Bhd* [2007] 7 MLJ 566.

<sup>56</sup> [1988] 2 MLJ 449.

<sup>57</sup> [1988] 2 MLJ 449 at 454; see also *PT Anekapangan Dwitama v Far East Food Industries Sdn Bhd* [1995] 1 MLJ 21.

cases the presumption of insolvency applies and the company will have to rebut such presumption.

Goode commented that the formulation of the test is deceptive in its simplicity since it raises a number of questions not fully explored in English law.<sup>58</sup> The difficulty lies with the word 'debts' itself; whether the court should look into future debts and if so, to what extent.<sup>59</sup> Courts in Australia have adopted a commercial approach to the meaning and held that it "indicates a continuous succession of debts rather than a calculation of debts existing on any particular day."<sup>60</sup>

In applying the test, only liquidated claims which at the relevant time constitute existing debts payable should be included.<sup>61</sup> Though in principle future, prospective and contingent debts and liabilities should be ignored, courts still have to bear in mind whether the company in question would be able to discharge its obligation when it is time to do so.<sup>62</sup> The court, however, is reluctant to specify the time period in the future because each case is different and peculiar to its own facts.<sup>63</sup>

The fact that the company does not have sufficient cash to pay its debts as they fall due is not a sufficient indication of insolvency for the company.<sup>64</sup> The company can still resort to realizing its assets or borrowing, provided this is done within the

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<sup>58</sup> Goode above n3 at [4-15].

<sup>59</sup> Ibid.

<sup>60</sup> *Bank of Australasia v Hall* (1907) 4 C.L.R 1514 at 1528.

<sup>61</sup> Goode above n3 at [4-18].

<sup>62</sup> Ibid.; *Bank of Australasia v Hall* (1907) 4 C.L.R 1514 at 1528; *Expo International Pty Ltd v Chant* [1979] 2 NSWLR 820; *Re Kerisbook Pty Ltd* (1992) 10 ACLC 619; see also Andrew Keay "The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidations" (1995) 21 Monash Uni LR 305 at 314-316.

<sup>63</sup> Keay, *ibid.*, at 316.

<sup>64</sup> Goode above n3 at [4-22].

prescribed time.<sup>65</sup> The decision in *Bank of Australasia v Hall*<sup>66</sup> illustrated that the debtor's ability to pay was not limited to its cash but include any moneys from sale or pledge of assets.<sup>67</sup> The courts, however, acknowledge not all assets can be included and realized, for it may result in the closure of business or breach of contract.<sup>68</sup> Hence, whether assets should be accounted for or not depends upon the nature of business and the nature of the assets.<sup>69</sup> In *Sri Jeluda Bhd v Pentalink Sdn Bhd*,<sup>70</sup> the Malaysian Court of Appeal decided that the company failed in rebutting the presumption when the money it asserted to be in its account in fact belonged to a third party.<sup>71</sup> As such, the company would not be able to pay its debts when they were due.

In *Syarikat Mohd Noor Yusof Sdn Bhd v Polibina Engineering Enterprise Sdn Bhd*,<sup>72</sup> the respondent sent a notice under section 218(2)(a) claiming a sum of RM896, 378.18. The respondent, however, did not obtain any judgment for such sums and the appellant disputed the debts. The court decided that the presumption of being unable to pay its debts did not arise in this case since the appellant was clearly a solvent company.<sup>73</sup>

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<sup>65</sup> Ibid.

<sup>66</sup> *Bank of Australasia v Hall* (1907) 4 C.L.R 1514 at 1528.

<sup>67</sup> See also the decision in *Sandell v Porter* (1966) 115 CLR 666; New Zealand unreported case *Re: Northbridge Properties Ltd* High Court Auckland, M46-49/75 and M77/75, 13 December 1977, as noted in "Insolvency and Companies" [1983] NZLJ 44; for Malaysia, see decision in *Lian Keow Sdn Bhd (In Liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors* [1988] 2 MLJ 449 at 454; *PT Anekapangan Dwitama v Far East Food Industries Sdn Bhd* [1995] 1 MLJ 21 at 29; *Sri Hartamas Development Sdn Bhd v MBF Finance Bhd* [1992] 1 MLJ 313 at 320.

<sup>68</sup> *Re Timbatec Pty Ltd* (1974) 24 FLR 30 at 36-37; *Bank of Australasia v Hall* above n 55.

<sup>69</sup> Keay above n62 at 324.

<sup>70</sup> [2008] 3 MLJ 692.

<sup>71</sup> [2008] 3 MLJ 692 at 711.

<sup>72</sup> [2006] 1 MLJ 446.

<sup>73</sup> [2006] 1 MLJ 446 at 455.

It is interesting to note in reaching the conclusion on the company's solvency status, the court referred to the company's paid up capital and found it was higher than the amount claimed by the respondent, hence the company was solvent. The Court of Appeal did not consider whether the amount of the paid up capital reflects the current value of the company's assets or whether the company has the ability to pay as and when the debt becomes due. This could probably be due to the fact that the company had disputed the debts and no judgment was ever made in respect of the sums. The court had in this case, applied the capital maintenance doctrine in order to determine whether the company was solvent when the trend seems to be replacing that doctrine with the solvency requirement.

One issue that arises from the Court of Appeal decisions in the case is whether paid up capital is the appropriate test to decide on the company's solvency status. As discussed in the previous chapter, capital maintenance doctrine does not provide adequate protection to creditors and has slowly been replaced by the requirement to satisfy the solvency test.<sup>74</sup>

The solvency test is more appropriate because it relates to the company's current financial position. The court's decision had, in fact, made the doctrine the determinant factor of solvency, which in my view, is incorrect. The capital maintenance doctrine indicates the amount of paid up shares contributed by shareholders in the past.<sup>75</sup> It does not display the current value of the company's funds which is the focus of the solvency tests.<sup>76</sup> The test advanced by the court could not be regarded as the balance sheet test because of the simplistic approach, comparing the company's paid up capital and the amount claimed without taking into account the contingent and prospective liabilities of the company.

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<sup>74</sup> Ross above n5 at 66-67.

<sup>75</sup> Ibid.

<sup>76</sup> Ibid.

The decision in *Syarikat Mohd Noor Yusof Sdn Bhd v Polibina Engineering Enterprise Sdn Bhd*<sup>77</sup> should be confined to its facts, namely there was dispute as to the existence of debts and there had never been any judgment made against the company in respect of the sum. The appropriate course for the creditor in this matter would be to exhaust all possible remedies under contract first, before commencing a winding up procedure.

## **8.7 Conclusion**

The new concept of solvency acts as a preventive measure by which companies are restricted from acting in certain ways should insolvency ensue from such deed. It focuses on the future and directors are required to make a prediction based on the current information available to them. Therefore, it is crucial for them to know how the courts will interpret these tests. Further, directors themselves may not be well versed in the information they have on hand, hence clear guidance is essential.

Seeing the difficulties to apply the tests due to the absence of clear definitions, it is necessary to have clear guidelines on how the tests should be applied. This is to ensure certainty and uniformity in the area while, at the same time, addressing the difficulties associated with applying the tests. The courts, rather than Parliament, remain the appropriate forum to provide these guidelines because courts can respond promptly to any changes and make decisions based on facts of each case. Therefore, courts, especially in the UK and Malaysia, must take a proactive role in providing guidelines on how the tests should be applied.

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<sup>77</sup> [2006] 1 MLJ 446.

## **CHAPTER 9 THE COMMON LAW DUTIES OF DIRECTORS TOWARD CREDITORS**

### **9.1 Introduction**

As discussed in the previous chapters, the principle of separate legal entity resulted in the company and shareholders being considered as two distinct personalities. This means, there is separation of ownership and management where ownership lies with the shareholders, while the board of directors manages on behalf of the company. The shareholders were seen as the watchdogs who supervise and control the directors' actions, in addition to the control provided by the market. Later, the ownership of shares in listed companies began to disperse and the control they exercised over the board of directors waned. In this respect, market control alone is not sufficient because the theory that the market will provide adequate control over directors will only work in an ideal situation. As a result of this, directors have free rein over the management of the company and there is opportunity for them to shirk their duty.

This chapter will investigate the legal response to this problem both under the common law and the statutory provisions. However, the arguments will concentrate on directors' duties in relation to protection of creditors only. The thesis will explore the extent to which the law on directors' duties can be used to protect creditors either directly or indirectly. Since creditors' interests become paramount when the company is insolvent, attention will be focused on this aspect.

Since this chapter will focus on two main players, the directors and the creditors, the first section will consider definitions of both directors and creditors. The second section will examine the legal aspects of directors' duties in relation to creditors' protection. It will discuss how this duty can be improved so as to provide better protection to creditors, particularly in an insolvent company.

## 9.2 Definition

### 9.2.1 Creditors

Generally, a creditor is a person or company to whom money is owed.<sup>1</sup> Debt is an obligation or liability to pay or render something, money, goods or services that are owed.<sup>2</sup> Debts in this context include prospective and contingent debts.<sup>3</sup> The existence of a debt is essential in order to determine whether a person is a creditor. Hence, in the situation where there is a bona fide dispute of debts, a person is held not to be a creditor.<sup>4</sup>

There are two types of creditors, voluntary and involuntary. The voluntary or consensus creditors are those who agree to enter into relationship with the company by extending credit or supplying goods and services.<sup>5</sup> Involuntary creditors refer to those who have not agreed to become creditors but become so as a result of the company's action or omission.<sup>6</sup>

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<sup>1</sup> *The Oxford Dictionary of English (2nd edition revised)* in English Dictionaries & Thesauruses. <[http://www.oxfordreference.com.ezproxy.waikato.ac.nz/views/SUBJECT\\_SEARCH.html?subject=s7](http://www.oxfordreference.com.ezproxy.waikato.ac.nz/views/SUBJECT_SEARCH.html?subject=s7)> at 22 October 2009.

<sup>2</sup> Ibid.

<sup>3</sup> A prospective debt is a debt which will definitely become due in the future whether at some determined date or upon the occurrence of a certain event- see *Stonegate Securities Ltd v Gregory* [1980] 1 Ch 576 at 579; a contingent debt is referred to debts which becomes due depending upon event(s) which might or might not happen as a result of an action by the person bound-see *Re Sutherland Dec'd* [1963] AC 235 at 249; see also *Re William Hockley Ltd* [1962] 1 WLR 555.

<sup>4</sup> See *Morgan Guaranty Trust Co of New York v Lian Seng Properties Sdn Bhd* [1990] 1 MLJ 282; *Re Lympne Investment Ltd* [1972] 2 All ER 385; *Mann & Another v Goldstein & Another* [1968] 2 All ER 769; *Emporium Jaya (Bentong) Sdn Bhd (in liquidation) v Emporium Jaya (Jerantut) Sdn Bhd* [2002] 1 MLJ 182.

<sup>5</sup> Andrew Keay *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish, New York, 2007) at 15.

<sup>6</sup> Ibid, at 18.

Voluntary creditors can be divided into secured creditors, unsecured creditors and preferential creditors.

### **9.2.1.1 Secured Creditors**

Secured creditors are so called because they hold security over the company's assets either in the form of fixed charge<sup>7</sup> or floating charge.<sup>8</sup> The creation of the security will allow creditors to be able to realise the assets if the company fails to fulfil its obligations.<sup>9</sup> The proceeds from the sale of the assets will be used to pay the company's obligation and any surplus will be returned to the company.<sup>10</sup>

Normally, creditors who are able to secure such arrangements are banks and financial institutions or large corporations. This type of creditor will be least affected by the company's insolvency since they are able to recoup their debts by realising assets at the first sign of distress, provided the security is adequate.<sup>11</sup> Otherwise, the creditor will become an unsecured creditor in respect of the unpaid balance. In addition to security over the company's assets, creditors can also include other forms of security in their contracts.<sup>12</sup> These contractual securities include the retention of title clauses, director's personal guarantee and restrictive covenants, particularly the

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<sup>7</sup> A fixed charge is attached to a specific asset of the company as security in favour of the creditor. The company cannot deal freely with the assets without consent of the creditor.

<sup>8</sup> A floating charge is not attached to any specific assets of the company. A floating charge will become a fixed charge once the charge crystallizes. Crystallization occurs upon the occurrence of event(s) specified in the instrument creating the charge. Unlike fixed charge, the company is free to deal with the assets in the ordinary course of business until crystallization.

<sup>9</sup> Vanessa Finch "Security, Insolvency and Risk: Who Pays the Price?" (1999) 62 MLR 633 at 634 ["Security"].

<sup>10</sup> Eilis Ferran "Floating Charges-The Nature of the Security" (1988) 47 CLJ 213 at 216.

<sup>11</sup> Ferran above n10 at 216.

<sup>12</sup> Finch "Security" above n9 at 635.

negative pledge.<sup>13</sup> The effectiveness of the contractual securities depends on the constructions of the terms in question.

### **9.2.1.2 Unsecured Creditors**

Most creditors fall within this group and they include small suppliers and trade creditors. When the company is insolvent, they will be the most vulnerable and often end up having to compromise with their payment. Since they rank at the bottom of the pile, the likelihood of receiving full payment for their debts is small. Therefore they will have to be satisfied with the distributions based on the *pari passu* principle.<sup>14</sup>

### **9.2.1.3 Preferential Creditors**

Generally they are unsecured creditors who have been given preferential treatment through statute such as the government's claim for tax and employees' claim for unpaid wages. The United Kingdom and Australia have abolished the priority accorded to the government's claim for taxes.<sup>15</sup> Employees' claim for unpaid wages is treated as priority because they are in the most vulnerable position compared to other trade creditors. Employees, unlike trade creditors, cannot diversify and, in most cases, wages are their only source of income.

## **9.2.2 Directors**

Directors are appointed to manage the affairs of the company in accordance with the Articles of Association and the Memorandum of Association. Generally, directors

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<sup>13</sup> For further discussions see Key above n5 at 19 and ch 20.

<sup>14</sup> See Finch "Security" above n9 at 634; Roy Goode *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London, 2005) at [7-01]-[7-04].

<sup>15</sup> Goode above n14 at [7-27]. For lists of preferential debts-see Schedule 6 of the Insolvency Act 1986.

are not personally liable for any losses or damage suffered by a third party because of the principle of separate legal entity. However, in some circumstances, directors can be personally liable for their actions, for example when they have breached their duty at common law or by statute as well as in torts.

In practice, directors are known as either executive or non-executive directors.<sup>16</sup> The responsibility and liability imposed on directors are similar, regardless of the categories.<sup>17</sup> The former are directors who are employed on full time basis while the latter are not. Directors are defined in the statute as “include[ing] any person occupying the position of director, by whatever name called.”<sup>18</sup>

A director, therefore, is identified by the functions performed rather than the label attached to the person. There are three types of directors:

- a) *de jure* directors;
- b) *de facto* directors; and

shadow directors.

### **9.2.2.1 De Jure Directors**

*De jure* directors are formally appointed according to the Company’s Constitution; the Articles of Associations and the Memorandum of Associations with their consent.<sup>19</sup>

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<sup>16</sup> Keay above n5 at 5.

<sup>17</sup> Ibid; see also *Ravichathiran a/l Ganesan v Percetakan Wawasan Maju Sdn Bhd & Ord* [2008] 8 MLJ 450 at 457.

<sup>18</sup> See section 126 of the New Zealand Companies Act 1993; section 250 of the UK Companies Act 2006; Part 1.2 Interpretation in the Australian Corporations Act 2001 and section 4 of the Malaysian Companies Act 1965.

<sup>19</sup> Keay above n5 at 5.

### 9.2.2.2 De Facto Directors

*De facto* directors are persons who are held out to be the directors of the company although they were not validly appointed according to the law.<sup>20</sup> They assume the position and claim to be the directors.<sup>21</sup> They are identified by the functions they perform for the company which only directors could undertake.<sup>22</sup>

### 9.2.2.3 Shadow Directors

A shadow director is a person who lurks behind another who he claims to be the director.<sup>23</sup> He is a person who controls the directors to act according to his instructions or directions.<sup>24</sup> It is essential to prove that there is a pattern of conduct and not rely on one specific occasion in which the *de jure* directors are accustomed to act on the instructions or directions of the shadow directors.<sup>25</sup>

## 9.3 Duty of Loyalty and Good Faith

The common law imposes a very strict duty on directors due to their position which is perceived as fiduciary.<sup>26</sup> A director is seen to be in a position of trust and

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<sup>20</sup> *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 182.

<sup>21</sup> *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 182.

<sup>22</sup> *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 182; *Secretary of State for Trade and Industry v Becker* [2003] 1 BCLC 555.

<sup>23</sup> *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 182.

<sup>24</sup> The definition of directors in the statute also include shadow directors - see section 251 of the UK Companies Act 2006; section 126 of the New Zealand Companies Act 1993; Part 1.2 Interpretation in the Australian Corporations Act 2001 and section 4 of the Malaysian Companies Act 1965. See also *Re Unisoft Group Ltd (No 3)* [1994] BCLC 609; see also *Re A Company (No 05009 of 1987) ex parte Copp & Anor* [1989] BCLC 13.

<sup>25</sup> *Re Lo-Line Electric Motors Ltd* [1988] BCLC 698.

<sup>26</sup> See Robert Flannigan “Fiduciary Duties of Shareholders and Directors” (2004) JBL 277 at 279-293; directors’ position in a company is in fact a fusion of several elements - an agent, a trustee, an

confidence, a trustee who has been entrusted with company's money to act on its behalf, and hence a very high standard of duty is required of them.<sup>27</sup> In addition, a director can also be seen as an agent acting on behalf of the company, its principal.<sup>28</sup>

Due to the doctrine of separate legal personality, the courts have traditionally always held that directors owe a duty to the company. However a company's legal personality is a creation of law, and in reality it comprises a web of relationships between various parties whose interests depend on the director's actions.<sup>29</sup> Therefore, it is essential to determine whose interests, among these various stakeholders, represent the interests of the company.

The law has always associated the company's interests to be that of the shareholders' and held that their interests represent the interests of the company.<sup>30</sup> Recently, the law has begun to recognize the interests of other players in the company, including the creditors.<sup>31</sup> Creditors had always been overlooked by the law in the past because they were perceived to be outsiders who could protect their own interests.<sup>32</sup>

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employee and a professional adviser - see also Peter Loose, Michael Griffiths and David Impey *The Company Director Powers, Duties and Liabilities* (10<sup>th</sup> ed., Jordans, Bristol, 2008) at 127; Robert P Austin and Ian M. Ramsay *Ford's Principles of Corporations law* (14<sup>th</sup> ed., Lexis Nexis Butterworth, NSW, 2010) at [8.010].

<sup>27</sup> See Flannigan *ibid*; directors' position in a company is in fact a fusion of several elements - an agent, a trustee, an employee and a professional adviser- see also Loose, Griffiths and Impey *ibid*.

<sup>28</sup> *Ibid*.

<sup>29</sup> See discussion in Chapter 6.

<sup>30</sup> *Re Smith & Fawcett Ltd* [1942] 1 All ER 542; *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286.

<sup>31</sup> The acknowledgement of duty to creditors, however, is limited to the situation where a company is insolvent; see *Walker v Wimborne* (1976) 3 ACLR; *West Mercia Safety Ltd (in liq) v Dodd* (1988) BCLC 250; *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 243; *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong* [2009] 1 MLJ 723.

<sup>32</sup> Paul Halpern, Michael Trebilcock and Stuart Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 *Uni Toronto LJ* 117 at 135; Vanessa Finch, "Security" above n9 at 641; Vanessa Finch, "Directors' Duties: Insolvency and Unsecured Creditor" in Alison Clarke (Ed.), *Current Issues in Insolvency Law* (Stevens and Sons Ltd, London, 1991) 87.

The creditors' main concern is the company's ability to make payment for its debts and this concern is heightened when the company is in financial difficulties.<sup>33</sup> Therefore, the courts have begun to acknowledge creditors' interests in situations where the company is insolvent. This approach has raised questions as to whether this is sufficient or whether the duty should be expanded to include pre-insolvency situations as well, and if so, how the duty should be formulated.<sup>34</sup> In addition to the common law duty, there are other provisions in the statute which have the aim of protecting creditors. (This topic will be explored in a later chapter).

The duty to act bona fide or in good faith is the core concept from which other duties flow.<sup>35</sup> Directors are expected, in discharging their duty, to act in the interests of the company in accordance with their fiduciary position. These duties were initially developed in the common law but have now been incorporated into statutes which either strengthen or modify the common law position. The duty of directors to the company to act bona fide can be divided into four categories:

- a) Duty to act bona fide in the interests of the company;
- b) Duty to use powers for proper purposes;
- c) Duty not to fetter discretion; and
- d) Duty to avoid actual and potential conflict of interest.

### **9.3.1 Duty to Act Bona Fide in the Interests of the Company**

Directors owe loyalty and good faith to the company, which means they must advance the interests of the company.<sup>36</sup> This concept is wide enough to cover the

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<sup>33</sup> Austin and Ramsay above n26 at [20-160].

<sup>34</sup> Keay above n5 at Ch13.

<sup>35</sup> John Farrar *Corporate Governance Theories, Principles and Practice* (3rd ed., Oxford University Press, South Melbourne, 2008) at 113.

<sup>36</sup> Lord Greene MR in *Re Smith & Fawcett Ltd* [1942] 1 All ER 542 held "They must exercise their discretion bona fide in what they consider not what the court may consider to be in the interests of the company and not for any collateral purposes;" Evershed MR in *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 stated: "The phrase 'the company as a whole' does not (at any rate in such a

interests of various parties in the company, for in most cases their interests are inter-related, this being necessary for the survival of the company. Difficulties arise when these interests are in conflict with one another and in such cases the question is whose interests should prevail. Since the duty is owed by directors to the company, no interests should triumph over the others; it is essential for directors in achieving their objectives not to expose any groups to unnecessary risks. Directors should consider all interests without any preference.

However, in defining the interests of the company, the courts traditionally equate those interests with the financial interest of the shareholders.<sup>37</sup> This is because a company was an extension of a partnership and partners were identified as the company.<sup>38</sup> Moreover, shareholders are the residual claimants of the company's assets after all other claims, including those of creditors, have been met.<sup>39</sup> This trend continued even after the separate legal entity principle was introduced. Creditors have always been considered as outsiders who can protect themselves by contract and hence received little sympathy from the courts.<sup>40</sup> However, in a modern complex society and a globalised economy, it is no longer sufficient for a company to concentrate only on shareholders' profits, and it must be subjected to a wider responsibility.<sup>41</sup>

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case as the present) mean the company as a commercial entity distinct from the incorporators: it means the incorporators as a general body;" *Foss v Harbottle* (1843) 2 Hare 461; *Re Roith (WM) Ltd* [1967] 1WLR 432.

<sup>37</sup> Paul L. Davies *Gower and Davies Principles of Modern Company Law* (8<sup>th</sup> ed., Sweet & Maxwell, London, 2008) at 127; Austin and Ramsay above n26 at [8.010]; Irene Trethowan "Directors' Personal Liability to Creditors for the Company Debt" (1992) 20 ABLR 41 at 77.

<sup>38</sup> Paddy Ireland "Company Law and the Myth of Shareholder Ownership" (1999) 62 MLR 32 at 39-40.

<sup>39</sup> Flannigan above n26 at 279; Jonathan R Macey and Geoffrey P Miller "Corporate Stakeholders: A Contractual Perspective" (1993) 43 *Uni Toronto LJ* 401 at 406

<sup>40</sup> Trethowan above n37 at 48.

<sup>41</sup> *Ibid*, at 74; James McConvill "Directors' Duties to Stakeholders: A Reform Proposal Based on Three False Assumptions" (2005) 18 *AJCL* 88 at 90.

The UK Companies Act 2006 has incorporated this wider responsibility of directors who have a duty to promote the success of the company.<sup>42</sup> This duty to promote the success of the company now replaces the duty to act bona fide in the interests of the company. The provision provides that the duty is to promote the success of the company for the benefit of its members as a whole, which suggests that the shareholders' interests are still paramount. Hence, the duty itself does not digress from the existing concept. Directors are only required to consider the interests of those listed in the Act, in furtherance of the success of the company for the benefit of the shareholders. This list is not exhaustive.

Therefore, it is open for directors to argue that there is no need for them to consider these other interests because it does not serve the purpose of promoting the success of the company.<sup>43</sup> Generally the power to enforce the provision still lies with the company (and the minority shareholders under the derivative action) and not with the stakeholders mentioned in the Act, which may present problems if the company refuses to take action on their behalf. Further, the Act does not clarify how the duty should be exercised if there are conflicts of interest between parties, and since the

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<sup>42</sup> Section 172(1) of the UK Companies Act 2006 provides "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- (a) the likely consequences of any decision in the long term;
- (b) the interests of the company's employees;
- (c) the need to foster the company's business relationships with suppliers, customers and others;
- (d) the impact of the company's operations on the community and the environment;
- (e) the desirability of the company maintaining a reputation for high standards of business conduct; and
- (f) the need to act fairly as between members of the company."

<sup>43</sup>Demetra Arsalidou "Shareholder Primacy in cl173 of the Company Law Bill 2006" (2007) 28 Co Lawyer 67.

overriding duty is to the shareholders, directors may overlook the other stakeholders in this situation.

It is settled law that directors are required to take creditors' interests into consideration when insolvency lurks because now creditors are the residual claimants of the company's assets.<sup>44</sup> However, it is not a direct duty owed to creditors, and the duty remains to the company. Creditors, therefore, do not have direct access to bring action against directors and it is up to the company to do so.<sup>45</sup> Hence, despite the court's acknowledgement of creditors' interests in insolvency situations, there is no change in the concept of directors' duty which continues to be to the company.

The courts and the statutes have always focused on creditors when the company has become insolvent or is about to become so. When the company is having financial difficulties, it is highly probably that it may be wound up, and at that point of time creditors will be subjected to the *pari passu* principle.<sup>46</sup> In this situation, the likelihood of creditors being paid in full is very low and they may have to be satisfied with lesser amounts. In addition, the law does not confer any right on creditors to take action against the company or directors, even when the company has been wound up, and the right lies with the liquidator who decides whether to pursue the action or not.

Directors should have regard to the interests of creditors in pre-insolvency situations because that may help them to make better decisions in the interests of the

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<sup>44</sup> Davies above n37 at [16-34]-[16-35]; *Walker v Wimborne* (1976) 3 ACLR 531; *West Mercia Safety Ltd (in liq) v Dodd* (1988) BCLC 250; *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 243; *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong* [2009] 1 MLJ 723.

<sup>45</sup> See the rule in *Foss v Harbottle* (1843) 2 Hare 461.

<sup>46</sup> Goode above n14 at [7-27]. For lists of preferential debts-see Schedule 6 of the Insolvency Act 1986.

company.<sup>47</sup> For example, if a company is faced with a high risk venture with potential high returns, under the current legal framework, directors should act in the interests of the company, namely the shareholders whose interests would be high profits.<sup>48</sup> Therefore the directors would most certainly take up the project. Given the risky nature of the project, there is a possibility that the venture would fail and affect the company's financial position.<sup>49</sup>

On the other hand, if directors also have a duty to consider the interests of creditors, they will have to weigh the effects of their decisions on creditors as well and such decisions would not only be based on the amount of potential profits to be generated. Directors should assess any decisions to be made with caution so that the company is not exposed to unnecessary or illegitimate risks.<sup>50</sup> This, in turn, may save the company from encountering financial difficulties in the future. Nevertheless, it is acknowledged that companies face commercial risks all the time and creditors themselves are well aware of this. What is proposed is not that the company is not allowed to take risks or should be overly cautious in assessing the risks, but that consideration should be also given to the interests of the creditors when making decisions.

### **9.3.2 Duty to Use Powers for Proper Purpose**

Pursuant to the duty of loyalty and good faith, directors must discharge their duty for purposes conferred on them by the Company's Constitution.<sup>51</sup> In order to determine whether the directors have breached their duty, the proper approach is for the courts

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<sup>47</sup> Brian Cheffins *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997) at 541.

<sup>48</sup> *Ibid.*

<sup>49</sup> *Ibid.*

<sup>50</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at 114.

<sup>51</sup> The Memorandum of Association and Articles of Association.

to look at the directors' purpose in using the power and not on the effect of exercising such power.<sup>52</sup> Nevertheless, it is still important that directors exercise their powers for the benefit of the company.<sup>53</sup> The courts, for instance, have imposed liability on directors for issuing shares with the aim of enhancing their control over the company.<sup>54</sup> However, if the directors were to issue more shares for legitimate commercial purposes, the court would not interfere with the decision.<sup>55</sup>

The courts reluctance to interfere in management's decisions unless there are legitimate commercial reasons illustrates the traditional view that it is not the role of the courts to decide on how the company should be managed.<sup>56</sup> Professor Farrar cautioned that the concept of non-interference by the courts should be contrasted with the business judgment rule; while the former relates to the business judgment doctrine, the latter refers to the presumption that directors will have no liability provided certain conditions are fulfilled.<sup>57</sup>

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<sup>52</sup> Austin and Ramsay above n26 at [8.200].

<sup>53</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, the Privy Council decided that directors were free to act without consent of the majority but most not do so for the purpose of diluting majority or creating new majority. In *Hogg v Cramphorn Ltd* [1967] Ch 254, the court held that if the issuance of shares is for an improper motive, it would be set aside regardless of whether it was made with the bona fide belief that it was for the benefit of the company. See also *Harlowe's Nomines Pty Ltd v Woodside (Lake Entrance) Oil Co No Liability* (1968) 121 CLR 483; *Dr Mahesan & Ors v Punnusamay & Ors* [1994] 3 MLJ 312; *Soo Boon Siong @Saw Boon Siong v Saw Fatt Seong and Soo Hock Seang \*as estate representative Soo Boon Kooi @ Saw Boon Kooy (deceased) & Ors* [2008] 1 MLJ 27.

<sup>54</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Soo Boon Siong @Saw Boon Siong v Saw Fatt Seong and Soo Hock Seang \*as estate representative Soo Boon Kooi @ Saw Boon Kooy (deceased) & Ors* [2008] 1 MLJ 27.

<sup>55</sup> *Punt v Symons & Co Ltd* [1903] 2 Ch 506.

<sup>56</sup> See generally and the cases discussed Austin and Ramsay above n26 at [8.060].

<sup>57</sup> Farrar above n35 at 149.

On the other hand, the court would not hesitate to prevent any actions which tend to enhance directors' control over the company.<sup>58</sup> This could be due to the possibility that when existing shareholders' control is diluted and replaced by that of the directors', the likelihood of abuse of power is high. Directors who are also the majority shareholders can now act as they please and can easily perform actions which are not provided for in the Constitutions ratified by the shareholders at the general meeting.

This could indirectly affect the creditors if the proposed actions result in the instability of the company's finances. In contrast, if the purpose of issuing new shares is to raise capital, the court has found such an action to be not improper.<sup>59</sup> The court's decision has indirectly protected the creditors' interests, especially if the decision is viewed from the perspective of the capital maintenance doctrine.<sup>60</sup>

When the company is insolvent or its financial status is doubtful, the court will also examine whether the purpose of the directors' action is to remove the funds from the reach of creditors. If the purpose of directors is this, the court is more likely to hold the directors liable for breach of duty even though the act in question is permissible by the Constitutions.<sup>61</sup>

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<sup>58</sup> Austin and Ramsay above n26 at [8.210].

<sup>59</sup> *Punt v Symons & Co Ltd* [1903] 2 Ch 506.

<sup>60</sup> See Gavin Kelly and John Parkinson "The Conceptual Foundations of the Company: A Pluralist Approach" in John Parkinson, Andrew Gamble and Gavin Kelly (Eds) *The Political Economy of the Company* (Hart Publishing, Oxford and Portland (Oregon), 2000) 113 at 115-116 and Chapter 6 of the thesis.

<sup>61</sup> *Re Day-Nite Carrier Ltd (in liquidation)* [1975] 1 NZLR 172; *Re Avon Chambers Ltd* [1978] 2 NZLR 638; *Re Horsley & Weight Ltd* [1982] 3 All ER 1045; *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1969] 2 All ER 1185; *Hilton International Ltd v Hilton* [1989] 1 NZLR 442; *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 222; *Re Peace Insurance Co Ltd* [1964] 1 MLJ 232.

### 9.3.3 Duty not to Fetter Discretion

In exercising their duty, directors should not allow others to influence their decisions but they must weigh their decisions to ensure that the company will benefit from their action.<sup>62</sup> As mentioned above, the directors' duty is to the company, and if directors limit their discretion in accordance with the wishes of certain persons or groups, there is the possibility that they may not be able to act in the best interests of the company.<sup>63</sup> Creditors may be affected if, as a result of directors limiting their discretion, their right to be paid is jeopardized. Likewise, if the directors' action does not benefit the company, creditors will also be affected because their interests are intertwined with the company's interests especially when they affect the company's chance to trade as going concern.

### 9.3.4 Duty to Avoid Actual and Potential Conflict of Interest

This duty is imposed with the aim of preventing directors from putting their interests above the company because as fiduciaries, they are involved in dealing with a third party's money and property, and may be tempted to act in ways that may prejudice interests of those in the company.<sup>64</sup> Hence, directors should be very careful to ensure not only that their action will not result in conflict of interest, but also not to put themselves in a position where there may be a possibility of conflict. The common

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<sup>62</sup> See section 173 of the UK Companies Act 2006 and section 134 of the New Zealand Companies Act 1993. There is no equivalent section in the Australian Corporations Act 2001 and the Malaysian Companies Act 1965.

<sup>63</sup> See *Thorby v Goldberg* (1964) 112 CLR where the court allowed directors to enter into an agreement to act in certain ways provided that at the time the agreement was signed they considered it to be in the interests of the company.

<sup>64</sup> See *Bray v Ford* [1896] AC 44 at 51. Lord Herschell held that "It is an inflexible rule of a court of equity that a person in a fiduciary position such as respondent's, is not, unless otherwise expressly provided entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is, as has been said, founded on principles of morality. I regard it rather as based on the consideration that human nature being what it is, there is danger in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those he was bound to protect."

law regards this duty as very important and imposes liability for breach of such duty even though the company does not suffer any losses.<sup>65</sup>

The following case shows that as fiduciaries, directors have a strict duty not to put themselves in situations where conflict of interests may arise. In *Regal (Hastings) Ltd v Gulliver*,<sup>66</sup> the directors argued that the company was not deprived of the business opportunity since it did not have funds and the directors purchased the shares with their money as members of the public. The court rejected the argument and found that the directors obtained the shares by reason, and only by reason, of their position. The court also stated that the directors' claim that the shares were purchased by them as members of the public was a travesty of facts and they could have protected themselves by disclosure at the general meeting.

The same argument was also used in the Malaysian case of *PJTV Denson (M) Sdn Bhd & Ors v Roxy (M) Sdn Bhd*.<sup>67</sup> The Federal Court, following the decision in *Regal (Hastings) Ltd v Gulliver*<sup>68</sup> upheld the High Court's decisions. The court decided that the transfer was voluntary, made in order to defraud the creditors and set aside the transaction. In respect of the registration of the land which was in the directors' name, the title to the land was indefeasible<sup>69</sup> but directors held the land in trust for the company.

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<sup>65</sup> *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461; see also *Bray v Ford* [1896] AC 44.

<sup>66</sup> [1942] 1 All ER 378 at 389.

<sup>67</sup> [1980] 2 MLJ 136; In that case the company entered into a sale and purchase agreement for a piece of land and registered the said land in its directors' name. Prior to the contract of sale of the said land, the respondent (Roxy), a creditor, obtained judgment against the company which was not satisfied. Roxy then brought an action against the company and its directors for declaration that the land belonged to the company against which the judgment may be executed. The company denied ownership and claimed that the land was bought by the directors with their own money as members of the public.

<sup>68</sup> [1942] 1 All ER 378.

<sup>69</sup> Section 340 of the Malaysian National Land Code 1965 (NLC) provides that the "title or interest of any person or body for the time being registered as the proprietor of any land,....shall be subject to the following provisions of this section, be indefeasible." Due to this provision, the directors' title

The decisions of the Federal Court illustrated some matters to be considered:

- a) The court has resorted to the directors' position as trustees in order to allow creditors to attach the property for the purpose of execution of judgment;
- b) Directors did not breach their duty to the creditors when the transfer of land was made because the court in Malaysia had not acknowledged that directors owe a duty to creditors even when the company is insolvent. The fact that the company is insolvent or on the verge of insolvency was apparent when the company failed to settle the judgment sum and there was an execution order being made against it.

Recently, there is an indication by the court that directors have a duty to consider the interests of creditors when the company is insolvent.<sup>70</sup> This tendency can be seen from the decision in *Kawin Industrial (in liquidation) v Tay Tiong Soong*<sup>71</sup> where it was held that "a duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of directors themselves to the prejudice of the creditors." The court then decided that the purported ratification was ineffective because the company was insolvent.

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to the land is indefeasible but the creditor is able to attach the land because the court regarded the position of the directors in this situation as trustees who held the land for the company.

<sup>70</sup> In other jurisdictions, however, the duty to creditors when the company is insolvent was established earlier in 1976 in an Australian case of *Walker v Wimborne* (1976) 3 ACLR 529; see other cases *Kinsela v Russel Kinsela Pty Ltd* (1986) 10 ACLR 395; for New Zealand see *Nicholson v Permakraft (N.Z) Ltd* [1985] 1 N.Z.L.R 243; see generally Andrew Keay "The Director's Duty to take into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 MULR 315["Duty"].

<sup>71</sup> [2009] 1 MLJ 723 at 734.

- c) Creditors do not have direct right to take action against the company or directors in respect of any injury suffered by them. The proper plaintiff in this respect is the company.<sup>72</sup> This case illustrated the creditors' difficulties if the company refused to take action on behalf of the creditors. It also raises question of whether creditors should have a right to take action against directors directly, similar to a shareholder's derivative action.<sup>73</sup> Shareholders are given rights in the company due to the historical doctrine that they are perceived to be the owners, while creditors are the outsiders.<sup>74</sup> However, as explained before, due to the separate legal entity principle and dispersal of ownership and control, there are no differences between shareholders and creditors today since shareholders' roles have been reduced to that of investors.<sup>75</sup> In addition, the emergence of stakeholders' theory which promotes the interests of every stakeholder in the company should be seen as an indication that each plays important roles in the success of the company.
- d) The court has rejected the claim by the company that directors had purchased the property with their own money as members of the public and stated that it was a travesty of facts. The same line of judgment was also enunciated by the court in *Regal (Hastings) Ltd v Gulliver*.<sup>76</sup> Based on the decisions, directors can only purchase assets or property if the company is not interested in the transaction in the first place. If the company withdraws its interest in the assets because of lack of funds, directors are still subject to a fiduciary duty. In this

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<sup>72</sup> See the case of *Foss v Harbottle* (1843) 2 Hare 461.

<sup>73</sup> The oppression remedy has been extended to include creditors in the Canadian Business Corporations Act and the Malaysian and Singapore Acts.

<sup>74</sup> Halpern, Trebilcock and Turnbull, above n32 at 135; Finch, "Security" above n9 at 641; Finch above n32 at 87.

<sup>75</sup> Ireland above n38 at 47.

<sup>76</sup> [1942] 1 All ER 378.

case, directors should disclose their interests in the assets to the company.<sup>77</sup>

Directors also breach their duty if they received a bribe or secret commission from a third party so that the company will act in accordance with the third party's wishes.<sup>78</sup> In *Simmah Timber Industries Sdn Bhd v David Low See Keat & Ors*,<sup>79</sup> the first defendant, who was the director, and the second defendant entered into a lease-back agreement with the company. The first defendant had obtained shares in the company in exchange for transferring the company's assets to the second defendant. As a result of the transfer, the first defendant controlled the company. The first defendant later entered into a sub-lease agreement with the second defendant in which payments were to be made to the company. The first defendant, however, took the payment under the sub-lease and did not account for it to the company. The court has described the arrangement as a "cleverly planned subterfuge to deplete the company's funds" and found that fraud has been committed on the company by its director. The court held that the director had breached his duty to the company by making secret profits. In this case, although it was the company which had been injured through depletion of its funds, creditors were also affected since it undermined the company's ability to pay its creditors.

Misuse of the company's funds is another instance where directors' breach of duty directly affects creditors if it results in the company having difficulty in paying its creditors. In *Paul A Davies (Aust) Pty Ltd v Davies*,<sup>80</sup> the directors were found to have breached their duty by using the company's funds for their own purpose. The directors in the case had decided to venture into a new business due to the economic downturn. The directors obtained an interest free loan from the company. The

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<sup>77</sup> See *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.

<sup>78</sup> *Mahesan v Malaysian Government Officers Cooperative Housing Society* [1978] 1 MLJ 149.

<sup>79</sup> [1999] 5 MLJ 421.

<sup>80</sup> (1983) 1 ACLC 1091.

company later went into liquidation and the liquidator brought an action against the directors for breach of duty. In this case, it was clear that the creditors' interests were affected since the company went into liquidation. It is also clear at common law that when the company is insolvent, directors have a duty to consider the interests of creditors.<sup>81</sup> Directors can also be charged under criminal breach of trust if they are found using the company's funds for their own purposes and not for the company's.<sup>82</sup>

Another example of directors acting in conflict of interests is when directors use the information available to them by virtue of being directors to take up corporate opportunities and deprive the company of the same opportunity.<sup>83</sup>

### **9.3.5 Duty of Care and Diligence and Skill**

Unlike the law on conflict of interest, the law in this area in the past has been very lenient in imposing a low standard of duty of care and skill on directors. The law on this aspect has taken the view that business involves risks and it may hamper commerce if directors are reluctant to take the risks for fear that they may be held liable for breach of duty.<sup>84</sup>

The traditional approach of the law in this area is that directors will be judged on the basis of what the ordinary person having characteristics similar to the directors in question might be expected to have acted on their own behalf.<sup>85</sup> There has been a

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<sup>81</sup> *Walker v Wimborne* (1976) 137 CLR 1.

<sup>82</sup> *Tan Sri Tan Hian Tsin v PP* [1979] 1 MLJ 73; *Chang Lee Swee v PP* [1985] 1 MLJ 75.

<sup>83</sup> *The Board of Trustees of the Sabah Foundations & Ors v Datuk Syed Kechik bin Syed Mohammed & Anor* [1999] 6 MLJ 497; see also the statutory duty under section 175 of the UK Companies Act 2006; sections 182-184 of the Australian Corporations Act 2001; section 132(2) of the Malaysian Act 1965.

<sup>84</sup> Farrar above n35 at135.

<sup>85</sup> *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.

misconception that the case law and the standard of duty are subjective, when in fact the standard is objective.<sup>86</sup> While the standard itself is objective, case law has taken into consideration the characteristics of a particular director in order to determine the class which the director belongs to.<sup>87</sup>

In other words, the court will take into consideration the skills as well as the diligence of the particular director in question and apply the objective standard. In *Re Brazilian Rubber Plantations and Estates Ltd*,<sup>88</sup> the court held that the director must exercise reasonable care in discharging his duty and it should be measured by the care an ordinary man might be expected to take in the same circumstances on his behalf. The consequence of such decisions is that the likelihood of directors being found liable for breach of duty of care and skill is very low, and only in cases amounting to gross negligence would directors be held liable.<sup>89</sup>

There has been a shift in the decisions of the courts in which directors are subjected to more demanding obligations.<sup>90</sup> In *Mountfort v Tasman Pacific Airlines of NZ Ltd*,<sup>91</sup> the High Court stated that the directors will not be liable if the risks taken are legitimate; in which a reasonable director believe the risks to be a reasonable business prospect.<sup>92</sup> In other words, the directors will have to show that the decisions they make have a reasonable expectation of success.

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<sup>86</sup> John Farrar "The Duty of Care of Company Directors in Australia and New Zealand" in Barry Rider (Ed.) *The Realm of Company Law: A Collection of Papers in Honour of Professor Leonard Sealy* (Kluwer Law International, London 1998) at 42 ["The Duty of Care"].

<sup>87</sup> Ibid.

<sup>88</sup> [1911] 1 Ch 425 at 437.

<sup>89</sup> Shanty Rachagan, Janine Pascoe and Anil Joshi *Principles of Company Law in Malaysia* (Malayan Law Journal, Malaysia, 2002) at 412.

<sup>90</sup> *Dorchester Finance v Stebbings* [1989] BCLC 4998; *Daniels v Anderson* (1995) ACSR 607.

<sup>91</sup> [2006] 1 NZLR 104 at 114.

<sup>92</sup> [2006] 1 NZLR 104 at 114; in reaching to its conclusion, the court has applied the analogy test as used in medical negligence in English cases i.e. compliance with acceptable professional standards will be a defence unless those standards are shown to be wholly unreasonable.

The courts' decisions in imposing a higher standard of care, skill and diligence indicate an approach which favours accountability and responsibility. This approach has also been incorporated into statutes. Despite the differences in the wording of the statutes, the four jurisdictions have taken the same approach. The New Zealand Companies Act 1993<sup>93</sup> uses the words "skill, care and diligence" while the UK Companies Act 2006<sup>94</sup> and Malaysian Companies Act 1965<sup>95</sup> use the words "care, skill and experience" in imposing standards on directors. The Australian legislation uses the words "reasonable care and diligence."

The Malaysian section 132(1A) which was amended and became effective on 15 August 2007, copies section 174 of the UK Companies Act 2006. The proposal to amend was recommended by the CLRC because the court was very slow in adopting the modern standard of duty of care which imposes an objective test. Further, there are not many cases on this area and as late as in 2003, in the case of *Abdul Mohd Khalid v Dato Haji Mustapha Kamal*,<sup>96</sup> the court was still referring to the case of *Re City Equitable Fire Insurance Co Ltd*<sup>97</sup> as authority.<sup>98</sup> In a recent case of *Ravichathiran a/l Ganesan v Percetakan Wawasan Maju Sdn Bhd & Ors*,<sup>99</sup> apart from mentioning that the director must exercise reasonable diligence while performing his duty, the court did not elaborate further on this issue. The court only made reference to the old case of *Re Forest of Dean Coal Mining*<sup>100</sup> and made no

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<sup>93</sup> See section 136 of the New Zealand Companies Act 1993

<sup>94</sup> See Section 174 of the UK Companies Act 2006

<sup>95</sup> Section 132(1A) of the Malaysian Companies Act 1965.

<sup>96</sup> [2003] 5 CLJ 85.

<sup>97</sup> [1925] Ch 407.

<sup>98</sup> See Malaysia Company Law Reform Committee "A Consultative Document on Clarifying and Reformulating the Directors' Role Duties," (2006) at [3.4-3.9][CLRC Clarifying and Reformulating the Directors' Role Duties].

<sup>99</sup> [2008] 6 MLJ 450.

<sup>100</sup> (1879) 10 Ch D 450.

other reference as to the development of the law in this area was made. The decision, however, can be viewed as an indication that the court has beginning to shift to the objective test. The test whether the directors have acted in breach of their duty is objective is later enunciated by the court in *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong*.<sup>101</sup>

Generally, in discharging their duties, directors are expected to act on the basis of the knowledge, skill and experience of a reasonable director. However, the court is also required to take into consideration the knowledge, skill and experience of the director in question. The statutes, therefore, have not changed the common law position but merely clarified the standard required.<sup>102</sup>

#### **9.4 Business Judgment Rule**

The debate on whether Australia and New Zealand should adopt the business judgment rule started as early as 1980s.<sup>103</sup> The term 'business judgment rule' originated from the United States, and has the main purpose of protecting directors who employed mechanisms in dealing with takeover defences.<sup>104</sup> The courts in the common law jurisdictions have generally been reluctant to meddle with the affairs of the company and the directors' decisions.<sup>105</sup>

This can be seen from the judgment by the Privy Council in *Howard Smith Ltd v Ampol Petroleum Ltd*<sup>106</sup> which stated that “there is no appeal on merits from

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<sup>101</sup> [2009] 1 MLJ 723.

<sup>102</sup> Farrar “The Duty of Care” above n86 at 42.

<sup>103</sup> For background details see Farrar above n25 at 147-152; Austin and Ramsay above n26 at [8.310].

<sup>104</sup> Farrar *ibid*, at 152.

<sup>105</sup> See generally and the cases discussed in Austin and Ramsay above n2 at [8.060].

<sup>106</sup> [1974] AC 821 at 832.

management decisions to courts of law, nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.” A similar view was echoed by the court in *Harlowe’s Nominee Pty Ltd v Woodside (Lake Entrance) Oil Co NL*,<sup>107</sup> where the court enunciated that “directors in whom are vested the right and duty of deciding where the company’s interest lie and how they are to be served may be concerned with a wide practical consideration, and their judgement, if exercised in good faith and not for irrelevant purposes is not open to review in the courts.”

The tendency of the courts not to interfere in the affairs of the company has prompted arguments that directors have always been protected by the courts in respect of commercial decisions and there is no justification for introducing the business judgment rule which aims to do the same. However, the existing concept of non-interference refers to the court’s reluctance of making or substituting directors’ decisions and it does not provide protection against any liability while the business judgment rule professes to protect directors from personal liability.<sup>108</sup> As such, the business judgment rule is essential to protect directors from liability when the decisions have been made in good faith and for the benefit of the company.<sup>109</sup>

The UK and New Zealand do not have express statutory provisions on the business judgment rule and prefer the courts to develop the rule. Nevertheless, the long titles of the New Zealand Companies Act 1993 make reference to the business judgment rule which indicate that the rule is recognised throughout the statute.<sup>110</sup> Only

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<sup>107</sup> (1968) 121 CLR 483 at 493.

<sup>108</sup> See Professor Farrar’s comment on this in Farrar above n35 at 149.

<sup>109</sup> Ibid.

<sup>110</sup> Paragraph (d) of the Long Titles states “to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power.”

Australia and Malaysia have express provisions on the business judgment rule in their statutes and discussion will only be in relation to these two jurisdictions.<sup>111</sup>

Both the Australian and Malaysian statutes establish that the business judgment rule is only applicable in respect of the duty of reasonable care, skill and diligence under the Act, common law and in equity. The Australian statute specifically excludes the applicability of the rule in respect of other directors' duties under the Corporations Act 2001 or any other laws. The same position applies in the Malaysian Companies Act 1965.

Section 180(2) of the Corporations Act 2001 permits directors who make business judgment to seek protection against liability as long as:

- a) the decisions are made in good faith and for proper purpose; and
- b) directors or officers do not have any material personal interest in the subject matter of the judgment; and
- c) directors or officers reasonably believe that they are appropriately informed about the subject matter; and
- d) Directors or officers rationally believe the judgement is in the best interests of the company.

The Corporate Law Reform Committee (CLRC) of Malaysia suggested the adoption of the rule in order to prevent situations where the company incurs losses due to directors' and the company's hesitation to take up opportunities associated with

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<sup>111</sup> See section 180(2) of the Australian Corporations Act 2001 and section 132(1B) of the Malaysian Companies Act 1965. South African and Germany now have their own versions. The South African Companies Act 2008 which replaces the Companies Act 1973 introduces a business judgment rule in which a director will have satisfied his or her duties in regard to the matter at hand if he or she took reasonably diligent steps to become informed about the matter, has no material financial interest in the matter or had properly disclosed such interest, and made a decision rationally in the belief that it was in the best interests of the company. <<http://www.mondaq.com/article.asp?articleid=81974>> at 29 January 2011. The German Corporate Governance Code also has the business judgment rule.

risks.<sup>112</sup> In addition, the CLRC felt that there must be a clear statement of law regarding directors' responsibilities and protection, and proposed adoption of the provisions similar to the Australian business judgment rule.<sup>113</sup> When the Act was amended in 2007, the business judgment rule in the statute was almost an exact copy of the Australian provisions.

Although the CLRC recommended that the rule should be only applicable to situations where decisions have actually been made by the directors, and does not apply when directors fail to exercise judgment or abdicate responsibilities, the final version of the provision is similar to Australia.<sup>114</sup> The definition of business judgment in section 180(3) of the Australian Corporations Act 2001 suggests that it applies to both positive action and omission in making the decisions on relevant matters pertaining to corporation's business operation.<sup>115</sup> In this aspect, the position in Malaysia will be the same.

As such, there are two main differences between the Australian and the Malaysian provisions:

- a) on who can benefit from the rule; the provision in the Australian Corporations Act 2001 applies to directors and other officers of the company while the Malaysian provision applies to directors only;
- b) on the usage of the words 'rational and reasonable' in respect of the fourth condition that must be fulfilled before reliance can be placed; the Australian provision states that directors or officers "rationally believe that the judgment is in the best interests of the company." The section then continues and points

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<sup>112</sup> CLRC Clarifying and Reformulating the Directors' Role Duties above n98 at [3.18].

<sup>113</sup> The said proposal was adopted in section 132(1B) of the Companies Act 1965 with effective date of enforcement on 15.08.2007.

<sup>114</sup> See CLRC Clarifying and Reformulating the Directors' Role Duties above n98 at. [3.20-3.21] and compare with definition provided in the Companies Act 1965- "business judgment" means any decision on whether or not to take action in respect of a matter relevant to the business of the company."

<sup>115</sup> Austin and Ramsay above n26 at [8.310].

out “...the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold”<sup>116</sup> while the Malaysian section says the director “reasonably believes that the business judgment is in the best interests of the company.”<sup>117</sup>

The Australian section assumes that judgment is rational unless no reasonable person in the same position would hold such a belief.<sup>118</sup> There are two ways of interpreting this element; firstly by using the common reasonable man test; whether a reasonable director in the same situation believes the judgment is in the best interests of the company.<sup>119</sup> Secondly, it could be interpreted as whether a reasonable director in the same situation believes that the judgment is rational; hence it is in the interests of the company.<sup>120</sup> The application of the rule in Australia is considered to be narrower than in the US because whether or not a judgment is rational will be assessed based on reasonableness.<sup>121</sup> Professor Farrar regards rationality as a foreign concept to the Australian court and one which may pose difficulties in interpretations.<sup>122</sup>

The Malaysian Companies Act 1965 does not have the word 'rational' and in its place has the word 'reasonable.' Hence, if a reasonable director believes it is in the best interests of the company, the director will be protected. The usage of the word reasonable here connotes an objective test. It is likely that the court will interpret this condition in accordance with the common concept of reasonableness i.e. whether a reasonable director in the same situation would have regarded the judgment to be in the best interests of the company.

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<sup>116</sup> See section 182(2)(d) Australian Corporations Act 2001.

<sup>117</sup> See section 132(1B)(d) Malaysian Companies Act 1965.

<sup>118</sup> Austin and Ramsay above n26 at [8.310].

<sup>119</sup> Ibid.

<sup>120</sup> Ibid.

<sup>121</sup> Ibid.

<sup>122</sup> Farrar above n35 at 151.

The importation of the US concept of rationality into the Australian law and the difficulty of interpretation may affect the effectiveness of the Malaysian business judgement rule. This is because the uses of the objective test and reasonableness in relation to director's duty has been long established by both statute and the common law. Directors are generally protected from liability if the decisions they made reasonably in the interest of the company. Hence, there is a possibility that directors will be held liable for decisions which are rational, i.e. which have logical basis but are not what reasonable directors would have taken. In this situation, the purpose of introducing the rule will be futile, since for directors the existing laws are sufficient to cover the reasonable situation.

The requirement that directors should be appropriately informed of the subject matter will encourage directors to make responsible decisions. The new amendment to the Act also provides that directors may rely on the reasonable information provided by a third party in exercising their duty.<sup>123</sup> In doing so, directors must be cautious of the additional costs that the company may incur and evaluate whether it is worthwhile since costs are also one of the factors that directors must consider before making decisions.

The requirement that the decisions must be made in good faith and for a proper purpose is consistent with the fiduciary duty required from directors. The existence of this rule is to ensure that the decisions are not made with improper motives such as to transfer wealth from the company to the directors. Creditors are indirectly protected since they can be assured that any decisions must be in accordance with the objectives of the company, which they have knowledge of and approve of before deciding to advance credit.

Directors are also required to obtain relevant information before any decision is reached. The availability of relevant information may assist directors to determine

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<sup>123</sup> See sections 132(1C) and (1D) of the Malaysian Companies Act 1965.

the prospect of success as well as the effects on creditors. If directors are able to gauge the prospect of success, they may also be able to predict the effect of their decision on the solvency of the company. The condition that directors must ensure that the judgement is in the interests of the company can also be a tool to protect creditors especially when directors are able to predict the success of the project.

The introduction of the business judgment rule into the Malaysian Companies Act 1965 is timely. The courts have been slow in responding to the needs of the business community and prefer to rely on traditional doctrines instead. Therefore, Parliament must take appropriate steps to ensure that the needs of the business community are looked after. As to whether the introduction of the rule will encourage directors to take more risks, it is too soon to tell but in order to be protected, directors will have to ensure that the conditions are fulfilled. Directors, therefore, are driven to be responsible and accountable for their actions.

The effect of the business judgment rule is to provide a safe harbour for directors, should their decisions turn out to be the wrong.<sup>124</sup> Nevertheless, the business judgment rule in the statutes to a certain extent provides protection to creditors. This can be seen from the four conditions that must be fulfilled before directors can avail themselves of the rule.

## **9.5 Liability for Civil Wrongs in Torts**

It has been settled law that the company will be vicariously liable for torts committed by its agents and employees as long as they act within the scope of their employment.<sup>125</sup> Directors are not liable in this circumstance because they are considered to be the minds and will of the company, which means their actions are

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<sup>124</sup> Farrar above n35 at 149.

<sup>125</sup> *Lloyd v Grace, Smith & Co* [1912] AC 716.

the act of the company itself.<sup>126</sup> On the other hand, directors can also be perceived as agents of the corporation and could be held liable for tortious action.<sup>127</sup> Case laws have developed with three types of tests to deal with director's liability in torts; the 'direct or procure' test<sup>128</sup>, 'make the tort his/her own'<sup>129</sup> test and the 'assumption of responsibility'<sup>130</sup> test.<sup>131</sup> The personal liability of directors is valuable if the company is insolvent or could not meet its liability because it provides an alternative avenue for creditors to recoup their losses.

In the New Zealand case of *Trevor Ivory Ltd v Anderson*,<sup>132</sup> the court held the director of a 'one man' company was not liable even though the company itself was liable for the negligent advice given to the plaintiff. The basis of the decision was that the director had not assumed any special responsibility towards the plaintiff. The

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<sup>126</sup> *H L Bolton & Co v TJ Graham & Sons* [1957] QB 159; see Ross Grantham and Charles Rickett "Directors' Tortious Liability: Contract, Tort or Company Law?" (1999) MLR 133 at 133; the doctrines of company law such separate legal entity and limited liability have been accepted as constraints to the imposition of personal liability on directors.

<sup>127</sup> See Susan Watson "Corporate Liability for Criminal and Civil Wrongs" in John Farrar (Ed.) *Companies and Securities Law* (Brookers Ltd, Wellington, 2008) 153 at 191; the view that directors in New Zealand are agents of the company and therefore liable for tortious act under the agency principle has been seen as negating the principle of limited liability, especially in a closely-held company where the director is also the shareholder; see also Ross Grantham and Charles Rickett above n126 at 135.

<sup>128</sup> *Rainham Chemical Works Ltd (in liq) v Belvedere Fish Guano Co Ltd* [1921] 2 AC 465; directors were held not to be liable in their capacity as directors because they have not expressly directed the tortious act; the decision was followed in *Performing Right Society Ltd v Caryl Theatrical Syndicate, Ltd* [1924] 1 KB 1; *Wah Tat Bank Ltd v Chan* [1975] AC 507; *Microsoft Corporation v Auschina Polaris Pty Ltd* [1996-7] 142 ALR 111.

<sup>129</sup> *White Horse Distillers Ltd v Gregson Associates Ltd* (1984) RPC 61, in order for the director to be liable for tort committed by the company, it is not sufficient that to show he commits or directs the act but also it must be shown that he must do so deliberately or recklessly to make the act his own; *King v Milpurrurru* (1996) 136 ALR 327.

<sup>130</sup> *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517; *Williams v Natural Life Health Foods Ltd* [1997] 1 BCLC 131.

<sup>131</sup> John Farrar "The Personal Liability of Directors for Corporate Torts" (1997) 9 Bond LR 102 at 103 ["The Personal Liability"].

<sup>132</sup> [1992] 2 NZLR 517.

judge adopted the principle of identification and stated the effect of incorporation is to have the directors acting in two capacities in which directors may act and in appropriate circumstances they are to be identified with the company itself.<sup>133</sup> In order to hold them personally liable, there must be clear evidence that the directors are acting as agents or servants of the company.<sup>134</sup>

The decision was later followed by the English case of *Williams v Natural Life Health Foods Ltd*<sup>135</sup> although the House of Lords treated the matter within the confinement of the law of torts instead of relying on the principles of company law as in *Ivory*.<sup>136</sup> Lord Steyn pointed out the concept of limited liability could not be the decisive consideration in making the decision although it is relevant. This is because limited liability limits the shareholders' financial risk to the capital they subscribed to the company and is not intended to provide immunity from tortious liability to directors or senior employees.<sup>137</sup>

The requirement in *Trevor Ivory* has imposed a burden on the claimant to establish special responsibility because of the doctrine of separate legal entity the presumption is that directors do not intend to assume responsibility but intend it to be the

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<sup>133</sup> *Trevor Ivory Ltd v Anderson*[1992] 2 NZLR 517.

<sup>134</sup> Hardie Boys J in *Trevor Ivory Ltd v Anderson*[1992] 2 NZLR 517, 527 stated "What does run counter for the purposes and effect of incorporation is the failure to recognise the two capacities in which directors may act; that in appropriate circumstances they are to be identified with company itself, so that their acts are in truth the company's acts. Indeed, I consider that the nature of corporate personality requires that this identification normally be the basic premise and that clear evidence be needed to displace it with a finding that a director is not acting as the company but as the company's agent or servant in a way that renders him personally liable."

<sup>135</sup> [1997] 1 BCLC 131.

<sup>136</sup> For more discussions see Andrew Borrowdale and Mary-Anne Simpson "Directors Liability in Tort Recent Development" (1995) C&SLJ 400; Farrar "The Personal Liability" above n131; Grantham and Rickett above n126; Watson above n127 at 185-197 and articles referred therein.

<sup>137</sup> *Williams v Natural Life Health Foods Ltd* [1997] 1 BCLC 131 at 834-835.

company's.<sup>138</sup> The rule has also conferred on directors a privilege which should only be extended to shareholders.<sup>139</sup>

The New Zealand Court of Appeal in *Body Corporate 202254 v Taylor*<sup>140</sup> analysed the rationales of decisions in both *Trevor Ivory*<sup>141</sup> and *Williams*;<sup>142</sup>

- a) if the actions of the employee can be attributed to the company, they are not the employee's actions;
- b) The concern for imposing personal liability on the employee would be an erosion of the concept of the limited liability;
- c) It is inconsistent with the pattern on contractual relationship between parties to allow a claim against an employee in tort; and
- d) The precondition of liability against an employee is that the employee assumed personal responsibility for the relevant action.

The court concluded that the director of the company did not owe any non-delegable duty of care to the purchasers of the units in the development.<sup>143</sup> However, there is a possibility of imputation of responsibility when a person promotes his or her professionalism in the brochure and his or her failure to supervise the project could expose the director to liability.<sup>144</sup> The court at the same time cautioned imposing automatic liability solely on that representation because it is a common for an

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<sup>138</sup> Grantham and Rickett above n126 at 138.

<sup>139</sup> Ibid.

<sup>140</sup> [2009] 2 NZLR 17.

<sup>141</sup> *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517; *Williams v Natural Life Health Foods Ltd* [1997] 1 BCLC 131.

<sup>142</sup> *Williams v Natural Life Health Foods Ltd* [1997] 1 BCLC 131.

<sup>143</sup> *Body Corporate 202254 v Taylor* [2009] 2 NZLR 17 at [37].

<sup>144</sup> *Body Corporate 202254 v Taylor* [2009] 2 NZLR 17 at [43].

individual trading through a company to stress his or her competence as part of promotion for the company.<sup>145</sup>

## 9.6 Liability under the Fair Trading Act 1986

In New Zealand, a claimant has the right to action for misleading and deceptive conduct<sup>146</sup> under the Fair Trading Act 1986. The courts have indicated willingness in this instance in addition to the corporation's liability, to impose on directors and agents' personal liability for breaches of the section. In *Kinsman v Cornfield Ltd*,<sup>147</sup> the Court of Appeal based its decision on the interpretations of the words 'in trade'<sup>148</sup> in section 9 as well as 'also' in section 45(2)<sup>149</sup> of the Act. The court had included corporate agents in management roles within the meaning of in trade.<sup>150</sup> In *Body Corporate*, the court held a person who is not trading on his or her own account can be personally liable under the Act. The conclusion is made based on the inclusion of the words such as 'profession' and 'occupation' within the definition of

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<sup>145</sup> *Body Corporate 202254 v Taylor* [2009] 2 NZLR 17 at [43].

<sup>146</sup> Section 9 of the New Zealand Fair Trading Act 1986 says "No person shall in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive."

<sup>147</sup> (2001) 10 TCLR 342.

<sup>148</sup> "Trade" is defined in section 2 of the Act as "any trade, business, industry, profession, occupation, activity of commerce, or undertaking relating to the supply or acquisition of goods or services or to the disposition or acquisition of any interest in land."

<sup>149</sup> Section 45(2) of the New Zealand Fair Trading Act 1986 states "any conduct engaged in on behalf of the body corporate:

- (a) by a directors, servant, or agent of the body corporate acting within the scope of that person's actual or apparent authority;
  - (b) by any other person at the direction or with the consent or agreement (whether express or implied) of a director, servant, or agent of the body corporate, given within the scope of the actual apparent authority of the director, servant or agent-
- shall be deemed, for the purpose of the Act, to have been engaged in **also** by the body corporate." (emphasis added).

<sup>150</sup> See also *Specialised Livestock Imports Ltd v Borrie* CA 72/01, 28 March 2002; *Goldbro v Walker* [1993] 1 NZLR 394; contrast the position in Australia where the courts applied a narrow interpretation - see *Concrete Constructions Pty Ltd v Nelson* (1990) 169 CLR 594, 603; *Plimer v Roberts* (1997) 80 FCR 303.

‘trade’.<sup>151</sup> With regard to the word ‘also’ in section 45 which deemed an act of an agent to be that of the company, the court held it indicated that both will have to be liable regardless of whether intention and knowledge are present.<sup>152</sup>

In Australia, section 52 of the Trade Practices Act 1974 on which New Zealand section 9 of the New Zealand is based, only provides for liability on the corporation. Directors will be held liable for the act only if he or she has aided, abetted, counselled or procured the contravention.<sup>153</sup> The corresponding section in New Zealand is section 43 which imposes secondary liability only when agents know the conduct is misleading or deceptive. In order for agents to be liable under the sections, both the Australian and the New Zealand courts require intention and knowledge.<sup>154</sup> Directors will be able to avoid liability under the section if he or she is merely a conduit and is not the source of the information.<sup>155</sup>

The decision in *Kinsman v Cornfield Ltd*<sup>156</sup> had been subjected to criticism because it does not provide any consideration on the common law principle of separate legal entity. The reliance on the word ‘also’ is seen as a weak argument and inconsistent with section 43 which requires intention and knowledge on part of directors before

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<sup>151</sup> [2009] 2 NZLR 17 at [71].

<sup>152</sup> [2009] 2 NZLR 17 at [71].

<sup>153</sup> See section 75B(1) of the Australian Trade Practices Act 1974: “A reference in this Part to a person involved in a contravention of a provision of part IV or V shall be read as a reference to a person who:

- (a) has aided, abetted, counseled or procured the contravention;
- (b) has induced, whether by threats or promises or otherwise, the contravention;
- (c) has been in any way, directly or indirectly, knowingly concerned in, or a party to, the contravention; or
- (d) has conspired with others to effect the contravention.”

<sup>154</sup> *Yorke v Lucas* (1985) 158 CLR 661; *Wheeler Grace & Pirucci Pty Ltd v Wright* (1989) 15 NSWLR 679.

<sup>155</sup> *Goldbro v Walker* [1993] 1 NZLR 394; *Body Corporate 202254 v Taylor* [2009] 2 NZLR 17.

<sup>156</sup> (2001) 10 TCLR 342.

liability can be imposed on them whereas liability in section 9 is solely based on a person acting on behalf of the company.<sup>157</sup> There is a possibility that the decision will be subjected to review and this has been indicated in the case of *Newport v Coburn*,<sup>158</sup> although the Court of Appeal did not go as far as to overrule *Kinsman*. The decisions in relation to personal liability of corporate agents in section 9 for misleading and deceptive also show gross incongruity with torts law.<sup>159</sup>

## 9.7 Defences Available to Directors

Directors will be able to escape liability if they can show that their decisions were made in good faith for the benefit of the company. This concept is wide enough to cover all aspects of directors' duties. In addition to this general defence, directors in Australia and Malaysia can also rely on the business judgment rule to provide them with refuge, although this rule is only available in respect of duty of care, skills and diligence. In respect of conflict of interest, directors will be able to keep any profits or benefits made if they disclose the facts at the general meeting.<sup>160</sup> The court has to weigh the balance between consumer protection considerations and undesirability of imposing unexpected liabilities on employees.

Directors should not be discouraged from investing in high risk projects as long as they can justify that their decisions are in the best interests of the company. Directors

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<sup>157</sup> Watson above n127 at 205-206; see also Peter Watts "Editorial: Directors' and Employees' Liability under the Fair Trading Act 1986 - the scope of "Trading" (2002) CSLB 77; Neil Campbell "Editorial: Corporate (and other) agents' liability under the Fair Trading Act 1986" (2006) CSLB 123.

<sup>158</sup> (2006) 8 NZBLC 101,717.

<sup>159</sup> *Trevor Ivory Ltd v Anderson*[1992] 2 NZLR 517; *Williams v Natural Life Health Foods Ltd*[1997] 1 BCLC 131

<sup>160</sup> See *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; *Fur Ltd v Tomkies* (1936) 54 CLR 583; *Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399; Statute also requires directors to make disclosure - see section 177 of the UK Companies Act 2006; section 140 of the New Zealand Companies Act 1993; section 131 of the Malaysian Companies Act 1965; and section 191 of the Australian Corporations Act 2001.

should not be overly concerned that they will be more vulnerable to personal liabilities if they are required to take consideration of other stakeholders including the creditors. This is because the fundamental concept of directors' duty, loyalty and good faith to the company is still paramount.

## **9.8 Conclusion**

The principle of that a director must act in good faith for the benefit of the company must be construed in accordance with the modern structure of the company. It is no longer acceptable that directors only consider the interests of shareholders which were closely connected to the historical development of the company. Directors, therefore, should consider the interests of various groups which represent the company when exercising their duty to the company. In other words, the interests of the company should be given liberal and wide interpretations to include those who represent the webs of relationship in the company.

In relation to creditors, the duty to consider their interests should not be confined to when the company is insolvent or approaching insolvency but should be maintained throughout the life of the company. Considering the interests of the creditors at the initial stage can act as a preventive measure and avoid the company from being wound up in which case the creditors will have to compromise on their debts. The current framework of the directors' duty can be maintained as long as when making decisions, directors consider the implication of their action on the company's ability to maintain itself as a going concern. Directors should obtain relevant information and weigh the probability of success before making any decisions. They must not be deterred in taking risks since if they have exercised their duty within the parameters of good faith in the interests of the company, they should be protected.

Imposing a duty on directors alone is not sufficient if it is not supported by the right of enforcement. Therefore, it is time that creditors be given standing to act against errant directors and not to rely on the company when the company is solvent and on

liquidators when it is insolvent. Creditors in Canada, Malaysia and Singapore have been given a right to apply to courts for remedy in cases of oppression.<sup>161</sup> Creditors must show the conduct complained of has affected their right as debenture holders in order to have remedy under the section. The provision in section 181 is wider than in the UK,<sup>162</sup> New Zealand<sup>163</sup> or Australia.<sup>164;165</sup> Courts are given wide discretion to

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<sup>161</sup> See section 181(1) Malaysian Companies Act 1965- Any member or **holder of a debenture of a company**, or in the case of a declared company under Part IX, the Minister, may apply to the Court for an order under this section on the ground:

- (a) that the affairs of the company are being conducted or the powers of the directors are being exercised in a manner oppressive to one or more of the members or holders of debentures including himself or in disregard of his or their interests as members, shareholders or holders of debentures of the company; or
- (b) that some act of the company has been done or is threatened or that some resolution of the members, holders of debentures or any class has been passed or is proposed which unfairly discriminates against or is otherwise prejudicial to one or more of the members or debenture holders (including himself).”

<sup>162</sup> Section 994 UK Companies Act 2006 provides remedy to members for unfairly prejudicial conduct.

<sup>163</sup> Section 174(1) New Zealand Companies Act 1993 allows a shareholder or former shareholders or a company or any other entitled person who consider the affairs of the company to be oppressive, unfairly discriminatory or unfairly prejudicial to complain.

<sup>164</sup> Section 232 of the Australian Corporations Act 2001 grants power to the court to order a remedy in respect of conduct of the company’s affairs which are oppressive, unfairly prejudicial to or unfairly discriminatory against members of the company.

<sup>165</sup> Lord Wilberforce in *Re Kong Thai (Sawmill) (Miri) Sdn Bhd; Kong Thai Sawmill (Miri) Sdn Bhd & Ors v Ling Beng Sung* [1978] 2 MLJ 227, the Privy Council at page 228-9 made the distinctions between section 181 and the UK position stated “This section can trace its descent from section 210 if the United Kingdom Companies Act, 1948 which was introduced in that year in order to strengthen the position of minority shareholders in limited companies. It also resembles the rather wider section 186 of the Australian Companies Act, 1951. But section 181 is in important respects different from both its predecessors and is notably wider in scope than the United Kingdom section.” In *Owen Sim Liang Khui v Piasu Jaya Sdn Bhd & Anor* [1996] 1 MLJ 113, the Federal Court discussed the difference of the section 181 with those from other jurisdictions. Gopal Sri Ram JCA at page 125-6 stated: “The first move towards further legislative liberalisation of the remedy appears to have been the Uniform Companies Act 1961 of Australia which introduced section 186, which was wider in terms than section 210 of the United Kingdom statute, but narrower than our section 181. Subsequently Australia, New Zealand and Canada legislated provisions, resembling section 181 though the latter is of wider import, particularly in regard to the powers of the court to grant relief to shareholders. The decisions of the courts of these countries upon pieces of such legislation, though often helpful, especially in the absence of local authority, must be applied with caution.”

decide on the suitable relief which should be applicable under the Act. The remedies provided under the provision are generally the same in all jurisdictions, with the exception of the order of winding-up, which is not available in the UK.<sup>166</sup>

Section 181 is wider than the other corresponding sections in terms of the grounds for application under in that it adds "disregard of the interests of members, shareholders or debenture holders." The same ground is available in New Zealand and Australia but the section can only be invoked by members and not by creditors. The UK however does not have "disregard of the members interests" as one of the grounds.

Although section 181 provides a direct remedy to creditors, the provision is limited to debenture holders only, not all creditors. The debenture holders' rights are governed by contracts and they are protected to the extent of security. Further, they are only entitled to relief under the Act if their rights as debenture holder are prejudiced by the conduct of company's affairs and in the situation, it is most likely they have included the right to appoint a receiver in the contract. Hence, the unsecured creditors' right to be paid remain in winding-up proceedings in the event the court grant it as a relief under section 181(2).

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<sup>166</sup> See section 181(2) of the Malaysian Companies Act 1965; section 174(2) of the New Zealand Companies Act 1993; section 996(2) of the UK Companies Act 2006 and section 233(1) of the Australian Corporations Act 2001.

## CHAPTER 10      DIRECTORS' DUTY TO PREVENT COMPANY INSOLVENT TRADING

### 10.1 Introduction

The first effort to address the issue of errant directors was initiated by the Greene Committee<sup>1</sup> in the UK. The proposed fraudulent trading section was originally consolidated in section 275 of the UK Companies Act 1929 and later contained in section 332 after the Act was replaced in 1948.<sup>2</sup> The aim of introducing the provision was to prevent directors who used their position and knowledge to buy goods on credit from taking security over those goods.<sup>3</sup> The directors who held the floating charges then sought to enforce the security by appointing a receiver and taking the goods out of the reach of other creditors when the company was on the verge of liquidation.<sup>4</sup>

The fraudulent trading provision remained in the UK legislation until 1986, when the Insolvency Act was introduced. The Cork Committee, which was appointed to review insolvency law, suggested that civil liability for fraudulent trading should not be retained, but the suggestion was not taken up.<sup>5</sup> Consequently, civil liability for fraudulent trading is currently governed by section 213 of the Insolvency Act 1986 and its criminal aspect is in section 993 of the Companies Act 2006. The Committee also proposed the introduction of a new provision called 'wrongful trading' which covers situations where no fraud or dishonesty are involved.<sup>6</sup>

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<sup>1</sup> The Greene Committee Report Cmnd 2657 (1926) [The Greene Committee].

<sup>2</sup> Andrew Keay *Companies Directors' Responsibilities to Creditors* (Routledge-Cavendish, London, 2007) at ch 3.

<sup>3</sup> The Greene Committee above n1 at [61-62].

<sup>4</sup> Ibid.

<sup>5</sup> Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982) at [1779] [Cock Report].

<sup>6</sup> Ibid, at [1777-1779].

In the beginning, Australia adopted the UK model of fraudulent trading provisions in its legislation but later departed from this position and now has its own provision to combat the problem. In 1961, the Uniform Companies legislation introduced a new criminal liability in regard to the officer of the company who was “a party to the incurring of a debt by the company without any reasonable expectation that the debt could be paid.”<sup>7</sup> Later, civil liability in relation to the same circumstances was introduced.<sup>8</sup> This liability was later enacted in the Malaysian and New Zealand legislation. While New Zealand has since amended its laws to the existing provisions in its Companies Act 1993, the old law still survives in the Malaysian Companies Act 1965. Australia too has amended its statute and the current position is now in section 588G of the Corporations Act 2001.

Like Australia, New Zealand had fraudulent trading provisions which are similar to section 332 of the UK Companies Act 1948. In 1980, two new provisions were inserted under section 320 Companies Act 1955 to make directors personally liable.<sup>9</sup> The first provision, was similar to the Australian section in the Uniform Act 1961, namely “where any person was while an officer of the company knowingly a party to the contracting of a debt by the company and did not, at the time the debt was contracted, honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts (including future and contingent debts).” Another provision included was “where any person was, while an officer of the company, knowingly a party to the carrying on of any business of the company in a reckless manner.” Due to some deficiencies, the Law Commission in 1989 proposed changes and, as a result, the current reckless trading under section 135 was enacted.

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<sup>7</sup> Australia Law Reform Commission, *General Insolvency Inquiry Report* (ALRC R45 Vol 1 1988) at [278] <[http://www.austlii.edu.au/au/other/alrc/publications/reports/45/45\\_vol\\_1.pdf](http://www.austlii.edu.au/au/other/alrc/publications/reports/45/45_vol_1.pdf)> at 25 January 2008.

<sup>8</sup> Ibid.

<sup>9</sup> John Farrar and Mark Russell *Company Law and Securities Regulation in New Zealand* (Butterworths, Wellington 1985) at 453-454.

Malaysia did not make any changes on this area and still retains the fraudulent trading provision which is a replica of the UK Companies Act 1948. It also maintains the insolvency provision adopted from Australia. The Malaysian Corporate Law Reform Committee (CLRC) had the opportunity to make changes in 2004 but did not propose any amendments to the section. Also, the circumstances as to when directors are held to be personally liable are different in each jurisdiction. It should be noted that the legislation started by imposing criminal liability with the main focus of punishing the person responsible. In the succeeding period, the focus shifted to compensating those who suffered losses, particularly the creditors who are most affected by the directors' action. This change indicates the recognition that other parties in the company also require protection from the company.

The first section of this chapter will provide comparative analyses of the three systems, particularly of the elements to be proven in proceedings against directors. Issues on remedies and the consequences of breaching the sections will be examined in the next chapter. The section will look at each jurisdiction in detail and see how the courts interpret the sections. The last section will explore the Malaysian law in respect of the duty to prevent insolvent trading, and make suggestions whenever necessary.

## **10.2 Comparative Aspects**

Directors can be subjected to personal liability if they fail to prevent the company from engaging in insolvent trading. In the UK, the provision which imposes such an obligation on directors is known as 'wrongful' trading,<sup>10</sup> 'reckless' trading<sup>11</sup> (in New Zealand), and 'insolvent' trading<sup>12</sup> (in Australia). The three provisions generally impose a duty on directors to prevent companies from engaging in business activities when the company is insolvent, although the elements which trigger off such a duty differ from one another.

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<sup>10</sup> Section 214 of the UK Insolvency Act 1986.

<sup>11</sup> Section 135 of the New Zealand Companies Act 1993.

<sup>12</sup> Section 588G of the Australian Corporations Act 2001.

### 10.2.1 Who will be Liable?

Unlike the earlier statutes, only directors will be subjected to liability in respect of wrongful trading, insolvent trading or reckless trading. Directors in this context include shadow directors although anyone who gives advice in his professional capacity is excluded.<sup>13</sup> Due to directors' extensive powers and authority on the management and the company's future, the law demands that they be responsible and accountable for their actions. This modern concept of responsibility and accountability, however, are polar opposites to the two main principles of company law, namely, the separate legal entity and limited liability, and there is no way to reconcile one with the other.

The decision to exclude managers from this duty is to compel directors to be more responsible and accountable in the company, for they are considered to be the minds of the company.<sup>14</sup> The decisions in *HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd*<sup>15</sup> indicate that managers are also considered as the brain of the company and it is submitted they should be included in the duty. It will benefit all parties, including creditors, if those who make decisions on company's direction were to be held liable and accountable because they will then have to be cautious and meticulous.

It also means that directors can no longer use lack of knowledge or information as the basis to avoid liability, for the courts have been very strict in the

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<sup>13</sup> See section 126 (4) of the New Zealand Companies Act 1993; section 251(2) of the UK Insolvency Act 1986; section 9 (part 1.2) of the Australian Corporations Act 2001.

<sup>14</sup> However, see the judgment of Lord Denning MR in the case of *HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd* [1957] 1 QB 159 at 172; His Lordship stated "A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the directing mind or will. Others are directors and a manager who represents the directing mind and will of the company, and controls what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such." The decision indicates that managers are also considered the brain of the company and therefore should not be excluded from liability.

<sup>15</sup> [1957] 1 QB 159.

interpretation of these provisions.<sup>16</sup> Courts have imposed on directors a duty to make proper enquiries and to monitor as well as to supervise the company. They cannot excuse themselves from liability by relying totally on third parties. The court in *Mason* summed up the directors' position in the company by stating "the days of sleeping directors with merely investment interests are long gone: the limitation of liability given by incorporation is conditional on proper compliance with the statute."<sup>17</sup>

### **10.2.2 Who has the Right to Enforce?**

The right to enforce the duty depends on when the liability arises. In the UK, only the liquidator has the right to bring an action against the directors, for liability only arises when the company is wound up. In New Zealand, in addition to liquidators, creditors and shareholders have the right to bring actions under section 135 and section 136.

In Australia, the right is normally exercised by the liquidators. However, creditors can bring an action under section 588G provided they obtain the consent from the liquidator.<sup>18</sup> Alternatively, after six months from the date of winding up, creditors can give notice to the liquidator of their intention to take action against the director, in which case, the liquidator has to either give consent or an explanation in writing for refusing.<sup>19</sup>

### **10.2.3 Elements to be Proven**

Under the New Zealand reckless trading provision, a director has a duty to prevent a *company from being carried on in manner likely to create substantial*

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<sup>16</sup> See the decisions in *Mason v Lewis* [2006] 3 NZLR 225; *Re Nippon Express (New Zealand) Ltd v Woodward* (1998) 8 NZCLC 261 at 765.

<sup>17</sup> *Mason v Lewis* [2006] 3 NZLR 225 at 237.

<sup>18</sup> See section 588R of the Australian Corporations Act 2001.

<sup>19</sup> See Section 588S of the Australian Corporations Act 2001. If neither consent nor explanation is given within three months, the creditors can proceed with the action-section 588T(1) of the Australian Corporations Act 2001.

*risks of serious loss to creditors.* A director in New Zealand also has a duty under section 136 *not to allow or cause the company to enter into obligations if there are no reasonable grounds to believe that the company will be able to meet those obligations.* In Australia, a director has a duty to prevent *a company from incurring debts if the company is insolvent at the time or becomes insolvent as a result of incurring the debt.* In the UK, the wrongful trading provision does not require the wrongful conduct to be proven, instead the director's knowledge, or deemed knowledge, needs to be established. Under wrongful trading, once a director knows or ought to have known that insolvent liquidation is unavoidable, *he or she has to take every step to minimise potential losses to creditors.*

The three provisions share similar aims, namely to protect creditors when the company is in financial difficulties, by preventing directors from continuing with business as usual. In addition, the implication of breaching the sections is the same; directors can no longer rely on the principle of separate legal entity and would be personally liable. However, there are differences in regard to when directors cross the threshold to become personally liable.

In New Zealand, what needs to be proven is that the way the company operates its business is likely to create substantial risks. In doing so, the focus would be on a series of circumstances, not on any specific event or time. Hence, the court will examine whether the director's conduct of the business creates substantial risks of serious loss to creditors. The provision also differs from section 136, for in this, it has to be proven at the time the obligation is incurred that the directors have reasonable grounds to believe it can be met by the company.

In Australia, a director is liable when the company 'incurs debts', which is akin to the requirement of 'incurring obligations' in the New Zealand section 136. Obligation can be referred to as 'an act or course of action to which a person is morally or legally bound; a duty or commitment'<sup>20</sup> while 'debts' is defined as 'a

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<sup>20</sup> (From *The Oxford Dictionary of English (2nd edition revised)* in English Dictionaries & Thesauruses. <[http://www.oxfordreference.com.ezproxy.waikato.ac.nz/views/SUBJECT\\_SEAR\\_CH.html?subject=s7](http://www.oxfordreference.com.ezproxy.waikato.ac.nz/views/SUBJECT_SEAR_CH.html?subject=s7)> at 22 October 2009.

sum of money that is owed or due.<sup>21</sup> Hence, the duty under section 136 is wider than that in section 588G. Once the time the debt is incurred is determined, it has to be proven that when debt was incurred the company was insolvent or likely to become so.

The director in Australia, therefore, has to pay attention to the effect of such debt on the company's financial status. If there are reasonable grounds to suspect that the company is insolvent or would become insolvent, the director is liable. The focus in section 136, on the other hand, is on the company's ability to meet its obligation, whether or not directors have reasonable grounds to believe that the company would be able to perform as and when it is required to.<sup>22</sup>

In the UK, a director's liability is based on his or her knowledge or imputed knowledge of the company financial status, namely that there were no reasonable grounds to believe the company could avoid liquidation. A liquidator does not have to prove any wrongdoing on the part of the directors, and it is sufficient to show that they had the knowledge, or ought to have known, that insolvent liquidation was inevitable. Once that is done, the burden shifts to the directors to show that they took all steps to minimise losses to creditors.

#### **10.2.4 When Liability is Incurred- Relevant Time**

The wrongful trading provision states that the relevant point of time at which knowledge or deemed knowledge should be scrutinised is "at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation."<sup>23</sup> The court, therefore, will have to examine the company's past transactions prior to the filing of the winding up

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<sup>21</sup> Ibid.

<sup>22</sup> Farrar *Corporate Governance Theories, Principles and Practice* (3rd ed., Oxford University Press, South Melbourne, 2008) at 174.

<sup>23</sup> Section 214(2)(b) of the UK Insolvency Act 1986.

petition<sup>24</sup> in order to ascertain the first sign of problems, namely the time when the company started suffering losses. In doing so, the court has to refer to the company's financial information, including past financial statements. Difficulties arise if the company fails to maintain proper accounts, and directors are deemed to have necessary knowledge which should have been apparent to them if the company had maintained proper accounts.<sup>25</sup>

In New Zealand, directors lose their right to rely on the separate legal entity principle if they agree or allow "the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company creditors."<sup>26</sup> In addition, directors in New Zealand are subjected to the requirement that they must not agree to the company incurring any obligation unless they "believe at that time on reasonable grounds that the company will be able to perform the obligation."<sup>27</sup>

The absence of any time frame in both sections implies that they apply throughout the life of the company, which the Parliament felt would provide better protection to creditors.<sup>28</sup> This is because when the contributions from directors are not limited to insolvent situations only, directors will have to be cautious every time they make decisions and not only when the company is having financial difficulties.

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<sup>24</sup> In the UK and Malaysia, the filing of the petition is deemed to be the date liquidation commenced; see section 129(2) of the UK Insolvency Act 1986 and section 219(2) of the Malaysian Companies Act 1965. However, in New Zealand, liquidation commences on the date on which and at the time at which the liquidator is appointed; see section 241(5) of the New Zealand Companies Act 1993. The position in Australia is similar to New Zealand, for liquidation is taken to have begun when the order was made or any other situations mentioned in section 513A of the Australian Corporations Act 2001.

<sup>25</sup> *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520 at 550.

<sup>26</sup> Section 135(a) and (b) of the New Zealand Companies Act 1993.

<sup>27</sup> Section 136 of the New Zealand Companies Act 1993.

<sup>28</sup> (23 February 1993) NZPD speech by Hamish Hancork (second reading) <<http://www.vdig.net/hansard/archive.jsp?y=1993&m=02&d=23&o=37&p=4610>> at 10 October 2010.

Hence, action can be brought against directors under the Act if "the way business is carried out is likely to create substantial risk of serious loss." In one decision, the court applied a literal interpretation, and consequently directors are prevented from taking up risks, even when there is a possibility of generating profits.<sup>29</sup> The implication of the decision is that it defeats the aim of the Companies Act 1993 which is evident from its long title; namely the recognition of the company as a vehicle for taking business risks.<sup>30</sup>

The decision in the case also illustrated the court's failure to recognise the link between risk-taking and profit, and that in deciding whether the risks are substantial, the potential reward should also be taken into consideration. This differs from Australia and the UK, for in both countries, one of the factors taken into consideration when assessing liability is the benefits reaped from taking risks.<sup>31</sup> From the wording of section 214 of the UK wrongful trading provision, it can be presumed that a company is allowed to take risks as long as it does not end up in liquidation. In addition, directors are required to take all steps to minimise losses once it becomes apparent that the company is in distress, which indicates the need for directors to weigh the risks being taken and the benefits which may be generated from them.

Nevertheless, in subsequent decisions, a liberal interpretation was used by the New Zealand Court of Appeal and the company was only prohibited from taking illegitimate risks, not all business risks.<sup>32</sup> This appears to be the current state of the law in relation to reckless trading and if the company is run in a way which exposes it to illegitimate risks, then the directors will be liable.

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<sup>29</sup> *Fatupaito v Bates* [2001] 3 NZLR 386 at 401; see also *South Pacific Shipping Limited (in liq); Traveller v Lower* [(2004) NZCLC 263, 570.

<sup>30</sup> The Long Title of the Companies Act – “ An Act to reform the law relating to companies, and, in particular,-  
a) to reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for production purposes, the spreading of economic risk, and the taking of business risks; and

<sup>31</sup> See Australian case *Vriasakis v ASC* (1993) 11 ACSR 162 ; for English cases see *Re Sherborne Associates Ltd* [1995] BCC 40; *Rubin v Gunner* [2004] 2 BCLC 110.

<sup>32</sup> See *South Pacific Shipping Limited (in liq); Traveller v Lower* (2004) NZCLC 263, 570 and *Mason v Lewis* [2006] 3 NZLR 225.

Under the Australian insolvent trading provision, directors incur personal liability when “at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent.”<sup>33</sup> Courts’ interpretation as to when debt is incurred is essential in order to establish liability and the relevant time would depend on the nature of the debt involved.<sup>34</sup> In construing the issue, there is one principle which the courts have adhered to, namely whether the debt in question was preventable and if so, at which stage could it have been avoided.

On matters relating to capital maintenance such as shares and dividends, the statute provides a specific table as to when debts are incurred.<sup>35</sup> The setting will assist the court in deciding whether the company is insolvent at the relevant time in question. The court will then scrutinise the company’s finances; whether the company at the particular time was unable to pay off its debts, and if the answer is in affirmative, the company is held to be insolvent. Hence, if the directors incurred debts at the time or consequently the company becomes insolvent, the directors will be liable.

### **10.2.5            Insolvency**

Wrongful trading can only be invoked when the company has gone into insolvent liquidation. Since the section is specific on insolvent liquidation, directors are not liable if the company is wound up on any other grounds mentioned in Act.<sup>36</sup> In addition, the pre-requisite of insolvent liquidation indicates that not all directors will be caught up by this provision, only those who know or ought to have known that liquidation was unavoidable are subjected to personal liability.

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<sup>33</sup> Section 588G(1)(c) of the Australian Corporations Act 2001.

<sup>34</sup> See discussions and cases therein in Robert P. Austin and Ian M. Ramsay *Ford’s Principles of Corporations law* (14<sup>th</sup> ed, Lexis Nexis Butterworth, NSW, 2010) at [20.090].

<sup>35</sup> See section 588G(1A) of the Australian Corporations Acts 2001.

<sup>36</sup> For grounds of winding up see section 122 of the UK Insolvency Act 1986; section 218 of the Malaysian Companies Act 1965; section 241(4) of the New Zealand Companies Act 1993 and sections 461, 459A and 459B of the Australian Corporations Act 2001.

Directors in Australia can be held accountable if the company incurs debt when it is insolvent or becomes insolvent as a result of the action. The liability in Australia does not depend only on actual insolvency; mere suspicion of the company's insolvent status is sufficient. This is indicated in section 588G(1)(c) which uses the word 'suspecting' the company is insolvent or would become insolvent. However, in the UK there must be clear proof of insolvency before liability is attached.<sup>37</sup>

The aim of the section is to prevent directors from dragging the company into further debts when the company's financial situation is doubtful. If the company has gone into liquidation before liability can be imposed on directors, it may be too late to prevent losses for creditors.<sup>38</sup> By setting a lower standard for liability, directors have to act cautiously when making decisions so that the company would not be exposed to insolvency.

While insolvency is an essential element for directors' personal liability in the UK and Australia, New Zealand does not have such a requirement. The Law Commission in its initial recommendation suggested that personal liabilities be imposed on directors when they have 'unreasonably risked insolvency'<sup>39</sup> although Parliament did not take it up when enacting the legislation in 1993. As a result, the current reckless trading provision under section 135 of the New Zealand Companies Act 1993 refers to exposing the company to 'substantial risks' before liability can be imposed on directors. Therefore, it is important for the courts, when construing the meaning of 'substantial risks,' to strike a balance between the need to protect creditors and the commercial interests of the

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<sup>37</sup> Clear proof is required by the court before the company can be subjected to liquidation-see section 123(1)(e) of the UK Insolvency Act 1986-"if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due".

<sup>38</sup> ALRC R45 Vol 1 1988 above n7 at [280].

<sup>39</sup> See Law Commission *Company Law Reform and Restatement* (NZLC R9,1989) at[516] and section 105 of the New Zealand Draft Companies Act.

company. Otherwise, it will defeat the main purpose of replacing the old law with the current reckless trading provision.<sup>40</sup>

### **10.2.5.1 Meaning of Insolvency**

Insolvency in the context of New Zealand and Australian statutes refers to the cash flow test, while in the UK the section specifically mentions the balance sheet test.<sup>41</sup> Directors in Australia, in particular, have to be vigilant once the company is unable to pay its creditors when the debts fall due, because under the test the company is already insolvent. Therefore, any action by directors from that point of time may expose them to personal liability if the court finds that there are reasonable grounds to suspect the company was insolvent or would become so.

In contrast, to ascertain whether directors in the UK have knowledge or ought to have knowledge that insolvent liquidation will be the consequence of their actions, the court would have to scrutinise the company's financial information. It is not sufficient for the liquidator to argue that the company had a liquidity problem, and he or she must prove that the company's liabilities exceeded its assets. The difference in the tests used may affect the question as to when liability arises, since in theory it is easier to detect or suspect insolvency under the cash flow test rather than the balance sheet test.

### **10.2.6 Burden of Proof**

The burden of proof in the three jurisdictions is similar, and it lies with the person who seeks to make the director liable.<sup>42</sup> He or she will have to prove the essential ingredients stated in the relevant sections, and once that is done, the burden shifts

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<sup>40</sup>See comments by Justice Sian Elias, 'Company Law After Ten Years of Reform' in *The Company Law Conference of the New Zealand Law Society* (1997) at 9.

<sup>41</sup> See Chapter 8 of the thesis.

<sup>42</sup> *Re Sherborne Associates Ltd* [1995] BCC 40; *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.

to the director to prove that he or she has a defence or defences to exonerate them from liability. The standard of proof is a civil standard balance of probability.

### **10.2.7 Standard of Liability**

The standard of liability applicable in reckless trading is an objective test; focusing on the manner in which the business is carried on and whether it would create a substantial risk of serious loss.<sup>43</sup> Unlike the UK and Australian legislation, there is no element of subjectivity mentioned in section 135 of the New Zealand Companies Act 1993. Section 136 of the New Zealand Companies Act 1993, on the other hand, uses both the subjective and objective elements.

There is a possibility that reliance solely on an objective element would result in the court substituting its own perspective or hindsight on the matter.<sup>44</sup> In most cases, the courts have relied on the evidence given by professional practitioners in a reconstruction of the company's financial position, and what he or she would have done in those circumstances.<sup>45</sup> The approach of the courts in New Zealand differs from that of the UK, for in the UK the courts have been cautioned not to use hindsight in making decisions, but instead to base their decision on the evidence available to directors at the time.<sup>46</sup>

However, by setting an objective standard on liability, directors are compelled to equip themselves with a minimum standard. It imposes a duty on directors to guide and monitor the company since the company's financial position is central to liability under the section. Directors therefore cannot leave the management of the company to a third party because it is important that they form their own opinion as to the company's position. Directors are compelled to be vigilant in exercising their duty and this could benefit the company as a whole.

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<sup>43</sup> *Mason v Lewis* [2006] 3 NZLR 225 at 234; see also *Fatupaito v Bates* [2001] 3 NZLR 386.

<sup>44</sup> Keay above n2 at 114.

<sup>45</sup> *Ibid.*

<sup>46</sup> See *Re Sherborne Associates Ltd* [1995] BCC 40.

In the UK wrongful trading law, the section clearly indicates that both subjective and objective tests are to be applied. The court in ascertaining directors' liability has to consider the general knowledge, skill and experience reasonably expected from a director carrying out the same function as well as the knowledge, skill and experience of that particular director in doing so.<sup>47</sup>

In Australia, a reasonable director test is the minimum standard, which all directors have to adhere to. Directors are absolved from liability as long as they act as a reasonable person in a like position would have acted. In the UK, the court will have to take into account firstly, the general knowledge, skill and experience reasonably expected from a person occupying the same position in the company. However, acting as a reasonable person would have does not necessarily release directors from liability; the court must also take into account the general knowledge, skills and experience the particular director has before deciding on his liability. As such, in the UK directors are subjected to a much higher test than in Australia because there is a two tier test that they have to go through.

In New Zealand, the directors' own perceptions of the risk are irrelevant and they are assessed on the objective standard of an ordinary prudent director. Due to this, there is a possibility of the court heavily relying on the evidence of insolvency practitioners and it may substitute its own hindsight in deciding whether the directors' action is justified.

### **10.2.8 Defences**

Australia has a list of defences available to directors and this is more comprehensive than in the UK and New Zealand. Directors can defend themselves from insolvent trading in a number of circumstances, namely, if at the time debt was incurred the director had reasonable grounds to expect and did

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<sup>47</sup> See sections 214 (4) (a) and (b) of the Insolvency Act 1986.

expect that the company was solvent or would remain solvent,<sup>48</sup> or has reasonable grounds to believe and did believe the competency and reliability of the third party's information that the company was solvent or would remain so.<sup>49</sup>

Although the UK wrongful trading law does not provide for reliance on a competent third party advice as one of the statutory defences, the courts do take that factor into consideration when deciding directors' liability. The courts will look at actions taken by directors when first confronted with the realisation that the company was insolvent, and cases have indicated that courts are sympathetic to directors who engaged professional advice and heeded it. In *re Bath Glass Ltd*<sup>50</sup> the court refused to make a disqualification order against the directors on the basis that among other actions, that they had sought and acted on the advice of a professional accountant. In addition, they had also made regular forecasts of the company's financial status and also reviewed them accordingly.<sup>51</sup> Nevertheless, directors who prolong liquidation and continue trading on the advice of professional auditors or accountants will not necessarily be able to escape liability if it turns out to be a wrong decision.<sup>52</sup>

Likewise in New Zealand, this type of defence is not specifically mentioned in either section 135 or section 136, although it is an exonerating factor under

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<sup>48</sup> Section 588H(2) of the Corporations Act 2001- "It is a defence if it is proved that, at the time when the debt was incurred, the person had reasonable grounds to expect and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time."

<sup>49</sup> Section 588H (3) of the Corporations Act 2001 – ' without limiting the generality of subsection (2), it is a defence if it is proved that, at the time when debt was incurred, the person:

- (a) had reasonable grounds to believe, and did believe:
  - (i) that a competent and reliable person (*the other person*) was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and
  - (ii) that the other person was fulfilling that responsibility; and
- (b) expected, on the basis if information provided to the first-mentioned person by the other person, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.'

<sup>50</sup> [1988] BCLC 329.

<sup>51</sup> See also *Re Douglas Construction Services Ltd* [1988] BCLC 397.

<sup>52</sup> Fidelis Oditah "Wrongful Trading" (1990) LMCLQ 205 at 208-209.

section 138. In *Mason v Lewis*,<sup>53</sup> the Court of Appeal implied that section 138, which provides a defence to a director who reasonably relies on the advice of a third party when discharging his or her duty, could be used for reckless trading.

In this case, the court concluded that the directors could not depend on the section because there were clear indications at the time that the company was insolvent and any reasonable director would not have agreed for the company to continue to trade. It is important for directors who wish to rely on section 138 to make sure that the advice given by the third party will not cause substantial risks of serious loss to creditors. The decision in the case can also be presumed to be equally relevant in regard to a directors' duty under section 136.<sup>54</sup> Moreover, section 138 appears under the general heading of director's duties, which also includes both sections 135 and 136.<sup>55</sup>

In the UK, in order to escape liability, directors must take positive actions to minimise creditors' losses. However, the section is silent on the position of directors who are not able to take any action due to illness or any other reasons which prevent them from taking part in the management of the company. This differs from Australia which has a specific defence for directors who are absent due to illness or for any other good reason.<sup>56</sup> It is submitted that in the light of the wording of the section which requires 'steps' to be taken to minimise losses, it is probable that directors who fail to take any affirmative action may be held liable by the court regardless of the reasons for failing to do so.<sup>57</sup>

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<sup>53</sup> [2006] 3 NZLR 225 at 237.

<sup>54</sup> Neil Campbell and David Cooper *Company Law Update* (New Zealand Law Society Seminar, 2008) at 45

<sup>55</sup> *Ibid.*

<sup>56</sup> See section 588H (4) of the Australian Corporations Act 2001. Section 588H(4) of the Corporations Act 2001- ' If a person was a director of the company at the time when the debt was incurred, it is a defence if it is proved that, because of illness or for some other good reason, he or she did not take part at that time in the management of the company.'

<sup>57</sup> See *Re Brian D Pierson* [2002] BCLC 275.

In the case of *Secretary of State for Trade and Industry v Taylor*,<sup>58</sup> a case under the Company Disqualification of Directors Act 1986, a director who knew of the company's impending liquidation but could not influence its board to take up his suggestion was held not to be unfit for the purpose of disqualification. The court went on to state that the fact the director failed to resign after protesting against further trading could not lead to the finding of unfitness.<sup>59</sup>

In New Zealand, the court's decision in *Mason v Lewis*<sup>60</sup> seems to incline towards directors having a duty to monitor the company despite engaging a third party to run it. Directors have to take reasonable steps to ensure that they are well aware of what is happening in the management of the company, as well as supervising its management.

It is also a defence in Australia for a director to prove that he or she has taken all reasonable steps to prevent the company from incurring debts.<sup>61</sup> The section imposes a heavy burden on directors to take all reasonable steps, which means he or she will not be able to rely on the defence if the court is of the opinion that there are still measures which the director failed to implement.

In the UK, once the court has identified the first sign of stress in the company, the next step is to examine the directors' conduct; a director can avoid liability if the court is satisfied that he or she had taken every step that ought to have been taken in order to minimise the potential loss to creditors. The existence of the phrase 'ought to have taken' implies that what is required from directors is to take reasonable steps. In doing so, the court will consider the general knowledge, skill and experience of a reasonable director, as well as that of the particular director.<sup>62</sup>

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<sup>58</sup> [1997] 1 WLR 407.

<sup>59</sup> [1997] 1 WLR 407 at 414.

<sup>60</sup> [2006] 3 NZLR 225.

<sup>61</sup> Section 588H(4) of the Corporations Act 2001- 'It is a defence if it is proved that the person took all reasonable steps to prevent the company from incurring the debt.'

<sup>62</sup> See section 214(4) (a) and (b) of the Insolvency Act 1986.

The difference between the UK and the Australian section 588H(5) is that, in the UK, directors are subjected to a lesser burden since the legislation does not require directors to take all reasonable steps, but only to take reasonable step. Therefore, in the UK as long as the court is satisfied that the director has taken reasonable steps to minimise losses, he or she is protected while in Australia, directors are not protected if, in the opinion of the court, they fail to take all reasonable steps.<sup>63</sup> In addition, the defence is available to directors in the UK after the company has gone into insolvent liquidation, or in other words after the company has engaged in the wrongful trading.

In Australia, however, directors must take all reasonable steps in order to prevent the company from incurring debts which may lead it into insolvency to begin with. It should be noted that the Australian legislation concentrates on preventive measures, while in the UK the focus is more on minimising losses after the fact.

New Zealand law does not provide for any specific affirmative actions as defences, unlike the UK and Australia. Directors, therefore, have to rely on section 135 and can avoid liability if, in the opinion of the court, the "business was not carried on in a manner likely to create substantial risks of serious loss to creditors." As such, the court's interpretations of what constitute substantial risks and serious loss are crucial in determining whether or not a director is liable.

From the wording of the sections mentioned above, it seems that directors in Australia will be the first to be caught under its insolvent trading provisions, followed by directors in New Zealand, and then by those in the UK. By stipulating that directors have a duty to prevent the company from incurring debts if there are reasonable grounds for suspecting that the company is insolvent or would become insolvent, the statute has imposed a stricter standard compared to New Zealand and the UK. The usage of the word 'suspect' in the section calls for directors' liability if the company's financial information shows the company is

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<sup>63</sup> See the discussions in Keay above n2 at 112-114.

trading at a deficit.<sup>64</sup> In other words, as soon as the company's accounts indicate deficit figures, it is a reasonable ground for directors to 'suspect' that the company may be insolvent.<sup>65</sup> Hence, they have to act cautiously and any action on their part to resuscitate the company at that point by incurring debts could open them to liability.

Directors in New Zealand confronting a similar situation, may still be able to engage in trading without incurring liability as long as it does not create substantial risks to creditors. The term 'substantial risks' mentioned in the reckless trading provision implies a higher threshold compared to mere suspicion in Australia. In the UK, the condition that the directors had knowledge or ought to have had knowledge to conclude that there was no reasonable prospect for the company to avoid insolvent liquidation, seems to indicate that substantial risk alone is not sufficient, but knowledge is also essential.

### **10.3 Duty of Directors under the UK Law**

The directors' liability for fraudulent trading in the UK was originally stated in section 275 of the Companies Act 1929.<sup>66</sup> The provision was later amended and incorporated in section 332 of the Companies Act 1948.<sup>67</sup> Section 332 of the 1948 Act maintained the provision in section 275, except in relation to who can be made liable.<sup>68</sup> The original version in section 275 imposed liability on 'directors whether past or present' whereas section 332 applied to 'any person'.

The Cork Committee, which was responsible for reviewing the UK insolvency law, found several deficiencies in respect of fraudulent trading in the Companies Act 1948. The section comprised both civil and criminal liability and there was a

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<sup>64</sup> Austin above n34 at [20-120] and T.E Cooke and Andrew Hicks 'Wrongful Trading-Predicting Insolvency' (1993) JBL 338 at 340-342.

<sup>65</sup> Ibid.

<sup>66</sup> Cork Report above n5 at [1758].

<sup>67</sup> Cork Report above n5 at [1775].

<sup>68</sup> Ibid.

tendency of the court to insist on the higher criminal standard.<sup>69</sup> A liquidator or creditor who wished to bring an action under fraudulent trading had to be able to prove ‘dishonesty’ which was one of the main elements of fraud, in order to succeed.<sup>70</sup> The insistence by the court on proving dishonesty was due to the criminal element of the section and this had hindered actions from being brought to courts.<sup>71</sup>

The Cork committee also found that the section was inadequate to provide compensation in situations where the person involved was not dishonest, but merely reckless or negligent.<sup>72</sup> In other words, the emphasis on dishonesty was essential to punishing the offender, but it was not appropriate for civil compensation because creditors could not recoup their losses.<sup>73</sup>

The Cork Committee made two proposals in respect of the fraudulent trading provision; namely, the criminal elements of the section should be maintained and the introduction of a new civil liability called ‘wrongful trading’ should be introduced.<sup>74</sup> As a result of the recommendations, a new wrongful trading provision was enacted in section 214 of the Insolvency Act 1986 and section 213 of the Insolvency Act 1986 deals with fraudulent trading. The legislature, however, did not follow the recommendation that fraudulent trading should only be applicable to criminal liability. The civil aspect of fraudulent trading is

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<sup>69</sup> See for example the decision of Pennycuik V-C in *Re Maidstone Buildings Provisions Ltd* [1971] 3 All ER 363 at 369 where the judge referred to the *Halsbury’s Law of England* (3<sup>rd</sup> ed.) p415 , para 631 “It is a general rule that penal enactments are to be construed strictly, and not extended beyond their clear meaning. At the present day, this general rule means no more than that if, after the ordinary rules of construction have first been applied, as they must be, there remains any doubt or ambiguity, the person against whom the penalty is sought to be enforced is entitled to the benefit of the doubt.’

<sup>70</sup> Cork Report above n5 at [1776].

<sup>71</sup> *Ibid.*

<sup>72</sup> *Ibid.*, at [1777].

<sup>73</sup> *Ibid.*

<sup>74</sup> *Ibid.*, at [1778].

maintained in section 213 of the Insolvency Act 1986 and the criminal liability regarding it is now governed by section 993 of the Companies Act 2006.

In this section, the UK Court's interpretations of the three sections and its assessment on the provisions will be examined. In analysing the court's decisions, reference will be made to both pre-1986 as well as post-1986 cases on fraudulent trading because the courts do not preclude them from being used for the new section. Similarly, when looking at the criminal aspect of fraudulent trading, the same cases as the civil liability will be referred to because both sections are alike. The only difference between the two sections is regarding the consequences of such liability.

### **10.3.1 Fraudulent Trading under Section 213 Insolvency Act 1986**

Section 213 of the Act states

- (1) "If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.
- (2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper."

There are three components which must be proven by the liquidator, namely:

- a) Party knowingly;
- b) carrying on of the business; and
- c) intent to defraud creditors or for any fraudulent purposes.

These elements will be examined in detail below.

### 10.3.1.1 Party to the Carrying on of the Business

The liability in the section is not limited to directors only, but to any person who has control over the company. The usage of the term ‘any person’ in the section allows action to be taken against anyone who has effective control over the company. In *Re Maidstone Buildings Provisions Ltd*<sup>75</sup> the court considered whether a company secretary can be made liable under the section. The court rejected liability on the basis that a company secretary was not involved in the carrying on of the business of the company. In order to be deemed a ‘party to the carrying on of the business’ some positive steps were required, and the function of a company secretary did not concern the management of the company, depending on the nature of his or her involvement in the company.<sup>76</sup>

However, the court’s decision that a company secretary’s duties did not involve the management of the company was rejected by the Court of Appeal in the case of *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd*.<sup>77</sup> where it was decided that in certain circumstances, a company secretary could bind the company. Professor Farrar has suggested that as a consequence of the decision the company secretary could be made liable under the Act.<sup>78</sup>

The case of *Re Gerald Cooper Chemical Ltd*<sup>79</sup> shows that a creditor/lender could also fall under the term a ‘party to ...’ if he accepts payments which he knows have been obtained through the carrying on of business with the intention to defraud creditors.<sup>80</sup> The court, however, clarified that the creditor in question was

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<sup>75</sup> [1971] 3 All ER 363.

<sup>76</sup> [1971] 3 All ER 363 at 368.

<sup>77</sup> [1971] 2 All ER 1028.

<sup>78</sup> John Farrar “Fraudulent Trading” (1980) JBL 340 at 343 [Fraudulent Trading].

<sup>79</sup> [1978] Ch 262.

<sup>80</sup> [1978] Ch 262 at 268.

not ‘a party’ if he knew that money would not be available to him if the company or debtor remained honest.<sup>81</sup>

In *Re Augustus Barnett & Son Ltd*<sup>82</sup> the parent company was held not liable under the section since it was not involved in the carrying on of the business, and no allegation of intent to defraud creditors was made. Hoffman J concluded that section 332 was wide enough to apply to situations where the outsider was not involved in the carrying on of the business, provided that the person participated in the fraudulent acts.<sup>83</sup> The judge referred to the case of *Re Gerald Cooper Chemical Ltd*<sup>84</sup> where the lender did not have a hand in carrying of the business but was held liable because of his involvement in fraudulent acts.<sup>85</sup>

Since one of the requirements for a person to be held liable is ‘the carrying on the business’, it is necessary to establish the meaning of the phrase. The case of *Re Sarflax Ltd*<sup>86</sup> indicated the expression used in the section was not equivalent to carrying on trade. The court, therefore, found that the collection of assets acquired in the course of business and the distribution of the proceeds of those assets constituted the carrying on of the business for the purpose of the section.<sup>87</sup>

The court in *Re Gerald Cooper Chemicals Ltd. (in Liquidation)*<sup>88</sup> clarified the point that the terms do not necessarily have to involve a series of transactions, but that it was sufficient to show that only one creditor was defrauded by a single act.

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<sup>81</sup> [1978] Ch 262 at 268.

<sup>82</sup> [1986] BCLC 170.

<sup>83</sup> [1986] BCLC 170 at 173.

<sup>84</sup> [1978] Ch 262.

<sup>85</sup> [1986] BCLC 170 at 173.

<sup>86</sup> [1979] 1 Ch 592.

<sup>87</sup> [1979] 1 Ch 592 at 599.

<sup>88</sup> [1978] Ch 262 at 268. The court decided that accepting of deposits when the company knows that it could not discharge the contract amounted to carrying on the business with intent to defraud. See also *Morphitis v Bernasconi and others*[2003] Ch 552.

In *Re Maidstone Buildings Provisions Ltd*<sup>89</sup>, it was held that the person in question must have taken some positive steps and failure to give advice to the company did not amount to carrying on the business within the meaning of the section. Therefore, based on the cases mentioned above, it is necessary to show that the person is actually involved in or becomes part of any activities of the company.

However in the light of decisions in *Re Augustus Barnett & Son Ltd*<sup>91</sup> and *Re Gerald Cooper Chemical Ltd*<sup>92</sup>, the courts seemed to emphasise that there must be fraudulent action and if the answer is in the affirmative, the person could be held liable despite not having been involved in the ‘carrying of the business.’

### **10.3.1.2 Intent to Defraud Creditors**

The courts have grappled with the meaning of intent to defraud ever since the provision was introduced in the 1929 Act. The statute does not provide a definition or guidelines as to what constitutes fraud under the section. Maugham J in *Re William C Leith Brothers Ltd*<sup>93</sup> held that the fraudulent trading provision is invoked “if a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospects of the creditors ever receiving payment of those debts, it is in general, a proper inference that the company is carrying on the business with the intent to defraud.”

In *Re Patrick & Lyon Ltd*<sup>94</sup>, the same judge narrowed down his interpretation by stating “fraud in the context of fraudulent trading connotes actual dishonesty involving, according to the current notions of fair trading among commercial men, real moral blame”. Scholars have made the criticism that it is difficult to

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<sup>89</sup> [1971] 3 All ER 363.

<sup>91</sup> 1986] BCLC 170.

<sup>92</sup> [1978] Ch 262.

<sup>93</sup> (1932) 2 Ch 71 at 77.

<sup>94</sup> [1933] Ch 786 at 790.

reconcile the two judgments with one another; the decisions in *Re William C Leith Brothers Ltd*<sup>95</sup> was perceived as too broad while in *Re Patrick & Lyon Ltd*<sup>96</sup> the construction was too rigid.<sup>97</sup> In *Re White and Osmond (Parkstone) Ltd*<sup>98</sup> (unreported), an attempt was made by the judge to resolve the two divergent interpretations of the section. The judge distinguished between situations where there is a genuine belief that the company's fortune can be turned around and where it is very unlikely that the company will succeed; only in the latter will there be fraudulent trading.<sup>99</sup>

Lord Hoffman in *Aktieselskabet Dansk Skibsfinansiering v Brothers*<sup>100</sup> referred to both judgments by Maugham J and Buckley J, and opined that fraudulent trading could not have been limited to situations mentioned by the two judges only, and whether directors are dishonest or not should be decided on the basis of the facts of each case. To do otherwise, the judge reasoned, would be a misuse of authority.<sup>101</sup> Professor Farrar, on the other hand, expressed his view that the decisions in *Re William C Leith Brothers Ltd*<sup>102</sup> and *Re Patrick & Lyon Ltd*<sup>103</sup>

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<sup>95</sup> (1932) 2 Ch 71.

<sup>96</sup> [1933] Ch 786.

<sup>97</sup> See John Farrar "Corporate Insolvency Law and the Law" (1976) JBL 214 at 224-225 ["Corporate Insolvency"]; Farrar "Fraudulent Trading" above n78; R.C Williams "Fraudulent Trading" (1986) 4 C&SLJ 14 at 23-24; Keay above n2 at ch 5.

<sup>98</sup> Unreported 30 June 1960; See also Keay above n2 at 55.

<sup>99</sup> Buckley J stated in his judgment "in my judgment, there is nothing wrong in the fact that directors incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fell due. What is manifestly wrong is if directors allow a company to incur credit at a time when the business is being carried on in such circumstances that it is clear that the company will never be able to satisfy its creditors. However, there is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them over the bad time"

<sup>100</sup> [2001] 2 BCLC 324 at 332-333.

<sup>101</sup> [2001] 2 BCLC 324 at 332-333.

<sup>102</sup> (1932) 2 Ch 71.

<sup>103</sup> [1933] Ch 786.

could be reconciled on the basis that the former was dealing with the proposition of evidence, while the latter with substantive law.<sup>104</sup>

Having determined that dishonesty is an important element to establish fraudulent trading, the next question is how it should be proven. In other words, should dishonesty be judged based on the director's state of mind (subjective test) or on what a reasonable man would perceive to be dishonest (objective test). Initially, the test adopted by the court was subjective; whether the director knew at the time of carrying on business that there was no reasonable prospect of creditors ever being paid.<sup>105</sup> However, the judge also stated in his judgment that an inference can be made that the company is carrying on business with intent to defraud, which can indicate the presence of an objective element in the test.<sup>106</sup>

The court in *Aktieselskabet Dansk Skibsfinansiering v Brothers*<sup>107</sup> decided that whether there was dishonesty must depend on the assessment of all the existing facts. On the issue of the standard to be applied to determine dishonesty, the judge adopted the test in *Hardie v Hanson*<sup>108</sup> i.e. whether the director is personally dishonest. The court also stated that for an inference of fraud to be made, there must be an additional element such as misrepresentation, deception or some personal advantage on the part of the directors.

The presumption that the court can deduce intent to defraud, which represents the objective test, was also apparent in the case of *Re Gerald Cooper Chemicals Ltd (in liquidation)*.<sup>109</sup> In that case, Lord Templeman stated that the word 'intent' in the section "must be taken to intend the natural or foreseen consequences of his act. Intent of a person carrying on the business is that the consequences of

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<sup>104</sup> See Farrar "Fraudulent Trading" above n78; Farrar "Corporate Insolvency" above n97 at 224.

<sup>105</sup> *Re William C. Leith Brothers Ltd* (1932) 2 Ch 71 at 77.

<sup>106</sup> Keay above n2 at 54.

<sup>107</sup> [2001] 2 BCLC 324.

<sup>108</sup> (1960) 105 CLR 451.

<sup>109</sup> [1978] Ch 262.

carrying it on (whether because of the way it is carried on or for any other reason) will be that creditors will be defrauded.”<sup>110</sup> It is submitted that the phrase "natural or foreseen consequences because of the way it is carried on or for any other reason" suggests an objective element.

In *R v Grantham*<sup>111</sup> the court held that intent to defraud can be assumed if at the time when the debts were contracted the person realised that there was no reason for thinking that funds would be available to pay the debt when it became due or shortly thereafter. In *R v Sinclair*<sup>112</sup> the judge held that “it is fraud if it is proved that there was the taking of a risk which there was no right to take which would cause detriment or prejudice to another...” From the decision, it shows that fraud can be present if the director acting recklessly and as result of that, a third party is in a disadvantaged position.

In *Twinsectra Ltd v Yardley and others*<sup>113</sup>, Lord Hutton stated that there are three possible standards which can be applicable in order to determine whether a person has been acting dishonestly. The first is purely subjective where a person is judged as dishonest if he transgresses his own boundary. The second, is purely objective and the person is adjudged to be dishonest if his conduct falls below what a reasonable and honest person would regard as honest, although the person himself may not be aware as such. The third, concerns a combination of both subjective and objective elements whereby the test is satisfied if the person in question is aware that he has acted dishonestly based on the standard of a reasonable and honest person. The judge concluded by stating that “dishonesty requires knowledge by the defendant that what he was doing would be regarded as dishonesty by honest people, although he should not escape a finding of dishonesty because he sets his own standard of dishonesty and does not regard as

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<sup>110</sup> [1978] Ch 262 at 267.

<sup>111</sup> [1984] 1 QB 675 at 682.

<sup>112</sup> [1968] 1 WLR 1246 at 1249.

<sup>113</sup> [2002] 2 AC 164 at 172.

dishonest what would offend normally accepted standards of dishonest conduct.”<sup>114</sup>

To sum up the court’s approach in ascertaining whether there is ‘intent to defraud’, it is submitted that the court started with general observations that fraud can be inferred if a company continued to carry on business when the directors know there were no reasonable prospects of the debts being paid. Later cases then clarified that fraud could not have been limited to such situations only and would depend on facts of each case. However, it is settled law that whenever fraud is involved, it is necessary to prove dishonesty on the part of the directors.

The earlier cases seemed to apply a subjective standard to determine dishonesty, focusing on the state of mind of the defendant at the time that decisions were made. However, the cases did not discount the possibility of making an inference of fraud which suggests an objective test. Some cases have insisted on additional factors such as misrepresentation, deception or personal gain before fraud can be inferred. From the latest decisions by the courts, the current position on the test of dishonesty is whether, on the balance of probabilities, the person in question knows that what he is doing is dishonest, based on what a reasonable honest man would regard as dishonest, or whether he is acting recklessly to the detriment of creditors.

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<sup>114</sup> [2002] 2 AC 164 at 174 see dissenting judgment by Lord Millet where his Lordship rejected the use of the combination test and held that it was sufficient to show that the person acted with the requisite knowledge. He opined that to determine the person’s state of mind is an aspect of *mens rea* and is more appropriate in criminal liability than in civil liability. For civil liability, he reasoned that it was sufficient if the person realised that his conduct was dishonest so that it constituted intentional wrongdoing.

The same test was also applied in *Royal Brunei Airlines Sdn Bhd v Philip Tan Kok Ming*[1995] 2 AC 378 at 389 and can be seen from the judgments of Lord Nicholls. The judge regarded acting dishonestly simply to mean “not acting as an honest person would in the circumstances.....Honesty has a connotation of subjectivity, as distinct from the objectivity of negligence. Honesty, indeed, does have a strong subjective element in that it is a description of a type of conduct assessed in the light of what a person actually knew at the time... Carelessness is not dishonesty. Thus... dishonesty is to be equated with conscious impropriety. However, these subjective characteristics of honesty do not mean that individuals are free to set their own standards of honesty in particular circumstances. The standard of what constitutes honest conduct is not subjective. Honesty is a not an optional scale, with higher or lower values according to the moral standards of each individual. If a person knowingly appropriates another’s property, he will not escape a finding of dishonesty simply because he sees nothing wrong in such behaviour.”

### 10.3.1.3 For any other Fraudulent Purposes

Another aspect of fraudulent trading is when the company is carrying on business for any fraudulent purposes. The phrase ‘fraudulent purposes’ has not been clearly defined by the court. In *R v Inman*,<sup>115</sup> the court clarified that fraudulent trading consists of two different types of offences, namely fraudulent trading with intent, and fraudulent trading for the purpose of achieving certain things. From the judgement, it is clear that the two phrases should be read disjunctively and that they refer to different circumstances.

It seems that the court in that case distinguishes fraudulent purposes based on whether carrying on business would achieve certain objectives from intent to defraud and for that intent to be present, the state of mind of directors is important. The court, however, did not discuss further what is meant by ‘certain things’. The court in *Aktieselskabet Dansk Skibsfinansiering v Brothers*<sup>116</sup> also discussed the existence of ‘something else’ such as misrepresentation, deception or personal gain before fraud can be inferred.

In an unreported case of *Re Murray-Watson Ltd*<sup>117</sup> which was cited by Lord Templeman in *Re Gerald Cooper Chemicals Ltd*<sup>118</sup>, Oliver J gave as an example the director of a company dealing with second-hand motor cars who wilfully misrepresents the age and capabilities of the vehicle. He held that the director could not be carrying on a business for fraudulent purposes, although the business was carried out in a fraudulent manner.

In light of these decisions, it is submitted that ‘fraudulent purposes’ may cover situations where the directors have obtained personal advantage by carrying on

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<sup>115</sup> [1967] 1 QB 140 at 148.

<sup>116</sup> [2001] 2 BCLC 324 at 332

<sup>117</sup> 6 April 1977.

<sup>118</sup> [1967] Ch 262 at 267.

the business with intent to defraud and when directors know by carrying on the business, creditors' rights will be prejudiced.

#### **10.3.1.4 Fraudulent Trading under Section 993 Companies Act 2006**

Fraudulent trading under section 993 of the Companies Act differs from that in section 213 in certain aspects. First, section 993 carries criminal liability and, therefore, the person who breaches this section will be subjected to imprisonment not exceeding ten years, or a fine or both.<sup>119</sup> Second, the section has a wider application because it is not limited to situations where the company is in liquidation only<sup>120</sup>. The interpretations of the section are similar to its civil provision because the wording of the section is identical, but the standard of proof in the criminal standard is that of proof beyond reasonable doubt.

#### **10.3.2 Wrongful Trading under Section 214 Insolvency Act 1986**

The wrongful trading provision in section 214 was introduced as a result of the recommendations made by the Cork Committee. The aim of the section is to impose liability on directors who fail to protect creditors when the company is insolvent. It contains preventative elements, since directors have a duty to ensure wrongful trading does not occur when the company is insolvent. Nevertheless, the requirement that the section can only be invoked when the company is in liquidation limits its effectiveness.

The duty is imposed on the basis that when the company is insolvent, the company is trading with creditors' money and therefore the duty should shift from shareholders to creditors. This is because directors are only liable if the company is in liquidation, which means it is already too late to salvage the

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<sup>119</sup> Section 993(3) (a) of the UK Companies Act 2006.

<sup>120</sup> Section 993(2) of the UK Companies Act 2006.

company. In this aspect, section 214 is similar to section 213 in which both are applicable only when the company is in liquidation.

In addition to imposing liability, the wrongful trading provision sets a minimum standard on the skills and knowledge a director should have, which standard is determined by both the objective and subjective tests. Directors, however, are judged based on the higher standard of the two tests. This will encourage directors to acquire the necessary skills and knowledge to run the company because failure to do so may expose them to liability under section 214. The provision also acts as a deterrent function where directors who fail to meet the minimum standard can be disqualified from acting as a director in the company or in the management of the company.<sup>121</sup>

Section 214(1) of the Insolvency Act 1986 states “Subject to subsection (3) below, if in the course of winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contributions (if any) to the company’s assets as the court thinks proper.”

There are three conditions set out in subsection (2) that must be proven by the liquidator before the burden shifts to the directors to show that they have taken every step which ought to be taken in order to minimise the losses to creditors.<sup>122</sup>

The conditions are:

- a) The company has gone into insolvent liquidation;
- b) At some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was

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<sup>121</sup> See Richard Schulte “Enforcing Wrongful Trading as a standard of Conduct for Directors and a Remedy for Creditors: the Special case of Corporate Insolvency” (1999) 20 Co Law 80 at 81.

<sup>122</sup> Section 214(3) of the UK Insolvency Act 1986 states “The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him, that person took every step with a view to minimising the potential loss to the company’s creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.”

no reasonable prospect that the company would avoid going into insolvent liquidation; and

- c) That person was a director of the company at the time.

### **10.3.2.1 Applicability of the section - who will be liable?**

Section 214 imposes liability on directors who know, or ought to have concluded, that the company would be in insolvent liquidation. The section does not require that the directors be involved in trading, unlike section 213 which requires the person to take some positive steps in carrying on the business before liability can be imposed.<sup>123</sup> Directors who may be liable under the section include shadow directors.<sup>124</sup>

A shadow director is defined in section 251(1) of the UK Companies Act 2006 as "a person in accordance with those instructions the directors of the company are accustomed to act." However, section 251(2) excludes a person who gives advice in his professional capacity to directors who then acted on the advice, as a shadow director.<sup>125</sup> From this definition, it will exclude solicitors, accountants and auditors, whose advice is often sought by directors, from liability under section 214. These professionals are excluded in order to ensure advice is freely given without fear of any liability. Otherwise, they may advise the company not to proceed with trading though it is very likely to generate profit and it may cost creditors the chance of being repaid.

The position, however, is not clear whether a parent company can be held to be a shadow director of its subsidiary. The law does not impose any statutory liability on the parent company for the debt of the company. Reliance continues to be on the court's discretion to lift the veil as and when it becomes necessary, in contrast

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<sup>123</sup> See *Re Maidstone Buildings Provisions Ltd* [1971] 3 All ER 363.

<sup>124</sup> See section 214(7) of the UK Insolvency Act 1986- "In this section 'directors' includes a shadow director".

<sup>125</sup> Section 251(2) of the UK Companies Act 2006- "A person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity". The same definition also contained in section 251 of the Insolvency Act 1986.

to Australia and New Zealand which provide a statutory duty for the parent company to be liable for the debts of its subsidiary. It is submitted that as in situations of lifting of the corporate veil, the question whether a parent company can be regarded as a shadow director would depend on the degree of control it exercised over the subsidiary.

Likewise, in respect of a finance company, whether it can be regarded as a shadow director would depend on the degree of control it exercises over the company and whether the actual directors of the company did not exercise any real authority or were free to decide the directions of its affairs. The matter was raised in *Re a company (No 005009 of 1987), ex parte Copp and another*<sup>126</sup> and the court refused to strike out the bank's application to the liquidator's claim that it should be liable under section 214. The court refused to strike out the claim that the bank was a shadow director because the recommendations made in the report for the company to follow were not unfounded. In reaching to his conclusion, Knox J relied on the available facts before him and ignored the possibility of further evidence at the trial.<sup>127</sup>

### **10.3.2.2 Insolvent liquidation**

Section 214 can be invoked only when the company has gone into insolvent liquidation, which means that liquidation on any other grounds is excluded. The test to determine insolvency for the purpose of insolvent trading is the balance sheet test, which focuses on the net assets of the company.<sup>128</sup>

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<sup>126</sup> [1989] BCLC 13.

<sup>127</sup> See also *Oditah* above n52 at 213.

<sup>128</sup> Section 214(6) of the UK Insolvency Act 1986-“ For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.” See also *Keay* above n2 at 86.

### 10.3.2.3 Reasonable Prospect/Predicting Company's Solvency

The statute does not define or give guidelines as to what constitutes a 'reasonable prospect' as envisaged in section 214. The provision requires directors to predict that the company's solvency will be affected as a result of their action. In foreseeing the company's future, directors are required to be aware when the company crosses the line from being solvent to having no prospect of maintaining its solvency.

Therefore, the time of knowledge of the company becoming insolvent is important because directors can be made personally liable once the line is crossed.<sup>129</sup> As such, directors are supposed to be sensitive to the changing nature of the company's position, for example by paying attention when the company suffers losses and the causes for such losses.<sup>130</sup> It is essential to ascertain the causes of such losses because it would determine whether remedial actions taken by the directors are reasonable, based on the tests enunciated in section 214(4) which will be discussed later in the chapter.

The Companies Act also requires the company to maintain and keep proper accounts,<sup>131</sup> which will assist directors to keep track of the company's solvency.<sup>132</sup> Directors are expected to have a basic knowledge of the accounting records so that they will be able to detect any changes in the company's position sooner.<sup>133</sup> The court however, is reluctant to impose knowledge on directors that the company has 'no reasonable prospect to avoid insolvent liquidation' too soon,

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<sup>129</sup> See also Keay above n2 at 93-94.

<sup>130</sup> Oditah above n52 at 210; the writer identifies many causes of insolvency namely from loss of major customers, the decline in the market demand for the output, mismanagement, economic downturn or incompetency.

<sup>131</sup> See Part 15 chapter 2 of the UK Companies Act 2006.

<sup>132</sup> Cooke and Hicks above n64 at 342.

<sup>133</sup> David Milman "Strategies for Regulating Managerial Performance in the 'Twilight Zone'-Familiar Dilemmas: New Considerations" (2004) JBL 493 at 497.

even though it was evident from the beginning that the company had little chances of success.<sup>134</sup>

The case of *Purpoint Ltd*<sup>135</sup> also shows that the court has given the benefit of the doubt to directors based on their skills to turn around the company to profitability. In other words, whether or not the company has crossed the fine line of ‘no reasonable prospect the company would maintain its solvency’ would also depend on the steps taken by the company once the problem had been discovered. Once directors have taken steps to bring the company to profitability, the reasonable length of time needed to do so would depend on the circumstances of each case.

#### **10.3.2.4 Knowledge of Directors/Tests Applicable**

Directors are subjected to two tests in ascertaining whether they have the necessary knowledge that the company has no prospect of avoiding insolvency liquidation. The tests are described in section 214(4) of the Insolvency Act 1986 - namely the objective test based on the general knowledge, skill and experience reasonably expected from a person occupying the same function and position in the company,<sup>136</sup> and the subjective test depending on the knowledge, skill and experience the director in question actually has.<sup>137</sup> Directors who are entrusted with specific functions in the company are also expected to have the knowledge, skill and experience associated with the position.

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<sup>134</sup> See *Re Purpoint Ltd* (1991) BCLC 491 at 498.

<sup>135</sup> *Ibid.*

<sup>136</sup> Section 214(4)(a) of the UK Insolvency Act 1986 – “ For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by reasonably diligent person having both-  
(a) the general knowledge, skill and experience that may be reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company...”,

<sup>137</sup> Section 214(4)(a) of the UK Insolvency Act 1986 – “ For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by reasonably diligent person having both-  
(b) the general knowledge, skill and experience that that director has.”

If the director in question has a higher standard of knowledge, skill and experience than ordinary reasonable directors, then he or she will be judged on the higher individual standard. However, the standard applicable to the director will be the reasonable standard if he or she possesses lower knowledge, skills and experience. This will ensure that the minimum standard of a reasonable director is maintained. This issue was discussed in the case of *Re Produce Marketing Consortium Ltd (No 2)*.<sup>138</sup> The minimum standard of knowledge expected from a reasonable director occupying the same function varies depending on the size of business and the nature of the business.<sup>139</sup>

The case provided that directors are deemed to have the necessary knowledge of the information that ought to have been obvious to them had the company complied with the requirement of maintaining proper accounts.<sup>140</sup> Thus, in assessing directors' knowledge, the information should not be restricted to materials the directors have before them but also extend to those which should have been available to them.

#### **10.3.2.4 Defences**

The burden is on the liquidator to show at which point before the commencement of winding up that the director knew or ought to have concluded that there were no reasonable prospects of the company avoiding insolvent liquidation.<sup>141</sup> Once this has been proved, the burden shifts to the director to show that he has taken every step he ought to have taken.<sup>142</sup> The director must convince the court that

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<sup>138</sup> [1989] BCLC 520.

<sup>139</sup> *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520 at 550- Knox J stated that " It follows that the general knowledge, skill and experience postulated will be much less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures."

<sup>140</sup> [1989] BCLC 520 at 550.

<sup>141</sup> See section 214(2)(b) of the UK Insolvency Act 1986.

<sup>142</sup> See section 214(3) of the UK Insolvency Act 1986- ' The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that

the steps taken were with the aim of minimising loss to creditors.<sup>143</sup> In other words, the section imposes a duty on the part of directors to minimise losses to creditors once liquidation is inevitable and if he or she succeeds he or she will be able to avoid liability under the section. Directors could only rely on the defence in section 214(3) of the Insolvency Act 1986 and could not depend on the general defences in section 1157 of the Companies Act 2006.<sup>144</sup>

It is, therefore, important to see how the courts construe the meaning of ‘every step that director ought to have taken.’ The usage of the words ‘ought to have taken’ gives the connotation of an objective element to the section, and therefore in determining whether a director has taken every step, the courts are referring to every reasonable step taken.<sup>145</sup> The objective element is further emphasised in section 214(4) in which courts are to have regard to the general knowledge, skill and experience of a reasonable person as well as those of the individual director. Like the standard applicable in determining whether directors have knowledge or ought to have knowledge that there are no reasonable prospects to avoid insolvent liquidation, directors will be subjected to the higher of the two standards. As such, directors cannot use their inexperience or lack of skills as a means to avoid liability because they will be judged on the skills and experience of a reasonable director in a similar situation.

A director who has greater experience and knowledge than a reasonable director on the other hand, is expected to take steps in accordance with his or her experience and knowledge. Therefore, a director could escape liability if he or

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there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

<sup>143</sup> See section 214(3) of the UK Insolvency Act 1986- ‘The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company’s creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

<sup>144</sup> See *Re Produce Marketing Consortium Ltd* [1989] BCLC 513; section 727 of the UK Companies Act 1985 has been replaced by section 1157 of the Companies Act 2006.

<sup>145</sup> Roy Goode *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London, 2005) at [12-37]; Keay above n2 at 113-114.

she takes steps reasonably expected from reasonable directors in similar circumstances.

When directors encounter the first sign of distress,<sup>146</sup> the most logical action for them is to engage professional advice and also to consult their creditors by convening a creditors' meeting, and then to decide on the appropriate action. In assessing the steps which ought to be taken by the director, the court should avoid using hindsight and should confine itself to the circumstances and information available to directors at the time decisions were made.<sup>147</sup>

A directors' decision to continue trading does not necessarily mean it is bad, because there are possibilities of trading the company out of difficulties or alternatively, of selling the company as a going concern at a higher value compared to if the company were to be put into liquidation immediately.<sup>148</sup> The Cork Committee in its recommendations proposed that directors or anyone who may be caught under wrongful trading be able to apply for anticipatory relief should their decisions to continue trading prove to be incorrect.<sup>149</sup> This will allow directors to continue trading within a certain period allowed by the court in order to see whether there is a possibility for them to turn the company to profitability without fear of being subjected to personal liability for wrongful trading.

However, this proposal was not adopted in the Insolvency Act 1986 and directors who decide to trade when they know there are no reasonable prospects of the company avoiding insolvent liquidation would be confronted with wrongful trading unless they had taken every reasonable step that ought to be taken. Hence, it is essential that a decision to continue to trade must be based on accurate information available at the time and directors must continue reviewing their

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<sup>146</sup> See Oditah above n52 at 210; the writer suggested whether the directors ought to have reasonably concluded there were no prospects of avoiding insolvency can only be answered by identifying the cause of insolvency. The next step is for the court to look at any steps taken to alleviate the circumstances.

<sup>147</sup> See *Re Sherborne Associates Ltd* [1995] BCC 40 at 54.

<sup>148</sup> Oditah above n52 at 208-209.

<sup>149</sup> Cork Report above n5 at [1798].

decisions.<sup>150</sup> Therefore, directors must maintain supervision and monitor the company's status, and, if necessary, review plans and decisions they have made. Directors whose company is having financial difficulties may decide to subject it to formal insolvency proceedings. The Cork Committee had recommended actions such as liquidation, receivership or administration be taken by directors whose company was facing financial problems.<sup>151</sup> Unlike the Australian insolvent trading provisions,<sup>152</sup> section 214(3) does not specifically cite formal insolvency proceedings as one of the factors for the courts to take into account when deciding whether a director has succeeded in his defence. In spite of that, in *Re Farmizer (Products) Ltd*<sup>153</sup> a liquidator only seeks contributions for the alleged wrongful trading up until the date the administration order was made. This gives the indication that directors who opted for formal insolvency proceedings may be able to limit their liability if not be totally absolved from it.

Likewise in Australia, there is no guarantee that a director who puts a company under administration proceedings will be free from liability; it depends on the time and result of such action. Due to the specific provision in the statute,<sup>154</sup> the court in Australia is obliged to take the matter into consideration, while in the UK it is left to the discretion of the court.

Insolvency law has always been in favour of rescuing and reorganisation of the company with winding up as the last option. The Cork Committee in its report has highlighted that one of the benefits of floating charge is the ability of its holder to appoint a receiver and manager. He or she is given extensive powers to manage the business of the company and in some circumstances may be able to

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<sup>150</sup> Oditah above n52 at 208-209.

<sup>151</sup> Cork Report above n5 at [501].

<sup>152</sup> See section 588H(9) of the Australian Corporations Act 2001- 'In determining whether a defence under subsection (5) has been proved, the matters to which regard is to be had include, but are not limited to:  
(a) any action the person took with a view to appointing an administrator of the company; and  
(b) when that action was taken; and  
(c) the results of that action.'

<sup>153</sup> [1997] 1 BCLC 589.

<sup>154</sup> See section 588H(9) of the Australian Corporations Act 2001.

turn the company into profitability before handing it back to its management. In other instances, the receiver and manager may be able to sell the company either in part or whole as a going concern.

The Committee had suggested the appointment of administrators regardless of whether there was a floating charge for the purpose of rescuing and reorganising the company.<sup>155</sup> It also recommended the proceeding as one of the courses that directors could take when confronted with a wrongful trading situation.<sup>156</sup> The original proposal of the administration proceeding was tedious and costly, but this was rectified by the Enterprise Act 2002 where the procedures were simplified in order to make it more accessible for the company at time of difficulties.<sup>157</sup>

## **10.4 Duty of Directors under New Zealand Law**

### **10.4.1 Introduction**

The law on the basic director's duties, prior to its amendment in 1993, had to be gleaned from case law because there were no express provisions in the statute. The Law Commission, therefore, decided that complete reforms were necessary in order to make it more accessible.<sup>158</sup> In relation to protections on creditors when the company continued trading at the time of financial difficulty, changes to the old provisions in section 320 of the Companies Act 1955 were recommended. It was thought that the courts' interpretations of the section hindered the company from taking business risks.<sup>159</sup>

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<sup>155</sup> Cork Report above n5 at (1982) [497-498].

<sup>156</sup> Ibid, at [501].

<sup>157</sup> See also the case of *Re Chancery Plc* [1991] BCLC 712 where the [word missing] allowed the administration proceeding to depart from the usual procedures where there would be a risk of wrongful trading. It should be noted, however, this case was decided before the procedures were simplified by the Enterprise Act 2002.

<sup>158</sup> NZLC R9 1989 above n39 at [186].

<sup>159</sup> See discussion by Justice Sian Elias above n40 at 9.

The Law Commission proposed that the old section be abolished and a new section be introduced which imposed liability on a director if he or she acted at a time when there were reasonable grounds to believe that the act concerned involved an ‘unreasonable risk of causing the company to fail to satisfy the solvency test.’<sup>160</sup> The Commission also recommended imposing a duty on the director not to cause the company to incur an obligation unless he or she believed at that time, on reasonable grounds, that the company would be able to perform the obligation when required to do so.<sup>161</sup> This suggestion was later incorporated in section 136 of the Companies Act 1993.

When the Act was finally enacted in 1993, the fraudulent element in section 320 of the Companies Act 1955 was abolished as suggested. However, some changes were made in respect of the other two provisions. The Justice Department substituted the Commission’s ‘unreasonable risk of causing the company to fail to satisfy the solvency test’ with a ‘reckless’ test. The reckless test was later modified to the current form by the Justice and Law Reform Select Committee. One of the reasons for changing it to the present form can be glimpsed from the parliamentary debate which stated that the liability would apply throughout the life of the company and not only in liquidation.<sup>162</sup>

Since section 135 was introduced in the Companies Act 1993, it has been subjected to many comments.<sup>163</sup> Among the main criticisms put forward by these

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<sup>160</sup> See the New Zealand Law Commission Draft Companies Act – section 105 (1) – “A director of a company must not agree to the company entering into a contract or arrangement or acting in any other manner unless he or she believes at that time on reasonable grounds that the act concerned does not involve an unreasonable risk of causing the company to fail to satisfy the solvency test.”

<sup>161</sup> Section 105(2) of the New Zealand Law Commission Draft Companies Act.

<sup>162</sup> (23 February 1993) NZPD speech by Hamish Hancork (second reading) <<http://www.vdig.net/hansard/archive.jsp?v=1993&m=02&d=23&o=37&p=4610>> at 10 October 2010.

<sup>163</sup> See comments made by David Goddard “Directors’ Liability for Trading While Insolvent: A Critical Review of the New Zealand Regime” in Ian Ramsay (Ed.) *Company Directors’ Liability for Insolvent Trading* (CCH Australia, Centre for Corporate and Securities Regulation, University of Melbourne, 2000) 169; Justice Sian Elias above n40; Justice Tompkins “Directing the Directors: The Duties of Directors Under the Companies Act 1993” (1994) 2 Waikato LR 13; Michael Bos and Martin Wiseman “Directors’ Liabilities to Creditors (2003)

authors are that the failure of the provision to recognise that business involves elements of risk taking. The uses of the phrase ‘likely to create substantial risks of serious loss’ in the statute has been interpreted by courts to prevent directors from taking any form of risks despite their potential to generate profits.

The concern was further emphasised when the High Court in *Fatupaito v Bates*<sup>164</sup> observed that the wording of section 135 seems to impose a strict duty on directors to avoid substantial risks of serious loss to creditors, and even in circumstances where potential for great reward exists, they are not allowed to take such risks. Nevertheless, the High Court did acknowledge that the degree of risk-taking corresponds with profits and to disallow any form of risk-taking would have inhibited the company’s attempt to turn around its fortunes.

The court’s strict interpretation, however, has been softened in the decision of *Re South Pacific Shipping Limited (in liq); Traveller v Lower*<sup>165</sup> where William Young J commented (obiter) that for section 135 to be functioning well, there is a need to make a distinction between legitimate and illegitimate business risks. The decision was later upheld by the Court of Appeal and confirmed in a later case of *Mason v Lewis*.<sup>166</sup> The later interpretation by the court on the section reflects the aims enunciated in the long title of the Act which acknowledged the company as means to take business risks and allowing directors wide discretion in matters relating to business judgment. At the same time, the Act also recognised the possibility of abuse in those circumstances and the need of the law to protect the interests of creditors as well as shareholders.

Another criticism levelled against the section is that the wording is ambiguous and unclear. This defeats one of the main purposes cited by the Law Commission

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NZLJ 262 and William Young J in *Re South Pacific Shipping Ltd (in liq); Traveller v Lower* (2004) NZCLC 263, 570 at 263,592.

<sup>164</sup> [2001] 3 NZLR 386, 401.

<sup>165</sup> (2004) NZCLC 263, 570 .

<sup>166</sup> [2006] 3 NZLR 225 (Court of Appeal), 233; see also *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104.

to reform the law, namely to reduce reliance on case law.<sup>167</sup> While the usage of ambiguous or vague terms in the Act gives wide discretion to the court to interpret their meanings, it also creates a heavy reliance on case law which the Law Commission proposed to eliminate. The courts, too, do not give many guidelines as to the meanings of the terms, more often than not repeating the wording of the section and being content to apply the sections after reviewing all relevant facts.<sup>168</sup> Justice Sian Elias also cautioned that the wide discretion accorded to the court could lead to the possibility of the court importing the old concept of recklessness into section 135 in order to give effect to the long title.<sup>169</sup>

In order to determine whether these criticisms are well founded, the court's decisions on this area will be examined. It will also look at the impacts of such interpretations on protection accorded to creditors and on directors' discretion to make business judgments.

#### **10.4.2 Reckless Trading under Section 135 Companies Act 1993**

##### **10.4.2.1 Statutory Provisions**

The title, reckless trading, in section 135 is quite misleading because it deals with the director's duty not to carry on the business in a manner likely to create a substantial risk of serious loss to creditors.<sup>170</sup> The reason for such a title is probably due to the resemblance of the wording of the section to the High Court's decision in *Thompson v Innes*.<sup>171</sup>

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<sup>167</sup> The Law Commission, in its report, stated that since directors' duties are not contained in the 1955 Act, "they have to be gleaned from a large volume of complex case law"- see NZLC R9 1989 above n39 at [186].

<sup>168</sup> Bos and Wiseman above n163 at 267.

<sup>169</sup> Justice Sian Elias above n40 at 9.

<sup>170</sup> See above n22 at 170.

<sup>171</sup> (1985) 2 NZCLC 99463.

Bisson J, when addressing the appropriate test under section 320(1)(b) which dealt with directors' liability for carrying the business of the company in a reckless manner<sup>172</sup> states

Was there something in the financial position of the company which would have drawn to the attention of an ordinary prudent director to the real possibility not so slight as to be a negligible risk, that his continuing to carry on the business of the company would cause the kind of serious loss to creditors of the company which section 320(1)(b) was intended to prevent?<sup>173</sup>

Section 135 imposes a duty on directors not to trade in manner which would expose the company's business to substantial risks of serious loss. Therefore, the courts will look at the way directors operate the business in order to decide whether liability ensues under the section.

In the case of *Re Group Hub Ltd (in liq); The PC Company Ltd v Sanderson*,<sup>174</sup> the court looked at the modus operandi of the company and found that the company never had substantial reserves, any profits made were modest, and it incurred periodic losses. The court hence decided that a company with such structure can only avoid liability under section 135 if it is able to trade profitably from the beginning.<sup>175</sup> Concern has been raised whether this is the right approach, given the fact that the majority of businesses started up in New Zealand are not able to trade profitably from their inception, thus exposing their directors to personal liability.<sup>176</sup>

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<sup>172</sup> Section 320(1)(b) of the New Zealand Companies Act 1955, a predecessor to section 135 of New Zealand Companies Act 1993.

<sup>173</sup> *Thompson v Innes* (1985) 2 NZCLC 99463 at 99472.

<sup>174</sup> Unreported case HC Hamilton, CP 18-00, 1 November 2001; Priestley J; see also *Re Gellert Developments Ltd* (2002) 9 NZCLC 262, 942.

<sup>175</sup> Bos and Wiseman above n163 at 266.

<sup>176</sup> *Ibid.*

A similar issue was raised in the English case of *Re Purpoint Ltd*<sup>177</sup>; a wrongful trading case, where the company had no capital base and its assets were either purchased by bank loans or acquired by hire purchase. Vinelott J expressed doubts as to whether a reasonable, prudent director would have allowed the company to commence trading at all, but refused to conclude that the director ought to have known the company was doomed from the start. To do that, the judge reasoned, would have been to impose too high a standard.

Although these two cases are subjected to two different statutes, it can be concluded that the court in *Re Group Hub Ltd (in liq); The PC Company Ltd v Sanderson*<sup>178</sup> was very strict in its interpretation and as a result could have deterred new businesses from forming. The UK court in *Re Purpoint*,<sup>179</sup> on the other hand, indicated the court's willingness to give the company an opportunity to trade to profitability, and only when it became apparent that was not the case did it impose liability on its director.

It also reflects the courts' attitude in the two jurisdictions in relation to the perception of a company as a vehicle to take business risks. In *Re Wait Investment Ltd (in liq)*,<sup>180</sup> directors who arranged for unconditional purchase of property of substantial value without arranging for finance and without any reasonable grounds to believe that they would be able to obtain the loan, were held to be liable for reckless conduct when the company in question did not have any assets or capital.

The literal interpretation of the section was illustrated in *Fatupaito v Bates*<sup>181</sup> where the court held that the wording of section 135 "appears to impose a stringent duty on directors to avoid substantial risks of serious loss to creditors

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<sup>177</sup> (1991) BCLC 491 at 498.

<sup>178</sup> Unreported case HC Hamilton, CP 18-00, 1 November 2001; Priestley J.

<sup>179</sup> (1991) BCLC 491.

<sup>180</sup> [1997] 3 NZLR 96.

<sup>181</sup> [2001] 3 NZLR 386 at 401.

and does not appear to allow for such risks to be incurred, even in circumstances where the potential for great rewards exists." O'Regan J's judgement seemed to indicate that the company could not trade out of financial difficulty if there were a risk involved in the act, even when there were potential for success. In doing so, the court failed to recognise the relationships between business and risk-taking as well as risks and reward. Consequently, it could stifle directors' wide discretion to make business judgment decisions.

However, William Young J in *Re South Pacific Shipping Limited (in liq); Traveller v Lower*,<sup>182</sup> acknowledged that the company has the right to take up business risks as long as the risk is legitimate. The judge reasoned that distinctions should be made between illegitimate and legitimate risks in order for the section to apply in a sensible way.<sup>183</sup> The judge listed some factors for consideration when determining whether a business risk is legitimate, and they are<sup>184</sup>:-

- a) whether those whose funds are affected fully understood the risk involved;
- b) the obligation directors have to creditors at the time when the company is insolvent;
- c) Whether the court acknowledged that the company should not stop trading immediately after the company becomes insolvent but should continue in an attempt to salvage it. In doing so, directors should consider the appropriate length of time to allow the company to continue trading; and
- d) Whether the conduct of directors in the circumstances was in accordance with orthodox commercial practice.

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<sup>182</sup> (2004) 9 NZCLC 263,570 at 263, 590.

<sup>183</sup> *Ibid*, at 263,593

<sup>184</sup> *Ibid*, at 263, 592.

The decision was later upheld by the Court of Appeal in *Mason v Lewis*<sup>185</sup> which reconfirmed the distinction between legitimate and illegitimate risks, and that directors will be personally liable only if the risks they take are illegitimate and substantial. In addition, the Court of Appeal, in construing the meaning of substantial risks and serious loss, referred with approval to the ‘sober assessment’ approach suggested by Mike Ross in his book *Corporate Reconstruction: Strategies for Directors*.<sup>186</sup> The sober assessment test requires directors to give a realistic view on whether the risk-taking is appropriate in the light of the company’s capability.<sup>187</sup>

The courts applying liberal interpretations in *Re South Pacific Shipping Limited (in liq); Traveller v Lower*<sup>188</sup> and *Mason v Lewis*<sup>189</sup> indicate their recognition that the company is a vehicle to take business risks as envisaged by the Act. At the same time, the courts are also aware that there should be a limitation as to the extent of risks which can be taken. Therefore, it is necessary to set a parameter to risk-taking and the court should be clear on this issue so that directors will be able to know when they will be liable.

It is suggested that the protection given to creditors in relation to section 135 should correspond to the risks involved.<sup>190</sup> In other words, creditors who have assented to the risks taken should not be allowed to rely on the provision in

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<sup>185</sup> [2006] 3 NZLR 225 at 233.

<sup>186</sup> Mike Ross *Corporate Reconstructions: Strategies for Directors* (CCH, Auckland, 1999); *Mason v Lewis* [2006] 3 NZLR 225 at 234.

<sup>187</sup> Ross *ibid*, at 40; the writer suggested “The first phrase ‘substantial risk’ requires a sober assessment by directors as to the company’s likely future income stream. Given current economic conditions, are there reasonable assumptions underpinning the director’s forecast of future trading revenue? If future liquidity is dependent upon one large construction contract or a large forward order for the supply of goods and services, how reasonable are the director’s assumptions regarding the likelihood of the company winning the contract? Even if the company wins the contract, how reasonable are the prospects of performing the contract at a profit?”

<sup>188</sup> (2004) 9 NZCLC 263,570.

<sup>189</sup> [2006] 3 NZLR 225.

<sup>190</sup> See also Brain J D Gould “Directors Personal Liability” (1996) NZLJ 437; the writer concluded that the law should ask “whether the behaviour of directors is appropriately risky rather than merely asking whether the behaviour is risky.”

respect of risks foreseeable by them. Creditors who have, for example, extended credit to the company after knowing its precarious financial position should not be allowed to rely on the reckless trading because they, themselves, have consented to the risk-taking. In such a situation, creditors should protect themselves against such risk by arranging for security.

The standard to determine whether section 135 has been breached is objective.<sup>191</sup> The Court of Appeal in *Mason v Lewis*<sup>192</sup> confirms the approach taken in the earlier case which stated that it was not the Parliament's intention to inject an element of subjectivity in the section or else it could have used, for instance, words such as 'knowingly cause or allow...'<sup>193</sup>

#### **10.4.2.2 Defences**

Section 135 and section 136 do not have specific defences which a director can rely on to exonerate himself or herself from liability. However, in respect of section 135, it is a defence for a director if he can prove to the satisfaction of the court that the risks he has taken are legitimate and not substantial.<sup>194</sup>

A director can also argue in his defence that the creditors knew of the risk he or she was about to take and consented to it.<sup>195</sup> For example, creditors who have extended credit to the company after knowing of its deteriorating state should not be allowed to use section 135 to their advantage if the venture fails to bring the company out of its current situation.

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<sup>191</sup> *Fatupaito v Bates* [2001] 3 NZLR 386.

<sup>192</sup> [2006] 3 NZLR 225.

<sup>193</sup> [2006] 3 NZLR 225 at 234.

<sup>194</sup> *Re South Pacific Shipping Ltd (in liq); Traveller v Lower* (2004) 9 NZCLC 263,570.

<sup>195</sup> *Ibid.*

### **10.4.3 Duty in relation Obligation under Section 136 Companies Act 1993**

#### **10.4.3.1 Statutory Provisions**

A director has a duty under section 136 to ensure that the company performs its obligation. The duty requires a director who has reasonable grounds to believe that the company could not discharge its obligation to prevent the company from entering into such a contract. The aim of this section is the protection of creditors who have every right to expect that the company will be able to fulfil the obligation.

To fulfil an obligation under section 136, a director must be certain the company has the capability to do so. The company, for instance, must have the necessary funds or at least be able to arrange for financial assistance in order to finance the performance of the transaction. This is illustrated in *Re Wait Investment Ltd*,<sup>196</sup> where a company entered into a sale and purchase agreement without first having arranged for the necessary funds to finance it. The court held that it was not reasonable for directors to expect that finances would be available to them after the signing of the agreement, given the fact that a number of applications had been rejected. The directors, therefore, had exposed the company to obligations when there was no reasonable grounds to believe it would be able to meet them.

Section 136 is concerned with whether the company has sufficient capital or cash funds available in order for it to perform its obligations. Directors therefore have to be vigilant of the company's financial status. In order to be fully aware of it, directors would have to monitor and supervise the company's performance and in case of any indication of problems, early detection made it easier for them to take steps to rectify it.

The test imposed by section 136 differs from section 135 in that the former recognises both subjective and objective elements in it. The subjective aspect can

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<sup>196</sup> [1997] 3 NZLR 96.

be seen from the wording ‘director believes...’ while the use of the term ‘reasonable grounds...’ indicates an objective standard.<sup>197</sup> In *Fatupaito v Bates*,<sup>198</sup> the director was found to have breached the duty since he was aware of the company’s insolvency and thus it would not be reasonable for him to believe that the company would be able to meet its obligation.

The difference between section 135 and section 136 is that, in the former, a director would have to assess whether it is justifiable for the company to take up risks in its current financial position in an attempt to bring the company back to profitability.<sup>199</sup> Section 136, on the other hand, deals with whether the company’s capital is sufficient for directors to believe on reasonable grounds for the company to be able to perform its obligation.<sup>200</sup>

#### **10.4.3.2 Defences**

Similar to reckless trading, there are no specific defences available under section 136. Directors, nevertheless, can depend on their belief on reasonable grounds that the company would be able to meet its obligation in order to escape liability. In addition, the defence under section 138 can also be used by directors to exonerate themselves.

#### **10.4.4 Duty not to Carry on the Business Fraudulently under Section 380 Companies Act 1993**

The wording of section 380(1) of the New Zealand Companies Act 1993 is similar to the UK section 213 of the Insolvency Act 1986 and section 993 of the Companies Act 2006. The section applies to “any person who knowingly is a party to the business with intent to defraud creditors or any other person or for a

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<sup>197</sup> See also *Fatupaito v Bates* [2001] 3 NZLR 386 at 405.

<sup>198</sup> [2001] 3 NZLR 386.

<sup>199</sup> See also Farrar above n22 at 174.

<sup>200</sup> *Ibid.*

fraudulent purpose.”<sup>201</sup> Although section 213 of the UK Insolvency Act 1986 deals with civil liability, while section 380 of the New Zealand Companies Act 2006 and section 993 of the UK Companies Act 2006 refer to criminal offences, the components to be proven under both Acts are the same. The courts in the UK have referred to cases under section 213 for the purpose of establishing liability under section 993.

Due to this, it is submitted that there is a likelihood that the New Zealand courts will interpret section 380(1) in the same way as their UK counterparts. The distinguishing factor between civil and criminal liability is the standard of proof for proving intention. In the former, it is on a balance of probabilities, while for the latter it is proof beyond reasonable doubt. Both sections 380 of the New Zealand Companies Act 1993 and 993 of the UK Companies Act 2006 apply throughout the life of the company and are not limited to when the company has been wound up, as required under section 213 of the UK Insolvency Act 1986.

Unlike subsection (1) which applies to any person who "knowingly becomes a party to the carrying on of the business," offences under subsections (2) and (3) are imposed only on directors of the company. Section 380(2) sets out the circumstances when directors of the company who have the intention to defraud creditors commit the offence.<sup>202</sup> The situations mentioned in the subsection deal mostly with the company's property being put out of the reach of the creditors.

It is not necessary for the directors in question to have obtained a personal advantage themselves. It is sufficient if, by deceit and fraud, they cause the

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<sup>201</sup> See section 380(1) of the New Zealand Companies Act 1993-“Every person who is knowingly a party to a company carrying on business with intent to defraud creditors of the company or any other person or for a fraudulent purpose commits an offence and is liable on conviction to the penalties set out in section 373(4)”. See also the section 213 of the UK Insolvency Act 1986 and section 993 of the UK Companies Act 2006.

<sup>202</sup> Section 380(2) of the New Zealand Companies Act 1993 –“ Every director of a company who,-  
a) by false pretense or other fraud induces a person to give credit to the company; or  
b) with intent to defraud creditors of the company,  
(i) gives, transfers or causes a charge to be given on, property of the company to any person; or  
(ii) causes property to be given or transferred to any person; or  
(iii) caused or was a party to execution being levied against property of the company.”

charge or property of the company to be transferred to any person. In addition to the criminal liability imposed by the section, insolvency law regards these circumstances to be voidable transactions which can be set aside under the Act.<sup>203</sup>

Section 380(3) of the Act was inserted as a result of the amendment to the Companies Act in 2006.<sup>204</sup> The section provides that “every director of a company commits an offence and is liable on conviction to penalties set out in section 373(4) who with intent to defraud a creditor or creditors of the company *does anything that causes material loss to creditors.*”<sup>205</sup> It should be noted that there is a resemblance to section 135 which refers to “...business carried on in *a manner likely to create a substantial risk of serious loss to creditors.*” In section 135, a director will be liable if the action taken causes a substantial risk which resulted in serious loss to creditors, and courts have made a distinction between legitimate and illegitimate risks in deciding whether the action is reasonable or not.<sup>206</sup> Section 380(3), on the other hand, deals with directors’ action which results in material loss to creditors where these directors have a dishonest intention to defraud them. The usage of the words ‘does anything’ in the section, indicates a positive action on the part of the directors and this will exclude any omissions on their part. The significant difference between the two sections is in relation to directors’ intention to defraud which must be present in section 380 and not in section 135.

It is submitted that despite the difference in the terms used in both sections, material loss in section 380 and serious loss in section 135, they both refer to the same thing. The court will look at whether the directors have the intention to defraud creditors through their action and consequently whether it causes material loss to creditors. Material loss in this aspect could be interpreted as a loss which is more than the ordinary or usual loss the creditors generally expect

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<sup>203</sup> See section 292 – section 296 of the New Zealand Companies Act 1993.

<sup>204</sup> The section was inserted by virtue of section 33 of the Companies Amendment Act 2006.

<sup>205</sup> See section 380(3) of the New Zealand Companies Act 1993.

<sup>206</sup> See *Re South Pacific Shipping Limited (in liq); Traveller v Lower* (2004) 9 NZCLC 263,570 and *Mason v Lewis* [2006] 3 NZLR 225.

from the carrying on of the business. It should also be noted that the use of the word ‘material’ in the section which indicates the degree of quantum of loss is important before a directors can be said to have committed an offence under the Act. This shows that the legislature recognises that business ventures involve risks and loss to creditors and liability should be imposed only when the act taken is unreasonable (or illegitimate as interpreted by the court under section 135, and the loss suffered is material. In light of this, it is submitted that there is the tendency of the court to interpret the new subsection (3) similarly to the interpretation in section 135.

Section 380 of the New Zealand Act imposes criminal penalty of imprisonment for a term not exceeding 5 years or a fine not exceeding \$200,000 if a person is convicted under the Act.<sup>207</sup>

## **10.5 Duty of Directors under Australian Law**

### **10.5.1 Introduction**

Australia has seen many changes to its insolvent trading provision since it first adopted the English model of fraudulent trading in 1931 which remained until 1961.<sup>208</sup> From the 1960s onward, Australia has departed from the English influence and developed its own version of Companies legislation which is more suitable to its conditions.<sup>209</sup> One of the main shortcomings of the earlier legislation in the area has been the lack of appropriate remedies available to creditors. The focus of the provisions has been on the criminal aspect, namely punishing the directors by imposing fines, imprisonment or disqualifications.<sup>210</sup> Although the remedies may have some impact on deterring directors from

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<sup>207</sup> See section 373(4) of the New Zealand Companies Act 1993.

<sup>208</sup> Rob McQueen “Limited Liability Company Legislation-The Australian Experience” (1991) AJCL 22 at 24. ALRC R45 Vol 1 1988 above n7 at 278

<sup>209</sup> Farrar above n22 at 16-19.

<sup>210</sup> ALRC R45 Vol 1 1988 above n7 at [278- 279].

engaging in ‘insolvent trading’, they do not benefit the creditors, for they will not be able to recoup losses from those directors.<sup>211</sup>

The provision which dealt with insolvent trading as opposed to fraudulent trading was first introduced in section 303(3) of the Uniform Companies Act 1961. It seems that the insolvent trading provision in Australia is an extension of fraud as it falls within the principle of *Derry v Peak*<sup>212</sup> as shown in *Orkin Bros Ltd v Bell*.<sup>213</sup> The Supreme Court of South Africa held it was an implied representation when the directors or officers of limited companies order goods from a merchant that they believe the company will probably be able to pay, and, if they know that there is no likelihood of payment and no means of payment, they have committed fraud.<sup>214</sup> Similar decisions had been made in English cases in which purchasing goods without intending to pay was a fraud.<sup>215</sup> The same theme appeared in the English case of *R v Jones*,<sup>216</sup> where it was held a person going into a restaurant and ordering a meal without any means or intention of paying was guilty of obtaining goods on credit by fraud.

However, it was initially made a criminal offence for "any person who was knowingly a party to the contracting of a debt when there are no reasonable or probable grounds or expectations of the company being able to pay the debt." Therefore, creditors had to rely on the Director of the Public Prosecutor to take action under the section. In addition, the standard of proof required was the criminal standard; beyond reasonable doubt, which contributed to the difficulty of enforcing the section.

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<sup>211</sup> Ibid, at [280].

<sup>212</sup> (1889) 14 App Cas 337.

<sup>213</sup> (1921) T.P.D 92, Supreme Court of South Africa (Transvaal Provincial Division).

<sup>214</sup> *Orkin Bros Ltd v Bell*(1921) T.P.D 92, Supreme Court of South Africa (Transvaal Provincial Division).

<sup>215</sup> *Ferguson v Carrington* (1829) 9 Barn. & Cr. 59; *Load v Green* (1846) 15 Mees &W 216.

<sup>216</sup> (1898) 1 Q.B. 119.

The first civil version of the insolvent trading principle which required directors to contribute personally into the company was initiated by the New South Wales Companies (Amendment) Act 1964.<sup>217</sup> The problem with the enforcement of this section was its dependency upon the conviction in section 303(3). Despite having the civil provision, creditors were often left without any remedies because the section was seldom invoked by the liquidators. Moreover, the procedures were lengthy, and therefore and as a result, not many actions were brought under the civil provision.<sup>218</sup>

Section 556, a predecessor to the current section 588G was enacted in 1981 and provided for civil liability.<sup>219</sup> The provisions did not depend on any criminal convictions although they were not free from defects. The Law Commission proposed for the wording of the sections to be restructured and identified several weaknesses which included that:<sup>220</sup>

- a) the provisions continued to contain both the criminal and civil elements; as can be seen from the decisions in *Metal Manufacturers Ltd v Lewis* (1986) 4 ACLC 739, *3M Australia Pty Ltd v Watt* (1984) 9 ACLR 203 and *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371;<sup>221</sup>
- b) the remedy is not for the benefit of the general body of creditors but only for those who bring the action against directors - therefore it would only benefit those with sufficient means;
- c) the section did not provide a standing for a liquidator - hence it would not benefit the general body of creditors, as evidenced from the decisions in *Ross McConnel Kitchen & Co Pty Ltd (in liq) v Ross* (1985) 9 ACLR 532; and

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<sup>217</sup> ALRC R45 Vol 1 1988 above n7 at[278].

<sup>218</sup> Ibid, at [278-279].

<sup>219</sup> In 1991, the Commonwealth introduced in the Corporations Act 1989 section 592 which dealt with insolvent trading and it is similar to section 556.

<sup>220</sup> ALRC R45 Vol 1 1988 above n7 at [279].

<sup>221</sup> See also section 556(1) of the Australian Corporations Act 1989.

- d) the section allows for multiple actions to be taken against the directors which may result in a race to bring the first action for fear that the assets may be depleted if waiting until later.

Due to these problems the Law Commission suggested that some changes be made to the insolvent trading provisions. Since previous legislation on insolvent trading concentrates upon the incurring of a particular debt or debts, the new provisions should focus on where the real abuse is, namely preventing trading from continuing when the company is insolvent.<sup>222</sup> As a result of the recommendations, section 588G was enacted: this imposes the duty on directors to prevent insolvent trading when the company is insolvent. The next section will explore the scope of section 588G in detail.

### **10.5.2 Insolvent Trading under Section 588G Corporations Act 2001**

Despite recommendations made by the Law Commission on the difficulty of interpretation of the wording such as ‘incurs a debt,’ section 588G retains it. Hence, cases under the previous section 556 will be used as references in analysing the court’s interpretation of the phrase. Under the insolvent trading provision, the essential elements to be proven before directors can be held liable are:

- a) the company incurs a debt;
- b) reasonable grounds for suspecting insolvency; and
- c) the company is insolvent or has become insolvent as a consequence.

#### **10.5.2.1 Incurs debts**

The meaning of the word ‘debt’ in this context has also created uncertainty pertaining to whether or not it includes contingent debt. It has been resolved nevertheless that debts within the meaning of the section only apply to liquidated

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<sup>222</sup> ALRC R45 Vol 1 1988 above n7 at [280]

amounts.<sup>223</sup> In *Hussein v Good*,<sup>224</sup> the Supreme Court of Victoria excluded contingent debts and its meaning was limited to only a debt owed immediately after it was incurred. In contrast, the Supreme Court of New South Wales in *Hawkins v Bank of China*<sup>225</sup> concluded that the word debt could include contingent debts. In *Bans Pty Ltd v Ling*,<sup>226</sup> it was decided that whether contingencies should be included has to be evaluated in a practical and commonsense manner.<sup>227</sup>

Hodgson J in *Standard Chartered Bank of Australia v Antico*<sup>228</sup>, stated that a company incurs a debt when " by its choice, it does or omits something, which as a matter of substance and commercial reality renders it liable for debts which otherwise it would not have been liable." This decision has been suggested that, for the section to be applied, there needs to be some positive acts on the part of the company to bring the debt into existence.<sup>229</sup> Therefore, only debts deemed to be voluntary, such as contractual debts, are included, while others, such as payment for damages, are not.<sup>230</sup> Hence, the application of the section is limited which means involuntary creditors or torts claimants are not protected.

### 10.5.2.2 When debt is incurred

It is crucial to determine when a company incurs a debt because that is the time when the liquidator or a creditor has to show that there are reasonable grounds to

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<sup>223</sup> See *Hawkins v Bank of China* (1992) 7 ACSR 349.

<sup>224</sup> (1990) 1 ACSR 710.

<sup>225</sup> (1992) 7 ACSR 349.

<sup>226</sup> (1995) 16 ACSR 404 (408).

<sup>227</sup> The decision is also consistent with the concept of 'substance and commercial reality' in *Standard Chartered Bank of Australia v Antico* (1995) 131 ALR 1.

<sup>228</sup> (1995) 131 ALR 1.

<sup>229</sup> Niall F Coburn "Insolvent Trading in Australia: The Legal Principles" in Ian M Ramsay (Ed.) *Company Directors' Liability for Insolvent Trading* (CCH Australia Ltd, Centre For Corporate Law and Securities Regulation, Faculty of Law, University of Melbourne, 2000) 73 at 96; see also reference therein; Austin and Ramsay above n34 at [20- 090].

<sup>230</sup> *Ibid.*

suspect that the company is insolvent or will become so as a result of incurring such debt. Section 588G (1A) provides an operative table as to when debt is incurred in respect of debts concerning shares and dividends. These debts are included because they are related to the law relating to capital maintenance which aims to protect creditors and which is similar to the purpose of insolvent trading. Other than debts mentioned in subsection (1A) the courts have grappled with how to determine the stage at which debts are incurred. In *Hussein v Good*,<sup>231</sup> the court held that debt is incurred at the time when goods are delivered. In *Standard Chartered Bank of Australia v Antico*<sup>232</sup>, the court decided that whether a debt is incurred at the time a contract is entered into or at acceptance of delivery, would depend on substance and commercial reality.<sup>233</sup> Mandie J in *Harrison v Lewis*<sup>234</sup> stated that

Although it is necessary to consider the terms of the relevant contract, the question when the debt is incurred within the meaning of the section does not depend on the strict legal analysis but turns on when, in substance and commercial reality, the company is exposed to the relevant liability. The reason for the emphasis upon substance and commercial reality lies in the need to ensure that the language is interpreted, or applied to the facts, in a way which serves the purpose, or fits the context, of a provision punishing insolvent trading and in a way which avoid absurd results.

From the decision in the case, it is clear that the courts must interpret the section so as to avoid absurd and unjust results. In doing so, the courts are prepared to give an interpretation based on commercial reality in place of a strict construction

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<sup>231</sup> (1990) 1 ACSR 710, see also *Taylor v Powell* (1992) 11 ALR 374.

<sup>232</sup> (1995) 131 ALR 1.

<sup>233</sup> The same approach was also taken in *Hawkins v Bank of China* (1992) 7 ACSR 349.

<sup>234</sup> (Unreported, Supreme Court of Victoria, Commercial and Equity Division, Mandie J, 23 February 2001).

of law of contract. The court must also focus, when interpreting, on the conduct and choice of the alleged insolvent company.<sup>235</sup>

### 10.5.2.3 Insolvency

The test of insolvency is provided under section 95A of the Corporations Act 2001 and is defined as the company's inability to pay its debt when it becomes due.

### 10.5.2.4 Reasonable Grounds to Suspect Insolvency

Before a director can be held personally liable under the Act, it must be shown that there are reasonable grounds for directors to suspect that the company is insolvent at the time the debt is incurred or will become so as a result of incurring such debt. The word reasonable in the section shows that the test is objective and the director is judged by the standard appropriate to a director or manager of ordinary competence.<sup>236</sup>

It has been suggested that in order to establish what is tantamount to 'reasonable grounds to suspect,' the court should look at all the circumstances, and cases have indicated the court's tendency to look at the commercial reality of the company's financial status.<sup>237</sup> The decisions are also consistent with the UK and the New Zealand approach as discussed above. One important change made to section 588G is the usage of the word 'suspect' instead of 'expect' as in the previous section 556 which indicates a lower standard.<sup>238</sup> In *Dunn v Shapowloff*,<sup>239</sup> the court held that 'expectation' within the meaning of the section goes beyond a

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<sup>235</sup> See also *Hawkins v Bank of China* (1992) 7 ACSR 349; *Metropolitan Fire Services Pty Ltd v Miller* (1997) 23 ACSR 609 at 704; see also judgement by Kitto J in *Queensland Bacon Pty Ltd v Rees* (1965) 115 CLR 266 at 301.

<sup>236</sup> *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371.

<sup>237</sup> Coburn above n229 at 99; *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371; *Metropolitan Fire Services Pty Ltd v Miller* (1997) 23 ACSR 609.

<sup>238</sup> Coburn above n229 at 100.

<sup>239</sup> [1978] 3 ACLR 775 at 789-790. see also *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371

mere hope or possibility which requires directors to predict the company's capability in the future.

The aim of the legislature in lowering the standard is to ensure that directors are more responsible and accountable in managing the company. This can be seen from the Parliament's action in enacting the law relating to director's duties. Over time, the duty imposed on directors, especially when the company is insolvent, is getting heavier.<sup>240</sup>

On the other hand, the lowering of the standard of care in section 588G has been criticised as discouraging competent and reliable directors from taking up office, while the errant ones are let off the hook.<sup>241</sup> The courts also have the tendency to be overly protective of creditors and less sympathetic of directors, which may result in honest and reliable directors being subjected to personal liability.<sup>242</sup>

#### **10.5.2.5 Failure to Prevent Incurring of Debts**

Apart from the elements mentioned in subsection (1), the liquidator or creditor must also prove<sup>243</sup> that the director is aware at the time debt is incurred that there are reasonable grounds to suspect that the company is insolvent or will become so. Alternatively, the director is also liable if a reasonable person in the same position would be so aware.

The plaintiff is required to prove awareness based on an objective standard of an ordinary competent person, and this is not based on the personal elements of the

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<sup>240</sup> See *Elliot v Australian Securities and Investment Commission; Plymin v Australian Securities and Investment Commission* (2004) VSCA 54 at [103].

<sup>241</sup> Dale A Oesterle "Corporate Directors' Personal Liability for "Insolvent" "Reckless" and "Wrongful" Trading: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders" (2001) NZBLQ 20 at 21; Coburn above n229 at 100-101.

<sup>242</sup> *Ibid.*

<sup>243</sup> Section 588G(2)- By failing to prevent the company from incurring the debt, the person contravenes this section if:

- (a) the person is aware at that time that there are such grounds for so suspecting; or
- (b) a reasonable person in a like position in a company's circumstances would be so aware.

defendant.<sup>244</sup> Therefore, a director's personal knowledge, skills and experience are irrelevant to establish liability, a position akin to New Zealand.<sup>245</sup> This stance, however, differs from that of the UK, for in the UK, the court is compelled by statute to take into consideration the ordinary competence standard as well as the individual directors' knowledge, skills and experience.<sup>246</sup>

The court in *Elliot v Australian Securities and Investment Commission; Plymin v Australian Securities and Investment Commission*<sup>247</sup> rejected the defense counsel's contention that the phrase "by failing to prevent the company from incurring debts" in the opening of section 588G(2) requires the plaintiff to establish that the director did not take effective steps to prevent the incurring of the debts. Counsel for the director argued that a director who failed to take steps to prevent a company from trading did not contravene section 588G(2) unless there had been identification of steps which might be taken by the director.<sup>248</sup>

The court, after having regard to the context, history and legislative purposes of sections 588G and 588H stated that

a director contravenes the section 'by not preventing' or 'by failing to prevent' a company from incurring a debt, and that a director will be taken to have so failed if debts are incurred by a company at a time when there are reasonable grounds for suspecting that the company is insolvent, or otherwise it would render section 588H meaningless and irrelevant.<sup>249</sup>

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<sup>244</sup> *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371 at 373.

<sup>245</sup> See section 135 of the New Zealand Companies Act 1993.

<sup>246</sup> See section 214(4) of the UK Insolvency Act 1986.

<sup>247</sup> (2004) VSCA 54 at [91].

<sup>248</sup> (2004) VSCA 54 at [88].

<sup>249</sup> *Elliot v Australian Securities and Investment Commission* (2004) VSCA 54; *Plymin v Australian Securities and Investment Commission* (2004) VSCA 54 at [116].

### **10.5.2.6 Defences - section 588H**

Section 588H provides four defences for directors to use once the elements contained in sections 588G (1) and (2) are proven. These defences, however, are not available in the case of criminal liability under section 588G (3) which depends on dishonesty. They are:

- a) Reasonable grounds to expect that the company is solvent;
- b) Reliance on a competent and reliable person;
- c) Absence from the management of the company due to illness or other good reason; or
- d) All reasonable steps to prevent incurring of debts have been taken.

#### **10.5.2.6.1 Reasonable Grounds to Expect that the Company is Solvent**

It must be noted that for directors to be liable under the Act, it is sufficient for the plaintiff to prove that the director ‘suspects’ insolvency, but to be exonerated, the directors must prove that there are reasonable grounds to expect that the company is solvent. The requirement of expectation in order to exculpate directors refers to a higher degree of certainty than suspecting.<sup>250</sup>

A director must be able to prove to the satisfaction of the court that at the time the debt was incurred he or she had reasonable grounds to expect that the company was solvent. The court will apply an ordinary prudent director standard when assessing whether it is reasonable to expect that the company would be able to pay off its debts. The court will scrutinise the company’s financial situation as a whole, including assets, liabilities, potential revenue, creditor’s promises for

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<sup>250</sup> *Tourprint International Pty Ltd v Bott* (1999) 32 ACSR 201; see also *Dunn v Shapowloff* [1978] 3 ACLR 775 at 789-790; *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371.

additional capital, as well as a reasonable degree of confidence that company would be able to trade out of difficulty.<sup>251</sup>

It lays a burden on directors to be involved in the management and to acquire reasonable information because failure to do so may expose them to liability. It is essential for the court when interpreting the law to give effect to the underlying principle, namely the duty to prevent insolvent trading in order to protect creditors. As such, the end result of its decision should have the impact of protecting creditors.

#### **10.5.2.6.2 Reliance on Competent and Reliable Persons**

A director can also raise a defence that he or she relied on third party information, and, based on that information formed a reasonable expectation of the company's solvency status. The section requires a director to prove two conditions, namely;

- a) he or she has reasonable grounds to believe and did believe:
  - (i) a competent and reliable third person provides adequate information on the company's solvency; and
  - (ii) that third person was fulfilling that responsibility; and
  
- (b) Expected that, based on information supplied by the third person, the company was solvent at the time debt was incurred and would remain so even if the debt was incurred.

A third party who provides information to directors, however, will not be subjected to liability, for insolvent trading provisions only applies to directors. A director firstly needs to show that the third person is competent and reliable. A competent person is judged on his or her skills and experience, as well as the nature of business involved. A reliable person, on the other hand, refers to the conduct or action he or she employs in applying those skills and experience. Hence, a director has to demonstrate that the third person giving the information

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<sup>251</sup> *Commonwealth Bank of Australia v Friedrich* (1993) 11 ACSR 247.

has the necessary skills as well as experience, and uses them in a manner considered as reliable. This section also imposes a duty on directors to monitor and supervise in order to ensure that the third party fulfils his or her responsibility.

In addition, a director has a burden of taking affirmative action<sup>252</sup> once information is supplied, for he or she cannot depend solely on the third party's information. A director must weigh the information given as a whole and must judge the company's status for himself or herself with a degree of certainty.

#### **10.5.2.6.3 Absent from Management**

If a director is absent from making decisions due to illness or good reason, he or she has succeeded in raising one of the defences under section 588H(4). The words 'illness or other good reason' is wide and could be subjected to many interpretations. Hence, the court should ensure that the interpretations display the purpose of the section which is to protect creditors by preventing insolvent trading. It should also be noted that over the years, the legislature has imposed a greater burden on directors in order to make them more responsible and accountable, and judicial interpretations should not undermine this philosophy.

#### **10.5.2.6.4 All Reasonable Steps to Avoid Incurring Debts**

This defence is based on the defence 'took all steps' in the UK. Therefore, just as in the UK, directors have to take positive action in order to depend on the section.<sup>253</sup> The point was highlighted by Simos AJA in *Byron v Southern Star Group Pty Ltd*<sup>254</sup> who decided that mere objection to the company's continuing

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<sup>252</sup> *Metropolitan Fire Systems Pty v Miller*(1997) 23 ACSR 699 at 711-712.

<sup>253</sup> See also Robert Baxt "Does the Director Protest Too Much? When Protesting May Not be Enough to Escape Liability Under the Insolvent Trading Provisions of the Corporations Law" (1997) 15 C&SLJ 197.

<sup>254</sup> (1997) 22 ACSR 553.

trading without any other action taken was not enough to take a director outside the liability.<sup>255</sup>

The judge in *Byron* quoted the decision of Hodgson J in *Standard Chartered Bank of Australia v Antico*<sup>256</sup> stated that

there may be circumstances in which failure of a single director to seek to persuade a managing director not to incur a debt, or to call a directors' meeting with a view to stopping the incurring of debts, or to resign, or to seek to have the company wound up, could amount to giving authority or consent to the incurring of a debt...<sup>257</sup>

The reasonable steps which can be taken by directors include engaging professional advice and subjecting the company to formal insolvency proceedings although this does not guarantee exculpation of liability.<sup>258</sup> The section specifically provides in subsection (6) that appointing an administrator is a relevant factor to take into consideration.

### **10.5.3 Liability of Holding Company for Insolvent Trading by Subsidiary under Section 588V-588X Corporations Act 2001**

The same duty is imposed on a holding company under section 588V of the Corporations Act 2001, albeit the holding company is only subjected to civil liability.<sup>259</sup> The holding company is under a similar duty to prevent insolvent trading by a subsidiary, and a liquidator has to prove the same elements as the

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<sup>255</sup> Compare with the UK decision in *Secretary of State for Trade and Industry v Taylor* [1997] 1 WLR 407 where the court refused to find the director unfit under the Company Directors Disqualification Act 1986 when the director who knew of impending liquidation, failed to influence the board's decision to continue trading and refuse to resign.

<sup>256</sup> (1995) 131 ALR 1.

<sup>257</sup> (1997) 22 ACSR 553 at [45]-[50].

<sup>258</sup> See section 588H(6) of the Australian Corporations Act 2001.

<sup>259</sup> See section 588W (1)(c) of the Australian Corporations Act 2001- the debt was wholly or partly unsecured when the loss or damage was suffered.

liability under section 588G. However, only a liquidator of the subsidiary has a right to bring an action under section 588V. Creditors have no such right since the rights only accrue once the company is wound up.<sup>260</sup> The liquidator has to bring an action against the holding company within six years of the filing of the petition.<sup>261</sup>

The liquidator must prove to the satisfaction of the court when the subsidiary incurs a debt, that the company is insolvent or became insolvent and the holding company has reasonable grounds for suspecting that the subsidiary is insolvent or would become insolvent.<sup>262</sup> Section 588V only applies to voluntary debts and therefore excludes involuntary creditors such as tort claimants from having the benefit of the provisions. The omission of torts victims from the provision has been criticised as one of the main defects of insolvent trading.

Although tort claimants are also left uncompensated in respect of debts in a single company, the situation is more precarious in the groups of companies. It is not uncommon for a holding company to set up an undercapitalised subsidiary for hazardous activities such as asbestos mining.<sup>263</sup> The victims of these hazardous activities are often left without compensation for there are minimal assets in the subsidiary which can be used to compensate them. The holding company, therefore, can insulate its assets from the potential tort claimants.

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<sup>260</sup> See section 588W of the Australian Corporations Act 2001. Section 588W (1) states " where:  
(a) a corporation has contravened section 588V in relation to the incurring of a debt by a company; and  
(b) the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency; and  
(c) the debt was wholly or partly unsecured when the loss or damage was suffered; and  
(d) the company was wound up;  
the company's liquidator may recover from the corporation, as a debt due to the company, an amount equal to the amount of the loss or damage."

<sup>261</sup> Section 588W(2) of the Australian Corporations Act 2001 provides "Proceedings under this section may only be begun within six years after the beginning of the winding up."

<sup>262</sup> See section 588V (1) of the Australian Corporations Act 2001.

<sup>263</sup> Ian M Ramsay "Holding Company Liability for the Debts of an Insolvent Subsidiaries: A Law and Economic Perspectives" (1994) 17 UNSWLJ 520 at 542; see also Damien Murphy "Holding Company Liability for Debts of Its Subsidiaries: Corporate Governance Implications (1998) 10 Bond LR 241 at 258.

Another defect of the section is in relation to its application, which is limited to subsidiary companies. The holding company can avoid liability simply by manipulating its control over the company outside the definition of subsidiary as provided under section 46 of the Corporations Act.<sup>264</sup>

The problems manifest could have been avoided had the legislature adopted the Law Commission's recommendations. The Law Commission suggested that a company which is related to another company should be liable for all or part of the amount admissible in winding up if the court is 'satisfied that it just to do so.' In deciding what amounts to 'just,' the three factors to be taken into considerations by the courts are:

- a) the extent to which the related company took part in the management of the company;
- b) the conduct of the related company towards the creditors of the company; and
- c) the extent to which circumstances that gave rise to the winding up of the company are attributable to the actions of the related company.

The usage of the term 'related company' has wider applications than subsidiary company and hence, the holding company could not escape liability by manipulating the technicalities of the definition of subsidiary. In addition, the difficulty concerning torts claims which are not covered under the current provision could have been addressed by adopting the 'amount admissible in winding up.' The provable debts cover a much wider wide range of claims by creditors and are not limited to contractual debts. Creditors generally can claim debts whether they are present or future, certain or contingent and other claims for unliquidated damages or compensation whether in tort, contract or any other cause of action that existed when the winding up began.<sup>265</sup>

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<sup>264</sup> Ramsay *ibid*, at 543-544.

<sup>265</sup> See section 553 of the Australian Corporations Act 2001.

On a positive note, the provision acknowledged that some creditors can protect their interests through contracts and, therefore, do not require protection from the law. Therefore, the liquidator can bring an action against the holding company on behalf of the unsecured creditors only.<sup>266</sup>

The liquidator also needs to show:<sup>267</sup>

- a) a holding company, or one or more of its directors, is or are aware at that time that there are grounds for so suspecting; or
- b) having regard to the nature and extent of the holding company's control over the affairs of the subsidiary and to any other relevant circumstances, it is reasonable to expect that:
  - a holding company in the company's circumstances would be so aware; or
  - one or more of such a holding company's directors would be so aware.

The section provides two situations in which a holding company is 'aware of the reasonable grounds for suspecting'. It is based on the actual knowledge of the holding company or its director(s) and the presumed knowledge based on the objective standard of the holding company or its director(s). The holding company would have the necessary knowledge on the subsidiary to suspect insolvency through its director who is also on the board of the subsidiary. In addition, the holding company has the obligation to prepare consolidated accounts in which relevant information on the subsidiary's financial health would have to be ascertained.

### **10.5.3.1 Defences**

The defences available to a holding company are similar to directors of a single company under section 588G. It would be difficult for the holding company to

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<sup>266</sup> Section 588W(1)(c) states - "the debt was wholly or partly unsecured when the loss or damage was suffered."

<sup>267</sup> See section 588V(1) (d) (i) and (ii) of the Australian Corporations Act 2001.

argue that there are reasonable grounds to expect that the company is solvent<sup>268</sup> if the information available indicates otherwise. It is possible for the holding company, however, to use the defence under section 588X (3) if it can prove its reliance on a reliable and competent third party.<sup>269</sup>

It is unclear on how a holding company would raise the argument of absence from taking part in the management due to illness or other good reasons as envisaged in subsection (4).<sup>270</sup> A holding company does not take part in the management of the subsidiary because, under the principle of separate legal personality, the companies are regarded as two different companies, each with its own board of directors. Likewise, the same reasoning applies in respect of the plausibility of the defence that the holding company ‘took all reasonable steps’<sup>271</sup> the requirement of the holding company having taken all reasonable steps to prevent the subsidiary from incurring debts clearly contravenes the very foundation of the company law.

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<sup>268</sup> Section 588X (2) states: “It is a defence if it is proved that, at the time when the debt was incurred, the corporation, and each relevant director (if any), had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.”

<sup>269</sup> Section 588X(3) states: “Without limiting the generality of subsection (2), it is a defence if it is proved that, at the time when the debt was incurred, the corporation, and each relevant director (if any):

- (a) had reasonable grounds to believe, and did believe:
  - (i) that a competent and reliable person was responsible for providing to the corporation adequate information about whether the company was solvent; and
  - (ii) that the person was fulfilling that responsibility; and
- (b) expected, on the basis of the information provided to the corporation by the person, that the company was solvent at that time and would remain solvent even if it incurred that debt and other debts that it incurred at that time.

<sup>270</sup> Section 588X(4) states: “If it is proved that, because of illness or for some other good reason, a particular relevant director did not take part in management of the corporation at the time when the company incurred the debt, the fact that the director was aware as mentioned in subparagraph 588V(1)(d)(i) is to be disregarded.”

<sup>271</sup> Section 588X (5) states: “It is a defence if it is proved that the corporation took all reasonable steps to prevent the company from incurring the debt.”

## **10.6 Duty of Directors under Malaysian Law**

### **10.6.1 Introduction**

The fraudulent trading provision in Malaysia is stated in section 304(1) of the Companies Act 1965 and is inherited from section 332 of the UK Companies Act 1948. The English version of fraudulent trading continues to exist in its current form in section 213 of the Insolvency Act 1986 for civil liability, and section 993 of the Companies Act 2006 for its criminal liability. Since the provision was enacted following the old law, any defects of the old law which prompted the UK to amend its legislation remain in section 304(1).

Although the UK has two separate sections on fraudulent trading, there is only one section which deals with both civil and criminal liability in the Malaysian Companies Act 1965. One of the drawbacks of having both criminal and civil liability in one provision is the tendency of the court to apply the higher criminal standard, resulting in a small number of cases being brought to the court. In its report, the Cork Committee recommended that the fraudulent trading provision should maintain its criminal liability and a new civil provision be introduced in the form of wrongful trading in section 214.

However, when the Insolvency Act 1986 was enacted, the civil aspect of fraudulent trading was maintained in section 213. Due to the similarities in the wording of the provisions, the Malaysian courts have since referred to the English cases under section 213 in interpreting the elements of section 304(1).<sup>272</sup> The Singaporean provisions on fraudulent and insolvent trading will also be compared because they are exactly the same as Malaysia. The Singaporean Companies Act 1967 adopted an Act similar to the Malaysian Companies Act 1965 after its separation from Malaysia in 1965. Since various changes have been made to the Singaporean Act.

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<sup>272</sup> It should be noted that the elements of fraudulent trading in section 993 of the UK Companies Act 2006 are similar to section 213 of the UK Insolvency Act 1986.

## 10.6.2 Responsibility for Fraudulent Trading under Section 304 Companies Act 1965<sup>273</sup>

Section 304(1) of the Act provides:

If in the course of the winding up of a company or in any proceedings against a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court on the application of the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any person who knowingly was a party to the carrying on of the business in that manner shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court directs.

The section imposes personal responsibility on "any person who knowingly carrying on the business of the company with the intent to defraud creditors ...or for any fraudulent purpose." The same section also applies to criminal liability and this was asserted in section 304(5) of Companies Act 1965. Section 304(5) states:

Where any business of a company is carried on with the intent or for the purpose mentioned in subsection (1) every person who was knowingly a party to the carrying on of the business with that intent or purpose shall be guilty of an offence against this Act.

Penalty: Imprisonment for three years or ten thousand ringgit.

The inclusion of both civil and criminal liability in one section has resulted in a call for a strict interpretation of the law; a higher standard of proof.<sup>274</sup> The Court of Appeal in *Siow Yoon Keong v H Rosen Engineering BV*<sup>275</sup> decided that the

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<sup>273</sup> See section 340 of the Singaporean Companies Act 1967.

<sup>274</sup> Counsel for the appellant director submitted strict interpretation is required since the section also contained criminal liability - see *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569 at 579.

<sup>275</sup> [2003] 4 MLJ 569 at 582.

provision use the phrase ‘if it appears’ signifies a lower degree of proof, and hence a civil standard balance of probabilities is sufficient.<sup>276</sup> The court’s decision suggests that judges are aware of the criticism that the application of the criminal standard deters cases from being brought to the court.<sup>277</sup> Hence, the uses of the standard of proof depend on the standard of liability sought by the applicant; the balance of probability for civil cases, and beyond reasonable doubt in criminal cases. Nevertheless, in all cases brought before the court in Malaysia, it was found that the evidence of fraud was apparent, and that it could be proven by using either standard.

Section 304(1) can be used when the company is in ‘the course of winding up or in any proceedings against the company.’ In *Tang Eng Iron Works Co Ltd v Ting Ling Kiew & Anor*,<sup>278</sup> the court concluded that an application under section 304(1) is also applicable prior to winding up. In this case, the plaintiff decided to commence an action under section 304(1) when facts unearthed during an examination of the defendant indicated that there was intention to defraud creditors. This differs slightly from the UK fraudulent trading laws because section 213 does not have the phrase ‘in any proceedings against the company.’ Therefore in the UK, the section can only be employed when the company is in the process of being wound up.

Despite the word ‘creditors’ in section 304(1), liability under section 304(1) does not depend on the numbers of creditors or transactions involved. The court can still find liability even if only one creditor was defrauded by one transaction as long as the transaction could be described as a fraudulent one committed in the course of carrying on of the business.<sup>279</sup> An example can be seen from the case of

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<sup>276</sup> The same civil standard was applied in *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong* [2009] 1 MLJ 723 and in *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors* [2010] 1 MLJ 185.

<sup>277</sup> The case of *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569, 579 was the first case under section 304(1).

<sup>278</sup> [1990] 2 MLJ 440.

<sup>279</sup> *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors* [2010] 1 MLJ 185 at 200-201.

*Siow Yoon Keong v H Rosen Engineering BV*<sup>280</sup> where the transaction in question was the passing of a resolution and only one creditor, Rosen, suffered losses. In order to interpret section 304(1), the courts have made reference to English cases to guide them. The elements of fraudulent trading which courts need to construe are:<sup>281</sup>

- a) Parties knowingly
- b) Carrying of any business
- c) Intent to defraud of for any fraudulent purpose

### **10.6.2.1 Party Knowingly**

Like section 213, the Malaysian provision imposes liability on "any person who was knowingly party to the carrying on of the business." Section 304(1) is more extensive than the insolvent trading provision in section 303(3) because the latter only applies to 'an officer of the company.' However, section 303(3) is wider in its application, when compared to the UK wrongful trading provisions, the Australian insolvent trading provisions and the New Zealand reckless trading provisions which only apply to directors.

In *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors*,<sup>282</sup> the plaintiff creditor took action against four directors for fraudulent trading. The court deduced from the facts of the case that the first and the second defendants were not parties to the carrying out of the business because, throughout the relevant period, the management of the company was in the hands of the third and fourth defendants. Both the first and the second defendants were not involved in the deed of assignment of trade receivables which was transferred to the holding company. The third and the fourth defendants, who were also directors of the holding company, were responsible for making the 'statement by directors' in the audited

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<sup>280</sup> [2003] 4 MLJ 569.

<sup>281</sup> These elements are similar to section 213 of the UK Insolvency Act 1986 and section 993 of the UK Companies Act 2006.

<sup>282</sup> [2010] 1 MLJ 185 at 203-204.

account. Due to this, the third and fourth defendants were held to be liable under the section.

### 10.6.2.2 Carrying on of any Business

To determine whether the company is carrying on the business within the meaning of section 304(1), the court in *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors*<sup>283</sup>, refers to several English cases<sup>284</sup> and concludes that the phrase means to include a myriad of activities and transactions undertaken by a company which did not necessarily involve trading. The liberal interpretation of the phrase was also seen in a Singapore case of *Rahj Kamal bin Abdullah v PP*<sup>285</sup> where the director was convicted for fraudulent trading when the company he controlled engaged in a pyramid selling type of investment scheme.

The usage of the words ‘any business’ in the section results in a wide interpretation being applied to as opposed to insolvent trading which is limited to only the activity of incurring of debts. This results in more activities of directors which can be subjected to personal liability which creates uncertainty and difficulty for them in organizing their activities.

In *Siow Yoon Keong v H Rosen Engineering BV*<sup>286</sup> the court had no difficulty in deciding that the passing of a resolution to ratify the uses of the company’s funds for the purpose of investments, and the sum of RM423,000 which was to be paid to the respondent were used to pay the appellant’s losses, constitute the carrying on of the business within section 304(1).

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<sup>283</sup> [2010] 1 MLJ 185 at 199.

<sup>284</sup> Reference were made by the High Court to *R v Grantham* [1984] 3 All ER 166; *Re Augustus Barnett & Son Ltd* [1986] BCLC 170; *Re Sarflax Ltd* [1979] 1 Ch 592 and *Re FP & CH Matthews Ltd* [1982] 1 All ER 338.

<sup>285</sup> [1998] 1 SLR 447.

<sup>286</sup> [2003] 4 MLJ 569 at 580.

The courts have acknowledged that the meaning of ‘carrying on of the business’ within the section covers a wide range of actions which are not necessarily confined to trading. This is evidenced from the courts’ decisions which concluded that activities such as the passing of resolutions to ratify the usage of company’s funds to pay for investments,<sup>287</sup> the usage of loan money for the purpose of payment for construction works,<sup>288</sup> and payment of certain sums owed to the defendant director in preference over other trade creditors including those who stand in priority over the defendant involved ‘carrying on of the business.’<sup>289</sup>

### 10.6.2.3 Intent to Defraud or for any Fraudulent Purpose

It is essential for the court to make an inference from the facts of each case in order to determine whether there is an intention to defraud creditors or whether it was done for a fraudulent purpose.<sup>290</sup> Nevertheless, for the purpose of section 304(1), showing an intention to defraud is sufficient and it is not necessary for the creditors to be in fact defrauded.<sup>291</sup> As such, the company’s financial state is irrelevant in determining the directors’ liability.

Despite its name, the insolvent trading in section 303(3) also does not require the company to be insolvent for liability to be imposed in directors. The section only

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<sup>287</sup> *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569.

<sup>288</sup> *Tang Eng Iron Works Co Ltd v Ting Ling Kiew & Anor* [1990] 2 MLJ 440.

<sup>289</sup> *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong* [2009] 1 MLJ 723.

<sup>290</sup> See the judgment in *PJTV Denson (M) Sdn Bhd v Roxy (Malaysia) Sdn Bhd* [1980] 2 MLJ 136 at 138 where the judge referred to English cases and stated: “Whether fraud exists is a question of fact, to be decided upon the circumstances of each particular case. Decided cases are only illustrative of fraud. Fraud must mean “actual fraud, i.e. dishonesty of some sort” for which the registered proprietor is a party or privy. “Fraud is the same in all courts, but such expressions as ‘constructive fraud’ are ...inaccurate;” but “‘fraud’ ... implies a wilful act, on the part of one, whereby another is sought to be deprived, by unjustifiable means, of what he is entitled.” ( *per Romilly M.R. in Green v Nixon* (1857) 23 Beav 530 & 535). Thus in *Waimiha Sawmilling Co Ltd v Waione Timber Co Ltd* [1926] AC 101 at 106 it was said that “if the designed object of a transfer be to cheat a man of a known existing right, that is fraudulent...”; see also *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors* [2010] 1 MLJ 185 at 201 “Whether there was any intention on the part of the defendant to defraud or to carry out any fraudulent purpose is a question of facts to be inferred from the surrounding circumstances and the subsequent conduct of the defendant especially the concealment of material facts.”

<sup>291</sup> *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong* [2009] 1 MLJ 723 at 732-733.

concerns the incurring of debts when there is no reasonable ground to believe the debt will be repaid. It illustrates the recognition of the company's illiquidity as common among businesses and liability should not be imposed solely on the reason of illiquidity. A company is allowed to continue to trade with the purpose to turn around the company's fortune and there is no duty on directors to take positive steps to minimize loss.

This allows directors precious time to plan the company's future without rushing to put the company into liquidation or other formal insolvency proceedings without the possibility of personal liability breathing on their necks.<sup>292</sup> In contrast, the UK wrongful trading requires directors to take positive steps to minimize the loss to the company which often puts pressure on directors to stop trading or subject it to formal insolvency proceedings as a means to avoid liability. The advantage manifest from the Singaporean and Malaysian provisions is consistent with the recommendation by the Cork Committee to allow directors to be able to apply for anticipatory relief should their decision to continue to trade prove to be wrong.<sup>293</sup>

In *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong*<sup>294</sup>, the court explained that finding an intention to defraud creditors means an intention to deprive creditors of an economic advantage or inflict upon them some economic loss. The decision in the case is consistent with the decision in *R v Grantham*<sup>295</sup> which stated "fraudulent trading can be made out even if it is not possible to establish that anyone has suffered a loss."

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<sup>292</sup> Joyce Lee Suet Lin "Fraudulent and Insolvent Trading in Singapore" (2000) 9 Int Insolv. Rev 121 at 124. Discussion in the article is on the Singaporean provisions of fraudulent and insolvent trading but also equally applicable to Malaysia due to the exact wording of the section.

<sup>293</sup> Cork Report above n5 at [1798]. The objective of this recommendation was to allow directors to continue to trade within a specific period of time without fear of personal liability. This recommendation, however, was not taken up by the legislature.

<sup>294</sup> [2009] 1 MLJ 723 at 732-733.

<sup>295</sup> [1984] QB 675 at 683-684.

The defendant in the case relying on the decision in *Re Sarflax Ltd*<sup>296</sup> contended that the company might discharge its liability in any order it pleased and such an act could not constitute fraud. The court distinguished the facts of both cases and held that the facts in *Re Sarflax Ltd*<sup>297</sup> involved bare facts of preferring one creditor over the other, while the present case concerned a series of interconnected transactions from the purchasing of the machinery to its subsequent sale and the usage of the proceeds of sale to pay off the defendant in preference to the other creditors, including those who had priority. These events, the court noted, took place while the company was already insolvent and therefore the obvious conclusion to be deduced from these was intention to defraud.

In *Sioh Yoon Keong v H Rosen Engineering BV*<sup>298</sup> the court found that there was intention to defraud creditors as well as that the business was carried on for fraudulent purposes. The defendant/appellant in the case caused a resolution to be passed to ratify an investment which was initially made under his own name after it was clear that loss was inevitable. The effect was to transfer the loss to the company and the use of the company funds to bail himself out, enabling him to escape personal loss. Consequently, there were no funds left to pay off the plaintiff/respondent.

In *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors*<sup>299</sup>, the court used the commercial concept of fair trading when ascertaining whether intent to defraud or fraudulent trading existed. The court held that when the transaction was made, the directors must have known that there was no reasonable prospect of the plaintiff ever receiving payment for the purchase price. This is due to the fact that the company was already downsizing at the time of the transaction and the company's physical assets and trade receivables were later transferred to the

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<sup>296</sup> [1979] 1 Ch 592.

<sup>297</sup> [1979] 1 Ch 592.

<sup>298</sup> [2003] 4 MLJ 569.

<sup>299</sup> [2010] 1 MLJ 185 at 203.

holding company. The directors who were held liable under the section were also the directors of the holding company and their action was found to be inconsistent with current notions of fair trading, and constituted deceitful and unethical practices.

The courts have adopted a wide definition of ‘intent to defraud’ as in the case of *Re William C Leitch Bros Ltd*<sup>300</sup>, and it should be noted that the reasoning used by the judge in this case for finding intent to defraud was that ‘the directors must have known that there was no reasonable prospect of the plaintiff ever receiving payment for the purchase price’ overlaps with the concept of insolvent trading under section 303(3). Section 303(3) states ‘..., no reasonable or probable ground of expectation... of the company being able to pay the debt,...’. It would seem that the difference between the two provisions is on the level of knowledge of the person in question. In this case, the inference of directors’ knowledge of no reasonable prospect of the plaintiff receiving payment stems from the fact that the company’s physical assets and its receivables have been transferred to the holding company.

In this case, the two directors who were found liable under section 304(1) were also directors of the holding company. Malaysia, like UK, does not have provisions like those in New Zealand and Australia which allow a holding company to be liable for the debts of its subsidiaries.<sup>301</sup> It will be more beneficial for creditors of a subsidiary, as in the case, to have the holding company liable for its debts because the holding company may be in a better position to pay off the debt compared to individual directors. If directors prove to be men of straw, then creditors end up with nothing.

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<sup>300</sup> [1932] 2 Ch 71.

<sup>301</sup> See section 271 and section 272 of the New Zealand Companies Act 1993 - Pooling of assets of related company. See also discussions of section 588V of the Australian Corporations Act 2001 above.

To date, there have been few cases of fraudulent trading which are brought before the court despite the fact that the section has been in existence since 1965.<sup>302</sup> Prior to this, a liquidator may have been unwilling to take a chance by bringing an action under fraudulent trading because there has been lack of precedent, for example, on which standard of proof should apply under the section. A liquidator has to act in the best interest of the company and he or she has to decide whether it is worthwhile to pursue an action against a director, especially when fraud is usually discovered when the company is wound up or in any other proceedings against the company.<sup>303</sup> Alternatively, a liquidator may prefer to bring action under other provisions under the Act, such as section 293 for undue preference, where courts have given clear guidelines on the interpretation of the section.

### **10.6.3 Liability for Insolvent Trading under Section 303(3) Companies Act 1965**

The Malaysian section 303(3) was adopted from the Australian provision in the Uniform Companies legislation 1961. Since then, the Australian legislation has gone through several reforms until the current provisions were enacted in section 588G of the Corporations Act 2001. Section 303(3) can be compared to the Australian section 592(1) of the Corporations Act 1989 since the essence of both sections are alike. It imposes criminal liability on "an officer of the company who was knowingly a party to the contracting of a debt who at the time of contracting no reasonable or probable expectation of the debt being paid."<sup>304</sup> Like section

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<sup>302</sup> See *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569 at 578, where counsel for the defendant noted in his submission that the case is the first case in the country under section 304(1) of the Malaysian Companies Act 1965. This case is also the first case in which the court has given clear interpretation of section 304(1).

<sup>303</sup> See *Tang Eng Iron Works Co Ltd v Ting Ling Kiew & Anor* [1990] 2 MLJ 440 where fraud was discovered during examination of defendant in order to seek payment for an award granted by arbitrator.

<sup>304</sup> Section 303(3) of the Malaysian Companies Act 1965 states: "If in the course of the winding up of a company or in any proceedings against a company, it appears that an officer of the company who was knowingly a party to the contracting of a debt had, at the time the debt was contracted, no reasonable or probable ground of expectation after taking into consideration to the other liabilities, if any, of the company at the time, of the company being able to pay the debt, the officer shall be guilty of an offence against this Act. Penalty: Imprisonment for one year or five thousand ringgit."

304(1), it also applies when the company is in the course of winding up or in any proceeding against the company,<sup>305</sup> which means it could apply prior to winding up.<sup>306</sup>

In conjunction with the conviction under section 303(3), a liquidator or any creditor or contributory of the company may apply for a declaration that the person be personally liable without any liability for payment of the debt.<sup>307</sup> Since civil liability is dependent upon criminal conviction, this section is not widely used by liquidators.<sup>308</sup> To date in Malaysia, there are no reported cases on the application of these provisions.

Liability under the Malaysian section is imposed on any officer of the company while its Australian counterpart places liability on directors or any person who takes part in the management of the company. However, the current Australian insolvent trading provision is enforced only against directors of the company.<sup>309</sup>

Offences under both sections are committed if the company incurs or contracts debts at the time when there are reasonable or probable grounds to expect that the company will not be able to pay all its debts. Section 592(1) went further to state that the ‘person’<sup>310</sup> involved contravenes the section if at the time debt is incurred there were reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they became due. Section 303(3), however, does not have this requirement and is only concerned with the

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<sup>305</sup> See section 303(3).

<sup>306</sup> *Tang Eng Iron Works Co Ltd v Ting Ling Kiew & Anor*[1990] 2 MLJ 440.

<sup>307</sup> Section 304(2) of the Malaysian Companies Act 1965 –“Where a person has been convicted of an offence under subsection 303(3) in relation to the contracting of such a debt as is referred to in that section the Court, on the application of the liquidator or any creditor or contributory of the company, may if it thinks proper so to do, 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.”

<sup>308</sup> ALRC R45 Vol 1 1988 above n7 at [278-279].

<sup>309</sup> See section 588G(1) of the Australian Corporations Act 2001.

<sup>310</sup> Person in this context refers to directors any persons who take part in the management of a company.

ability of the company to pay off its debts at the time they were contracted. The relevant time under the Australian provisions refers to the time when debts were incurred, the company was not able to pay off its debts, or consequent to incurring the debts, the company could not pay off its debts.

An officer of the company will only be liable for insolvent trading in respect of contractual debts only and not any other debts, a deficiency which remains in the current Australian section. The exclusion of involuntary creditors raises doubt as to whether creditors are actually protected as intended by the section. Initially, when the provision was enacted the aim was to punish the person responsible and therefore, the exclusion of involuntary creditors may not be as important, but throughout the years the focus has shifted to compensating creditors. Therefore, it is necessary to include all creditors and not be limited to contractual creditors only.

Section 304(2) can only be enforced by the liquidator, contributory or creditors once there has been a conviction under section 303(3). Therefore, their hands are tied if the prosecution decides not to charge the person involved. Further, even if there is a prosecution, there is no guarantee that it will result in a conviction. The existence of the precondition may prevent creditors from being compensated. Under section 592(1), only creditors have the right to bring the civil action, a liquidator is not conferred such right.<sup>311</sup> As a result, only creditors with sufficient means will be able to take advantage of the civil provisions. In addition, it also caused multiplicity of proceedings.

Consistent with criminal liability, section 303(3) uses the word 'expect' rather than 'suspect' as in the current section 588G of the Corporations Act 2001.<sup>313</sup> This requires a higher threshold of knowledge and awareness.<sup>314</sup> The test to determine knowledge or awareness on the part of the officers of the company is

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<sup>311</sup> See *Ross McConnel Kitchen & Co Pty Ltd v Ross* (1985) 3 ACLC 326.

<sup>313</sup> Section 592(1) also used the word 'expect'.

<sup>314</sup> See decisions by Einfeld J in *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699 at 711.

objective reasonable grounds and the establishment of liability is not dependent on personal elements.<sup>315</sup> The standard of proof of section 592(1) is the criminal standard, beyond reasonable doubt.<sup>316</sup> It is not clear as to the position in Malaysia because there is no decided case under section 303(3). However, in decided cases under section 304(1), the courts noted that the section only uses the words ‘if it appears’ and concluded that it indicates that a lower standard of proof is required.<sup>317</sup> It should also be noted that the fraudulent trading provisions contain both civil and criminal liability. It is submitted, therefore, that the court may apply the same lower standard to section 303(3) because it also uses the phrase ‘if it appears.’

Australia has since reformed section 592(1) and replaced it with section 588G of the Corporations Act 2001. However, despite the changes in some wording of the section, the essences of insolvent trading provisions remain the same. The current section uses ‘reasonable grounds for suspecting insolvency’ in place of ‘reasonable grounds for expecting that the company will not be able to pay all its debts...’ Insolvency is defined under the Act as the inability to pay off debts as and when they become due and payable.<sup>318</sup> In terms of procedures, the section provides for civil penalty which is no longer contingent upon criminal conviction although there is, in addition, a criminal penalty for dishonesty. The reform is deemed as appropriate considering that civil and criminal liabilities have different objectives. The civil liability has the aim of compensating creditors while the purpose of criminal conviction is to punish the offenders.

In addition to the criminal sanction and personal liability in Malaysia, a director who has been a director of a company which at any time has gone into liquidation

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<sup>315</sup> *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699 at 704.

<sup>316</sup> *Ross McConnel Kitchen & Co Pty Ltd v Ross* (1985) 3 ACLC 326.

<sup>317</sup> *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569; *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong* [2009] 1 MLJ 723 and in *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors* [2010] 1 MLJ 185.

<sup>318</sup> Section 95A of the Australian Corporations Act 2001 defines insolvency as: “A person is solvent if and only if the person is able to pay all the person’s debts as and when they become due and payable.”

can be disqualified from taking part in the management of the company for a period not exceeding five years.<sup>319</sup> The relevant section has been inserted as a result of an amendment to the Companies Act in 2007. The purpose of enacting the section is to promote accountability and transparency. By disqualifying directors whose company has been subjected to liquidation, members of the public will be protected from these errant directors.

The Corporate Law Reform Committee (CLRC) in 2006 proposed that the existing fraudulent trading and insolvent trading provisions should remain. The committee, instead, focused on improving and reforming directors' duties for the purpose of improving accountability and transparency.

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<sup>319</sup> See section 130A of the Malaysian Companies Act 1965.

## **CHAPTER 11      REMEDIAL CONSEQUENCES OF BREACH OF DIRECTORS' DUTIES**

### **11.1 Introduction**

In the preceding chapters, discussions have been centered on directors' common law and statutory duties, particularly in relation to creditors' protection, in order to determine when and how directors would be liable. This chapter will address the remedies and consequences of such breaches and in doing so will discover whether creditors benefit from them. Since the thesis uses a comparative methodology, various provisions will be examined to determine any similarities or differences in the wording of the statutes. Then case analyses from different jurisdictions will be examined to determine how judges interpret the sections, and consequently whether creditors will benefit from them. Apart from statutory provisions, remedies accorded at common law will also be considered.

In addition, this chapter will look at the corporate insolvency processes which are available to directors when the company's finances are in dire straits. Each of these alternatives will be considered to determine its advantages as well as disadvantages and its effects on creditors.

### **11.2 Corporate Insolvency Processes**

#### **11.2.1 Receivership<sup>1</sup>**

A secured creditor who obtains a charge on the company assets does so by way of a debenture. The debenture reserves the right of the debenture holder to appoint a receiver<sup>2</sup> in the event the company defaults on any of the terms of debenture. The

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<sup>1</sup> A receivership refers to the situation when a receiver is appointed in order to protect the interest of the debenture holders.

<sup>2</sup> A receiver can be divided into a 'receiver' and a 'receiver and manager.' The former is merely to collect and realize the secured assets covered by the debenture and he or she is not authorized to carry on the business of the company. The latter, on the other hand, is expressly empowered in the instrument which appointed him or her to run the company with the intent to realize the assets on the basis of a going concern. For the purpose of the discussions, a receiver in this thesis refers to both a 'receiver' and a 'receiver and manager.'

power to do so is an archaic equitable remedy which a creditor exercised in order to safeguard his or her interests.<sup>3</sup> Initially, the creditor would have to apply to the court in order to appoint a receiver and later begin to include such right in contracts. The appointment of a receiver gained popularity at the same time floating charge obtained legal recognition in the latter part of the nineteenth century.<sup>4</sup>

A receiver owes his or her duty to the debenture holder who makes the appointment, as seen from the judgment of Evershed M.R in *Re B Johnson & Co (Builders) Ltd*.<sup>5</sup> However, it is acknowledged the company and other creditors also have an interest in relating to the realization of the company's assets. In *Downsview Nominees Ltd v First City Corporation Ltd*,<sup>6</sup> in an appeal from New Zealand, the Privy Council reiterated the findings of Evershed M.R in *Re B Johnson & Co (Builders) Ltd*<sup>7</sup> and held the receiver breach his duty if he abuses the powers conferred in the debenture to preserve and realize the assets. The receiver in the case was appointed not for the purpose of preserving and realizing assets held under the debenture but to prevent the plaintiff from enforcing the second debenture. Further, in the absence of *mala fides* and fraud, the company cannot complain even though the receiver's action put the company or other creditors in a disadvantaged position.

A receivership is used to enforce a charge holder's right which means assets subject to the debenture will not be available to unsecured creditors.<sup>8</sup> The usual scenario is at the twilight of financial difficulties, a debenture holder would exercise his or her

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<sup>3</sup> *Bond Brewing Holdings Ltd v National Australia Bank Ltd* (1990) 1 ACSR 445 at 456.

<sup>4</sup> Krishnan Arjunan and Low Chee Keong *Lipton & Herzberg's Understanding Company Law in Malaysia* (LBS Information Services, NSW,1995) at 412.

<sup>5</sup> [1955] 2 All ER 775, Evershed M.R at 780 stated "...not with any duties to carry on the business of the company, in the best interests of the company, but in order to realise, for the debenture holders or mortgagees, the security which they had got; and only for that limited purpose is he given the power of management."

<sup>6</sup> [1993] 1 NZLR 513 at 522-524.

<sup>7</sup> [1955] 2 All ER 775.

<sup>8</sup> Eilis Ferran "Floating Charges-The Nature of the Security" (1988) 47 CLJ 213 at 216.

right to appoint a receiver. The receiver would then collect the assets, realize and distribute them to the debenture holders.<sup>9</sup>

Consequently, the unsecured creditor would not benefit from the mechanism unless the debenture holder surrendered the assets to the company for the benefit of the general creditors. The unsecured creditors often find themselves at a disadvantage because once a receiver is appointed, there is a possibility he or she would expedite the processes to dispose the assets, pay the debenture holder and discharge the duty. In doing so, the receiver has, in most cases, deprived unsecured creditors of the opportunity to maximize the amount paid to them. This is because when a receiver rushes in to realize the property, it also prevents the company with high potential to survive from being saved.

In some instances, even if the company is sold eventually, it may attract a higher value than if it is dismantled and sold in pieces. The unsecured creditors in this circumstance do not have any legal redress. They could not make use of the court-appointed receiver because it has been shown that court had no power to permit the appointment of a receiver to manage the affairs of the company when the company is in financial difficulties.<sup>10</sup> The right to do so is only conferred on the debenture holders whose security is at risk.

The court rejected an application by the unsecured creditor in *Bond Brewing Holdings Ltd v National Australia Bank Ltd*<sup>11</sup> to appoint a receiver. The bank in the case had lent on an unsecured basis and was concerned that the company was disposing of its assets to the prejudice of the applicant. The judge has to be cautious in appointing a receiver since it empowers the receiver to deal with the property without company's consent. A receivership in this context is equivalent to the invasion of the company's privacy and has long lasting effect, although the process

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<sup>9</sup> Ibid.

<sup>10</sup> *Bond Brewing Holdings Ltd v National Australia Bank Ltd* (1990) 1 ACSR 445.

<sup>11</sup> (1990) 1 ACSR 445 at 456-458.

is for a short period of time. This is due to the perception of a receiver's appointment not as a company doctor but as an undertaker.

A receivership has a far reaching effect for often once a receiver is appointed, other creditors, secured and unsecured, start to panic and will rush to get payments from the company. The unsecured creditor would then file a winding up petition, while other secured creditors will start appoint a receiver. The effect of this would be to divide the property and reduce the value of the company. Consequently, the unsecured creditors will be left with the crumbs after all the preferential and secured creditors have been paid.

### **11.2.2 Voluntary Administration**

Administration is an alternative procedure available to the company which is insolvent or at the brink of insolvency. A winding up signifies the end of the company, and creditors are entitled to what is left in the company according to the *pari passu* rule.<sup>12</sup> Administration offers an opportunity to preserve a company as a going concern.

In the UK, the administration process was modified in 2002 by the Enterprise Act. The significant changes made by the Act included the abolition of the administrative receiver as regards floating charges made on or after 15 September 2003, simplifying the procedures to enter administration by dispensing with the need to obtain a court order, and replacing multi-purpose administration by a single purpose administration to be selected according to a three-part hierarchy.<sup>13</sup>

Schedule B1 which was inserted in the Insolvency Act 1986 by virtue of the Enterprise Act 2002 sets out three tiers of hierarchic objectives.<sup>14</sup> An administration

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<sup>12</sup> Roy Goode *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London , 2005) at [7-02]-[7-04].

<sup>13</sup> *Ibid* at [10.08].

<sup>14</sup> *Ibid*.

process begins with the appointment of an administrator whose function is to manage the affairs of the company with the view of bringing it to profitability, or to achieve a better result for the company's creditors than would be likely in winding-up, or realizing property to distribute to secured or preferential creditors. An administrator will have to fulfill the first objective and if it is not possible to proceed with the second aim, and to move to the next if the second purpose could not be achieved.<sup>15</sup> It is important to note that the duty to realize and distribute property to secured and preferential creditors must be exercised so as not to prejudice the general creditors. The administration procedures are consistent with the rescue culture which was dominant in the 1990s.<sup>16</sup>

It will benefit the company's creditors if the company is sold as a going concern at a higher value compared to the sale of its assets in pieces. In this aspect, the role of an administrator is similar to that of a receiver, although they owe a duty to different parties. A receiver, whose duty is to the debenture-holder who made the appointment, is not obliged to sell the company's assets at a higher price as long as the debts owed to the secured creditor are discharged. An administrator, on the other hand, owes his or her duty to the company for the benefit of general creditors.

The idea is to put the company in the hands of a third person, an administrator, who will manage the affairs of the company, and if circumstances permit, rescue it as a going concern<sup>17</sup> Often, an administrator makes suggestions for reorganization if he or she believes that such a step would benefit the creditors.<sup>18</sup> During the administration period, the administrator controls the assets of the company and most

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<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid, at [10-20]; see also at [1-21].

<sup>18</sup> Ibid.

rights against the company are frozen.<sup>19</sup> This is to give an opportunity to an administrator to concentrate on the management of the company without having to fend off actions from creditors.<sup>20</sup> Hence, it is seen as a temporary measure while the company is searching for a long term solution.

In Australia, the administration process is stated in Part 5.3A of the Corporations Act 2001. The Act particularly stated that the intention of the administration process is to execute a deed of company arrangement (DCA). The objectives of this mechanism are contained in section 435A of the Act which has only two objectives, similar to the UK.<sup>21</sup> However, the third aim of administration in the Insolvency Act 1986, namely to realize property in order to distribute it to one or more of the secured or preferential creditors, is absent in the Australian legislation.

An administrator's function is to investigate the company's affairs, business, property and financial circumstances as soon as practical, and to recommend whether the company should execute a DCA, be wound up or to end the administration,<sup>22</sup> and these functions do not differ from those in the UK. New Zealand amended its Companies legislation in 2006, and as a result, a new Part 15A was inserted. The new voluntary administration in force in the New Zealand legislation is modeled after the Australian Corporations Act. Malaysia does not have similar provisions in its Companies Act and the external management mechanisms remain in receivership and liquidation.

The Malaysian Corporate Law Reform Committee (CLRC), in 2007, published a consultative document which, amongst other things, recommended the adoption of

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<sup>19</sup> Ibid, at [1-22].

<sup>20</sup> Ibid.

<sup>21</sup> For New Zealand see section 239A of the Companies' Amendments Act 2006.

<sup>22</sup> Robert P. Austin and Ian M. Ramsay *Ford's Principles of Corporations law* (14<sup>th</sup> ed., Lexis Nexis Butterworth, NSW, 2010) at [27-030], section 438B(2) of the Australian Corporations Act 2001; section 239AE of the New Zealand Companies Amendments Act 2006.

similar legal provisions as in the UK, Australia and New Zealand, namely a Judicial Management System and a Corporate Voluntary Arrangement to complement the existing system in section 176.<sup>23</sup> The CLRC proposed to introduce a statutory scheme known as Judicial Management to facilitate the rehabilitation process.<sup>24</sup> It allows an aggrieved creditor (either secured or unsecured) to apply to court for an order to place the management of the company in the hands of a judicial manager who has the necessary skill and experience.<sup>25</sup> Once appointed, a judicial manager will prepare a workable restructuring plan which must be acceptable to the majority of creditors and be sanctioned by court.

The aims of a restructuring plan are similar to those in the Australian and New Zealand legislation, as well as in the UK to a certain extent.<sup>26</sup> A period of moratorium shall commence from the date of presenting a petition for Judicial Management until the appointment order is in force. During that period, no proceedings can be initiated against the company. The CLRC also recommended having a Company Voluntary Administration (CVA) modeled after the UK with modifications where necessary.<sup>27</sup> An Administration process provides a gateway for exit routes for the company in time of difficulty. A reorganization procedure

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<sup>23</sup> Malaysian Corporate Law Reform Committee “A Consultative Document on '1) Reviewing Corporate Insolvency Regime - The proposal for a Corporate Rehabilitation Framework; 2) Reforming the Company Receivership Process; 3) Company Charges and Registration” (2007) at ch 1 [CLRC Corporate Insolvency Regime].

<sup>24</sup> *Ibid*, at [2.17].

<sup>25</sup> *Ibid*, at [2.1]

<sup>26</sup> See section 239A of the New Zealand Companies Amendments Act 2006 and section 435A of the Australian Corporations' Act 2001. The objects of voluntary administration are to provide for the business, property and affairs of an insolvent company to be administered in manner which would:

- (a) maximize the company's chances of continuing existence; or
- (b) if it is not possible to maintain the company's continuing existence, to provide better returns to creditors and shareholders than would result from immediate liquidation.

<sup>27</sup> CLRC Corporate Insolvency Regime above n23 at [3.1].

involves a situation where the company reaches an agreement with its creditors for the satisfaction of their claims otherwise than by payment in full.<sup>28</sup>

In the UK, the prime objective is to bring the company to profitability, and if liquidation is inevitable, the administrator should opt for a course of action such as a company voluntary arrangement (CVA). It should be noted, nevertheless, that an administration does not always result in a restructuring or reorganization of a company. The recommendations made by an administrator would depend on the information obtained from the company during the period of administration. There are many forms of agreements which can be achieved between a company and its creditors and the usual types of CVA are the composition<sup>29</sup> and scheme of arrangements.<sup>30</sup>

The Malaysian Companies Act 1965 provides for reconstruction of companies in section 176. The section sets out several modes; namely a compromise scheme,<sup>31</sup> a moratorium<sup>32</sup> scheme of arrangement, arrangements under section 176(11) which involve the reorganization of rights and liabilities of members, transferring assets of one company to another controlled by the same shareholders, amalgamation, or in

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<sup>28</sup> Ibid.

<sup>29</sup> An agreement by which creditors accept in single sum or by installment, an amount less than that due to them; see Goode above n12 at 26.

<sup>30</sup> Embracing such diverse schemes as conversion of debts into equity subordination of secured and unsecured debt, conversion of secured into unsecured claim and vice versa, increase or reduction of share capital and other forms of reconstruction and amalgamation (Goode above n12 at 26). The same modes apply to New Zealand, Australia and Malaysia.

<sup>31</sup> A compromise scheme is a method in which creditors agree to accept a lesser payment than they are owed for the full settlement of debts. This scheme may also include both a moratorium and compromise or some creditors may agree to convert their debts into shares in the company; see also Krishnan Arjunan and Low Chee Keong above n4 at 409.

<sup>32</sup> A moratorium scheme is to enable the company to continue in business and eventually to pay its debts in full. A deferment, however, is given to the company to settle its debts, hence the moratorium. During this period, the company is managed by the scheme administrator or a manager appointed by creditors.<sup>32</sup> Pursuant to the amendment in 1998, there is a moratorium of 90 days, or, for good reason, a longer period can be granted by the court for a scheme of arrangement or compromise; See Krishnan Arjunan and Low Chee Keong above n4 at 409.

certain circumstances, a compulsory acquisition.<sup>33</sup> Unlike in administration, in which the company's management is placed in the hands of an external party, restructuring in section 176 continues to remain in the hands of the board of directors. This practice is effective as long as the management has the confidence of everyone who has interests in the company. The CLRC proposed that the current section 176<sup>34</sup> remain but should only apply to a solvent company.<sup>35</sup> The Judicial Management and the CVA, on the other hand, are suggested for a company in financial difficulties.

The recommendations by CLRC reflect the rescue culture which is also evidenced in the UK, Australia and New Zealand. The CLRC considered that the rehabilitation of the company would benefit not only the company, its members and creditors, but also members of the public.<sup>36</sup> The CLRC quoted abandoned housing projects which were notorious during the financial crisis in 1998 as an example for justification of its proposal.<sup>37</sup> Nevertheless, despite its private and public benefit, Parliament did not adopt the recommendation and no changes were made to section 176 in 2007.

All jurisdictions compared above have the systems to more or less restructure and rehabilitate the company. The aims of those procedures are to rescue the company as a going concern as far as possible. In the event survival is unlikely, the systems will seek to ensure that the distributions of assets to creditors are better than in liquidation.

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<sup>33</sup> Ibid.

<sup>34</sup> The current section 176 governs the procedures to be followed in all types of schemes covered under the Act. The Act allows a high degree of flexibility in which types of schemes to be implemented. It provides for alternatives to the drastic steps of liquidation.

<sup>35</sup> CLRC Corporate Insolvency Regime above n23 at [4.1].

<sup>36</sup> Ibid, at [1.2].

<sup>37</sup> Ibid.

### 11.2.3 Winding-up

Liquidation is a common remedy sought by creditors when the company is insolvent. There are two types of liquidation: voluntary and involuntary.<sup>38</sup> There are various grounds on which application for liquidation can be made to the court; but the most usual reason is insolvency.

Creditors of an insolvent company choose this remedy because once liquidation commences, all actions against the company are frozen. The effect of this is assets of the company, except those covered by charges, cannot be taken out of the company and will form a pool of assets available for distribution. Once a winding-up order has been granted by the court or a resolution is passed by a company, a liquidator will be appointed to manage the affairs of the company.

One of the liquidator's main duties after being appointed is to accumulate assets of the company to realize and later distribute them among creditors in accordance with the law. In addition to assets belonging to the company, the law empowers a liquidator to recover those which have been disposed of or transferred to another person in certain circumstances. A liquidator has the right under the law to apply to the court for a declaration that the transaction is void or voidable on the basis it confers unfair or improper advantage on one creditor at the expense of the general body of creditors.<sup>39</sup> In winding up, any disposition of the property, transfers of shares or any alteration in the status of company's members after the commencement of winding up is void unless the court otherwise orders.<sup>40</sup> The power of the court to make a validation order is absent in Australia and New Zealand. The liquidator is also allowed to apply for an order that the charge over property or undertakings of

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<sup>38</sup> A voluntary liquidation takes in two forms: members' and creditors'. A winding-up by court order is initiated by an application to the court by a person, normally a creditor as listed in the statute.

<sup>39</sup> See section 239 of the UK Insolvency Act 1986; section 293 of the New Zealand Companies Act 1993; section 588FA-FD of the Australian Corporations Act 2001; and section 293 of the Malaysian Companies Act 1965.

<sup>40</sup> See section 127 of the UK Insolvency Act 1986 and section 223 of the Malaysian Companies Act 1965.

the company is voidable or void in certain circumstances.<sup>41</sup> The avoidance of these transactions boosts the company's assets and will increase the likelihood of the creditors getting payment.

These undertakings can generally be divided into two categories; preferences and fraudulent conveyances.<sup>42</sup> The transaction, regardless of its motive, is also known as unjust enrichment because by disposing or transferring assets in favour of one creditor, the debtor company is, in fact, depriving other creditors of their chances of being paid. The situation of 'robbing Peter to pay Paul'<sup>43</sup> is deemed unfair, since it causes one creditor to be paid ahead of others instead of ranking equally among them. The liquidator can apply for a declaration whether it takes place motivated by kindness, sense of duty or some fraudulent intent, unless the transfer is made due to threat from the creditor.<sup>44</sup> The effect of making such a transaction is that it gives an advantage to the creditor on whom the settlement is made to receive payments ahead of other creditors. The courts also have the power to set aside a charge over any property or undertaking of a company given within a specific time.<sup>45</sup> The effect of voidable charges is to increase the pool of assets available to general creditors because the secured creditor could no longer enforce them.

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<sup>41</sup> See Section 294 of the New Zealand Companies Act 1993; Section 293 of the Malaysian Companies Act 1965, section 245 of the UK Insolvency Act 1986; and section 588FJ of the Australian Corporations Act 2001.

<sup>42</sup> Andrew Keay *Avoidance Provisions in Insolvency Law* (LBC information Services, NSW, 1997) at 33-35.

<sup>43</sup> John Farrar 'The Bankruptcy of the Law of Fraudulent Preference' (1983) JBL 390 at 390.

<sup>44</sup> *Ibid.*

<sup>45</sup> See section 293 of the New Zealand Companies Act 1993.

### 11.2.3.1 Effects of Successful Avoiding Transactions

#### 11.2.3.1.1 Recovery from the Preferred Creditors/ Anyone who Received Benefits

Australia has six types of voidable transactions which are governed under Part 5.7B of the Corporations Act 2001. Generally, in order to be a voidable transaction, it must occur where the company is being wound up and it must be entered into when the company is insolvent or becomes insolvent as a result of the transaction.<sup>46</sup> These are insolvent transactions,<sup>47</sup> for example, an unfair preference insolvent,<sup>48</sup> and an uncommercial transaction,<sup>49</sup> an insolvent transaction with a related entity,<sup>50</sup> an

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<sup>46</sup> See section 588FC of the Australian Corporations Act 2001- “A transaction of a company is an insolvent transaction of the company if, and only if, it is an unfair preference given by the company, or an uncommercial transaction of the company, and:

- (a) any of the following happens at a time when the company is insolvent:
  - (i) the transaction is entered into; or
  - (ii) an act is done, or an omission is made, for the purpose of giving effect to the transaction;or
- (b) the company becomes insolvent because of, or because of matters including:
  - (i) entering into the transaction; or
  - (ii) a person doing an act, or making an omission, for the purpose of giving effect to the transaction.”

<sup>47</sup> See section 588FE(2) of the Australian Corporations Act 2001- “The transaction is voidable if:

- (a) it is an insolvent transaction of the company; and
- (b) it was entered into, or an act was done for the purpose of giving effect to it:
  - (i) during the 6 months ending on the relation-back day; or
  - (ii) after that day but on or before the day when the winding-up began.”

<sup>48</sup> See section 588FA(1) of the Australian Corporations Act 2001- “A transaction is an unfair preference given by a company to a creditor of the company if, and only if:

- (a) the company and the creditor are parties to the transaction (even if someone else is also a party); and
- (b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding-up of the company.”

<sup>49</sup> See section 588FE(3) of the Australian Corporations Act 2001- “The transaction is voidable if:

- (a) it is an insolvent transaction, and also an uncommercial transaction, of the company; and
- (b) it was entered into, or an act was done for the purpose of giving effect to it, during the 2 years ending on the relation-back day.”

An uncommercial transaction is defined in section 588FB(1) of the Australian Corporations Act 2001 as one that a reasonable person in the company’s circumstances would not have entered into.

insolvent transaction entered with the purpose of defeating creditors,<sup>51</sup> an unfair loan<sup>52</sup> and unreasonable director-related transactions.<sup>53</sup>

The Australian Corporations Act 2001 also specifies the nature of recovery a liquidator could obtain in section 588FF. Among the orders the court can make are to pay an amount equal to some or all the company had paid for,<sup>54</sup> to restore the property to the company,<sup>55</sup> to pay an amount in the court's opinion fairly representing the benefit received from the transaction,<sup>56</sup> or any other orders under the provisions.<sup>57</sup> The courts in the UK have powers to make orders as stated in section 241 of the Insolvency Act 1986 and the orders are generally the same as those conferred on the Australian courts. In both preference<sup>58</sup> and undervalue

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<sup>50</sup> See section 588FE(4) of the Australian Corporations Act 2001: “The transaction is voidable if:  
(a) it is an insolvent transaction of the company; and  
(b) a related entity of the company is a party to it; and  
(c) it was entered into, or an act was done for the purpose of giving effect to it, during the 4 years ending on the relation-back day.”

<sup>51</sup> See section 588FE(5) of the Australian Corporations Act 2001: “The transaction is voidable if:  
(a) it is an insolvent transaction of the company; and  
(b) the company became a party to the transaction for the purpose, or for purposes including the purpose, of defeating, delaying, or interfering with, the rights of any or all of its creditors on a winding-up of the company; and  
(c) the transaction was entered into, or an act done was for the purpose of giving effect to the transaction, during the 10 years ending on the relation-back day.”

<sup>52</sup> See section 588FE(6) of the Australian Corporations Act 2001: “The transaction is voidable if it is an unfair loan to the company made at any time on or before the day when the winding-up began.”

<sup>53</sup> See section 588FE(6A) of the Australian Corporations Act 2001- “The transaction is voidable if:  
(a) it is an unreasonable director-related transaction of the company; and  
(b) it was entered into, or an act was done for the purposes of giving effect to it:  
(i) during the 4 years ending on the relation-back day; or  
(ii) after that day but on or before the day when the winding-up began.”

<sup>54</sup> Section 588FF(a) of the Australian Corporations Act 2001.

<sup>55</sup> Section 588FF(b) of the Australian Corporations Act 2001.

<sup>56</sup> Section 588FF(c) of the Australian Corporations Act 2001.

<sup>57</sup> Sections 588FF (d)-(j) of the Australian Corporations Act 2001.

<sup>58</sup> See section 239(3) of the UK Insolvency Act 1986.

transactions,<sup>59</sup> the provisions clearly state the purpose of making orders is to restore to original position had no transactions have taken place.

In New Zealand, the Companies (Amendment) Act 2006 has substantially changed the law on preference found in section 292. The heading of the section has been substituted with insolvent trading voidable. It allows the liquidator to apply to set aside the transaction provided the transaction falls within the definition of insolvent transaction and it occurred within a time specified.<sup>60</sup> An insolvent transaction is a transaction which was entered into at the time when the company is unable to pay its debts and the effect would have enabled the person to receive more than he or she would have received in the company's liquidation.<sup>61</sup>

Likewise, in *Re Excel Freight Ltd (in liq); Waikato Freight & Storage (1988) Ltd v Meltzer*,<sup>62</sup> the Court of Appeal looked at the parliament's intention in enacting the provision. The purpose of preference has shifted in the 1993 Act from intent to effects; whether the transaction has a preferential effect instead of whether the company has the intention to prefer one creditor over the other. Nevertheless, the court went on to state it was not the intention of parliament to make absolutely voidable all transactions which have preferential effects. Instead, a balance has to be made between the interests of creditors in general and the creditor who received payment which has preferential effect. The existence of protection accorded a creditor who received payment in the ordinary course of business despite having preferential effect, showed the Parliament intended a *commercially unremarkable payment to stand*. (emphasis added). Section 295 of the New Zealand Companies

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<sup>59</sup> See section 238(3) of the UK Insolvency Act 1986.

<sup>60</sup> Section 292(2)(a) of the New Zealand Companies Act 1993.

<sup>61</sup> Section 292(2)(b) of the New Zealand Companies Act 1993; see also *In Countrywide Banking Corporation v Dean* [1998] 1 NZLR 385 at 394. The Court of Appeal decided the interpretation of "ordinary course of businesses must be viewed objectively and the focus should be on the ordinary operational activities of businesses as going concerns not responses to abnormal financial activities."

<sup>62</sup> (2001) 9 NZCLC 262, 504 at 262,509-262,513.

Act 1993 lists orders the court can make if a preference transaction is proven. The types of orders described in the section generally reflect the restoration of the position prior to the transaction in question.

The law on preference transactions in Malaysia is derived from section 320 of the UK Companies Act 1948 and is embodied in section 293 of the 1965 Act. It states any transaction under the section shall be voidable or void as it would have been under the bankruptcy law.<sup>63</sup> It does not specify as to the type of remedy a court can make under the section but the central importance underlying the section is that where a debtor company has, at a relevant time, given a preference to any person, the liquidator may apply to the court for an order to set aside the preference.<sup>64</sup>

In order to determine the remedy under the section, reference needs to be made to the provisions in the Bankruptcy Act 1967, namely sections 53A, 53B and 53C which lay down procedure and law to be followed after a transaction is proven to be fraudulent preference.<sup>65</sup> This is by virtue of these provisions in the Bankruptcy Act 1967 which are *mutatis mutandis* to section 293 Companies Act 1965. The remedy available in section 53B(2) Bankruptcy Act 1967 is the right to recover the property if it is still in the hands of the preferred creditor. If however, the property has been resold to another person, the liquidator is entitled to proceeds of sale from the preferred creditor.<sup>66</sup>

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<sup>63</sup> See *Lian Keow Sdn Bhd (in liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors* [1988] 2 MLJ 449.

<sup>64</sup> *Sime Diamond Leasing (M) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liquidation)* [1998] 4 MLJ 569.

<sup>65</sup> *Lian Keow Sdn Bhd (in liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors* [1988] 2 MLJ 449 at 457.

<sup>66</sup> *Lian Keow Sdn Bhd (in liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors* [1988] 2 MLJ 449 at 457; see also section 53B(2) of the Bankruptcy Act 1967.

### 11.2.3.1.2 Recovery from Third Party

In respect of property which has been transferred to third party, section 241(2) of the UK Insolvency Act 1986 allows the liquidator to recover or impose an obligation on such person, provided certain conditions are fulfilled. The section states such an order shall not prejudice the interest of any person who acquired the property other than from the company and was in good faith for value or prejudice any interest deriving from that interest.<sup>67</sup> The section further states the order shall not require the person who received benefit from the transaction or preference in good faith for value to pay the liquidator or the administrator unless that person is a party to the transaction or the payment is in respect of preference given to that person at the time when he was the creditor of the company.<sup>68</sup>

The New Zealand provision also gives protection to the person who acquires property from other than the company, as long as it was for valuable consideration and without knowledge of the circumstances under which the property is acquired from the company. In Malaysia, the liquidator is still entitled to recover proceeds of sale when the property has changed from the creditor who has ‘acquired property from the company’ to the third party under section 53B(2)(b) Bankruptcy Act 1967.<sup>69</sup> The right to trace the proceeds of sale will continue even if the third party has then resold the property to a subsequent purchaser.<sup>70</sup> Section 53B(3) affords a defence in this situation if it can be shown the property acquired from the preferred creditor is for valuable consideration and in good faith.

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<sup>67</sup> Section 241(2)(a) of the UK Insolvency Act 1986.

<sup>68</sup> Section 241(2)(b) of the UK Insolvency Act 1986.

<sup>69</sup> *Lian Keow Sdn Bhd (in liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors* [1988] 2 MLJ 449 at 456.

<sup>70</sup> *Lian Keow Sdn Bhd (in liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors* [1988] 2 MLJ 449 at 457.

This is illustrated in the case of *Lian Keow Sdn Bhd (in liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors*<sup>71</sup> where the court granted the liquidator's application to recover proceeds of sale from the property sold by the first respondent (preferred creditor) to the second respondent. The court also allowed recovery from the second respondent in respect of the resale of property to a subsequent person.

Section 588FF of the Australian Corporations Act 2001 does not clearly state whether recovery can be made from a subsequent transferee. However, it can be argued that the word 'person' from the section could be given a wide interpretation so as to include subsequent transferee.<sup>72</sup>

The undue preference provision in Malaysian section 293 Companies Act 1965 can only be enforced by a liquidator. This is evident from the wording of section 53(1) Bankruptcy Act 1967 read with section 293 Companies Act 1965 which clearly state 'as against the Director General of Insolvency.'<sup>73</sup> Based on this, it is submitted the proceeds of recovery can only be applied on unsecured creditors. This is because a liquidator's duty is to collect assets, realize and distribute them to the general body of creditors. The same reasoning is given by the Australian court.<sup>74</sup> In the UK, it has long been established that the secured creditors could not reap the benefits from avoidance transactions.<sup>75</sup>

The objective of restitution is to put the company in a position it would have been if the transaction had not taken place. This can be seen in the types of orders the court can make which generally involve an order to restore the property to the company, to

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<sup>71</sup> [1988] 2 MLJ 449.

<sup>72</sup> See also Keay above n42 at 336-338.

<sup>73</sup> See also *Meiden Electric Engineering Sdn Bhd v Mtrans Holdings Sdn Bhd* [2006] 5 MLJ 749, 754.

<sup>74</sup> *Re Quality Camera Co Pty Ltd* [1965] NSW 1330; *NA Kratzman Pty Ltd v Tucker (No 2)* (1968) 123 CLR 295; *Bayley v National Australia Bank Ltd* (1995) 16 ACSR 38.

<sup>75</sup> *Re Yagerphone Ltd* [1935] Ch 392 and confirmed in *Re MC Bacon Ltd* [1991] Ch 127.

recover the proceeds of sale or to pay the benefits the person received from the transaction to the company. The court may have difficulties in making a restoration order if there are changes in circumstance which alter the position of the parties in the transaction, such as an increase or decrease in the value of the property.

The creditor who received the property may have made some improvements so as to increase its value. Therefore, he or she would be aggrieved if the court orders him or her to return the property to the company. The creditor may argue the restoration of the property to the company would result in other creditors receiving more advantage than they would have, contrary to the aim of the law.

In the UK, in addition to the order to restore the property or proceeds of sale to the company, the court is empowered to require any person to pay in respect of any benefit received to the office-holder.<sup>76</sup> The court has the discretion to order the sums deemed appropriate, which means the court may order the creditor to pay the value of property at the time of transaction to the office-holder.<sup>77</sup>

Alternatively, the court orders the restoration of the asset to the company and requires the office-holder to pay an amount representing the improvements made to it.<sup>78</sup> This order, however, imposes an obligation on the office-holder to search for funds to pay the creditor and is not practical in considering the company's financial state.<sup>79</sup> If the increase in value of the property increases without any action from the creditor, it would be appropriate for the court to make a re-vesting order to the company because the general body of creditors would have obtained the benefit even

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<sup>76</sup> Section 241(1)(d) of the UK Insolvency Act 1986.

<sup>77</sup> The term office-holder refers to the liquidator or the administrator – see section 238(1) and section 239(1) of the UK Insolvency Act 1986.

<sup>78</sup> Andrew Keay “The Recovery of Voidable Preferences: Aspects of Restoration” in Francis Rose (Ed.) *Restitution and Insolvency* (Mansfield Press LLP Professional Publishing, London, 2000) 237 at 251[“Voidable Preferences”].

<sup>79</sup> *Ibid.*

if the property remained in the company.<sup>80</sup> The same position is reflected in section 588FF(1)(c) of the Australian Corporations Act 2001 and section 295 of the New Zealand Companies Act 1993.

In New Zealand, section 296 asserts the court should not make for recovery of assets or its equivalent value if the person who has obtained the property does so in good faith and had given value for the property or had altered position in reasonable beliefs the transfer is valid and would not be set aside.<sup>81</sup> Another condition attached to the section is if it is, in the court's opinion, inequitable to order recovery in full. However, this provision is only applicable to those who have entered into the transaction in good faith, which is a defence against a claim by a liquidator or an administrator in all jurisdictions.

In Malaysia, it can be argued the same situation applies because section 53B(2) accords the right to recover 'the property or its value or the money or other proceeds.' It is possible for the court to order the creditor to pay the liquidator that which reflects the value of property at the time the transaction took place.<sup>82</sup>

Similar orders can also be made if the value of the property has decreased without any interference from the creditor. The court could grant an order requiring the creditor to pay the value of the property at the time of transaction. Andrew Keay suggested the more equitable solution to this problem is to order the re-transfer of the property to the creditor and to require him or her to pay an amount reflecting the benefit he or she has received from it between the dates of transaction to the court's

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<sup>80</sup> Ibid, at 252.

<sup>81</sup> See section 296(3) (a) of the New Zealand Companies 1993.

<sup>82</sup> See section 296(3) (b) of the New Zealand Companies Act 1993. The subsection of the amended section 296 also uses both an objective and subjective tests in determining insolvency of a company. The recovery order would not be made if it is shown that a reasonable person in the same position would not have suspected insolvency. It must also be shown that the person in question does not have reasonable grounds for suspecting that the company is insolvent or would become insolvent as a result of the transaction.

order.<sup>83</sup> If the value of the asset is reduced due to the act or omission of the creditor, the same author said the combination of section 241(1)(a) of the UK Insolvency Act 1986, namely the return of the property to the company and to pay the benefit received under section 241(1)(d) of the same Act reflecting the loss in value.<sup>84</sup> Due to the similarities in the orders a court could make, the same consequences will apply in Australia,<sup>85</sup> New Zealand<sup>86</sup> and Malaysia<sup>87</sup>

Apart from undue preference, a liquidator can also apply to recover for any settlement deemed to be at under value.<sup>88</sup> A liquidator is entitled to recover the difference between the cash paid for the acquisition of the property and its actual value.<sup>89</sup> The same relief is available to the liquidator in respect of property sold by the company to its director.<sup>90</sup> Despite having a power under the Act to recover the amount, section 295 has rarely been utilized by the liquidators.

To date, there is no case being decided under the section and this could be due to badly drafted sections.<sup>91</sup> The section, for instance, is only applicable to assets which are sold or bought for cash considerations and parties can avoid the effect of the

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<sup>83</sup> Keay “Voidable Preferences” above n78 at 253.

<sup>84</sup> Ibid.

<sup>85</sup> See sections 588FF(1)(b) and (c) of the Australian Corporations Act 2001.

<sup>86</sup> See sections 295 of the New Zealand Companies Act 1993.

<sup>87</sup> See section 53B(2) of the Malaysian Bankruptcy Act 1967.

<sup>88</sup> See section 295 of the Malaysian Companies Act 1965.

<sup>89</sup> Section 295(1) -“ the liquidator may recover from the person or company from which the property, business or undertaking was acquired any amount by which the cash consideration for the acquisition exceeded the value of the property, business or undertaking at the time of its acquisition.”

<sup>90</sup> Section 295(2)-“the liquidator may recover from the person or company to which the property, business or undertaking was sold any amount by which the value of the property, business or undertaking at the time of the sale exceeded the cash consideration.”

<sup>91</sup> Krishnan Arjunan and Low Chee Keong above n4 at 458.

provision by arranging for other types of considerations.<sup>92</sup> In addition, the phrase ‘value of the property’ is too wide and the liquidator may have difficulty to establish it. As such, it would be easier for a liquidator to use the provision if, for example, the recovery stems from the transaction being at under value or over value, or creditors being prejudiced from the action.<sup>93</sup>

In New Zealand for example, a liquidator will be able to recover based on the difference between the value actually paid and received by the company.<sup>94</sup> In addition to specifying the time limit, the section also highlights the effect of the transactions on the company’s insolvency. The emphasis on the effect of insolvency at the time the transaction was entered into or due, is similar to the Australian provisions as well as those of the UK.<sup>95</sup> Malaysia, however, does not have such condition in respect of transactions deemed to be over-valued or under-valued.

Similarly in the UK, a liquidator or an administrator can apply to have the property restored to the original position if the settlement is entered at an under-value. Unlike the situation in Malaysia which only applies to cash consideration, the UK and New Zealand provision do not have the restriction. In the UK, the provision uses the term ‘money or money’s worth’<sup>96</sup> to describe consideration, while the New Zealand section merely states ‘the value of consideration or benefit’ received.<sup>97</sup>

Winding-up remains one of the most popular remedies among creditors because it allows distribution to take place equally among creditors. This will, in a way, protect the unsecured creditors by giving them an opportunity to recover their money.

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<sup>92</sup> Ibid.

<sup>93</sup> Ibid.

<sup>94</sup> Sections 297(1) and (2) of the New Zealand Companies Act 1993.

<sup>95</sup> See section 588FC of the Australian Corporations Act 2001; section 240(2) of the UK Insolvency Act 1986.

<sup>96</sup> See section 238(4) of the UK Insolvency Act 1986.

<sup>97</sup> See section 297 (1)(b) of the New Zealand companies Act 1993.

Without this class action, the unsecured creditors may not have the means to take action against the company. Further it will create a situation where creditors will race to the court to get their money back at the expense of small unsecured creditors.

### **11.3 Classification of Remedies**

There has been a dearth of literature in this area despite the importance of tracing the consequences of law which imposes liability on directors. It is essential to identify what the remedies are because without satisfactory legal redress the laws will not be effective in meeting the aims of the statute. The section will be arranged in the following order - the first part will define the different types of remedies; part two will discuss the difference in the remedies envisaged in the statutes. To do so, the wording of the provisions in the UK, New Zealand, Australian and Malaysian Acts will be examined. The third section will evaluate the courts' interpretations of the statutory provisions in order to discover whether judicial constructions are consistent with the wording and aims of the statute. Finally, the section will discuss the final destination or who are the beneficiaries of damages awarded by the court against directors.

#### **11.3.1 Definitions**

##### **11.3.1.1 Civil Remedies**

A civil remedy is usually granted by the court in terms of damages. Damages are a monetary compensation which aims to put a person in a position that he or she would have been in if a breach had not occurred. They are granted for the loss suffered by the party in pursuance of a breach of duty. Monetary compensation for breach of duty for wrongful/fraudulent/insolvent trading is generally calculated based on the loss/damage/injury suffered by creditors as a result of continuing trading. Hence there is a causal link between trading and the creditor's loss.<sup>98</sup>

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<sup>98</sup> The causation principle in this aspect is akin to the causation in torts, namely the injury suffered must be a consequence of a breach of duty and should not be too remote.

In addition to the general remedy of damages, an equitable compensation such as accounts of profits regardless whether the company suffered any losses,<sup>99</sup> rescission of contract<sup>100</sup> and a declaration of trust<sup>101</sup> are also available to creditors.

### 11.3.1.2 Civil Penalties

A civil penalty is a hybrid between a civil and a criminal law sanction.<sup>102</sup> It shares a common trait with criminal law in that the harm caused by the act should be prevented and punished. However, the ‘offender’ lacks the dishonest intention essential to criminal law and it is not justifiable to impose such a penalty on him or her. Therefore, the standard of proof for civil penalty is the civil standard of balance of probabilities and not beyond doubt.

Insolvent trading in Section 588(2) Corporations Act 2001 is an example of liability which has a civil penalty consequence.<sup>103</sup> The right to enforce a civil penalty lies with the Australian Securities and Investments Commission (ASIC) and the court can make a declaration that a contravention of the provision has occurred once it is satisfied that all elements in the section are proven. ASIC can then seek a pecuniary penalty order<sup>104</sup>, disqualification order<sup>105</sup> or a compensation order.<sup>106</sup> A liquidator has

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<sup>99</sup> *Regal (Hastings) Ltd v Gulliver* (1967) 2 AC 134; *Furs Ltd v Tomkies* (1936) 54 CLR 583; *Cook v Deeks* [1916] 1 AC 554.

<sup>100</sup> *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488.

<sup>101</sup> It applies in a situation where director’s breach involves improper use of the company’s property and the director retains the property, the court may declare the director a constructive trustee to the property on behalf of the company- see *Paul A Davies (Aust) Pty Ltd (in liq) v Davies (No 2)* [1982] 8 ACLR 1; the company has the right to trace the property in the hands of the third party who has knowledge of the relevant circumstances - *Linter Group Ltd v Goldberg* (1992) 7 ACSR 580.

<sup>102</sup> See Australia Law Reform Commission *Principled Regulation: Federal Civil and Administrative Penalties in Australia* (ALRC R95 2002); <<http://www.austlii.edu.au/au/other/alcrc/publications/reports/95/>> at 2 May 2010. Australia Law Reform Commission *Securing Compliance : Civil and Administrative Penalties in Australian Federal Regulation* (ALRC Discussion Paper56 2002) <<http://www.austlii.edu.au/au/other/alcrc/publications/dp/65/DP65.pdf>> at 2 May 2010.

<sup>103</sup> See section 1317E of the Australian Corporations Act 2001.

<sup>104</sup> See section 1317G of the Australian Corporations Act 2001.

the power to apply for a compensation order but not the pecuniary penalty or the disqualification order.

The pecuniary penalty refers to the payment of a sum up to \$200,000 which a director<sup>107</sup> could be liable to pay, a concept similar to a 'fine' in criminal sanctions. The basis of a director's liability under this provision depends on his or her culpability, unlike a civil remedy which generally is decided on the losses suffered as a consequence of the breach. Although the liability is criminal in nature, directors will be subjected to civil rules of evidence and procedures. Hence, the standard of proof applicable under the section is a balance of probabilities and not, beyond reasonable doubt.

### **11.3.1.3 Criminal Penalties**

A criminal penalty is imposed on a person who has committed an act considered to be harmful to the public at large. The aims of the criminal penalty are twofold, to punish the offender, and to deter the offender as well as members of the public from committing the same act. Thus it is important that the punishment meted out to the offenders corresponds to the severity of their acts. A criminal penalty requires the offender to have an intention to commit an act and an example can be found in the fraudulent trading and insolvent trading provisions which require dishonest intention.<sup>108</sup>

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<sup>105</sup> See section 1317G of the Australian Corporations Act 2001.

<sup>106</sup> See section 588J and section 1317H of the Australian Corporations Act 2001.

<sup>107</sup> Civil Penalty is defined in section 9 as "Civil penalty order means by of the following:  
(a) a declaration of contravention under section 1317E;  
(b) a pecuniary penalty order under section 1317G;  
(c) a compensation order under section 1317H or section 1317HA;  
(d) an order under section 206C disqualifying a person from managing corporations."

<sup>108</sup> See section 993 of the UK Companies Act 2006; section 588G(3) Australian Corporations Act and section 304(5) of the Malaysian Companies Act 1965.

Criminal penalties can take the form of a monetary penalty, namely a fine, or a restriction of a person's liberty in terms of imprisonment, or both.<sup>109</sup> The fine imposed on a person under criminal law is similar to the civil penalty in that it is imposed in accordance with his culpability. However, imprisonment can be imposed only under criminal law sanctions.

### **11.3.2 Offence of Fraudulent Trading**

In respect of criminal liability for fraudulent trading, only the UK, New Zealand and Malaysia have provisions on this.<sup>110</sup> Australia has only one, namely the insolvent trading provision which covers both criminal and civil liability; which will be explained later.

The consequence of breaching the sections is the same, that is directors will be subjected to either imprisonment or fine or both.<sup>111</sup> It should be noted that the UK section provides a maximum period of time for imprisonment, but not the amount of the fine.<sup>112</sup> This means judges have discretion to decide on the suitable penalty for directors. The New Zealand and the Malaysian Acts, in contrast, specify both the maximum length of imprisonment as well as the quantum of the fine to be imposed.<sup>113</sup> The offence for fraudulent trading is based on directors' intention to

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<sup>109</sup> See examples in the fraudulent trading in 993 of the UK Companies Act 2006; section 588G(3) of the Australian Corporations Act and section 304(5) of the Malaysian Companies Act 1965.

<sup>110</sup> See section 993 of the UK Companies Act 2006; section 380 of the New Zealand Companies Act 1993 and section 304(5) of the Malaysian Companies Act 1965.

<sup>111</sup> See section 993 of the UK Companies Act 2006; section 380 of the New Zealand Companies Act 1993 and section 304(5) of the Malaysian Companies Act 1965.

<sup>112</sup> Section 993(3) of the UK Companies Act 2006- "A person guilty of an offence under this section is liable-

(a) on conviction on indictment, to imprisonment for a term not exceeding ten years or a fine (or both)

(b) ..."

<sup>113</sup> See section 373(4) of the New Zealand Companies Act 1993: "A person convicted of an offence against any of the following sections of this Act is liable to imprisonment for a term not exceeding 5 years or to a fine not exceeding \$2000,000:

(f) section 380 (which relates to carrying on business fraudulently)"

defraud, which implies their culpability. Therefore, the courts must take this factor into consideration when deciding the appropriate penalty.

It is acknowledged that the creditors' position is not likely to be improved since directors are not making any contributions which will be distributed among them. However, the punishment meted out by the sections may have both deterrent and protective measures. Due to the threat of a custodial sentence, directors will either avoid committing the offence in the first place or perpetrating it again. In addition, it may also serve as a warning to other directors not to commit the act or else suffer the same fate. Consequently, all other parties including creditors, shareholders and member of the public will benefit from it because directors will be cautious and accountable in making decisions.

### **11.3.3 Civil Responsibility for Fraudulent Trading**

Under this section, the UK section 213 of the Insolvency Act 1986 will be discussed, together with the Malaysian section 304(1) because only they provide civil liability for fraudulent trading. The juxtaposition of the two sections reveals their similarities, at the same time exposing the huge difference in respect of the effects when the provisions are breached. Section 213 states that those who breach the section "are liable to make such contributions (if any) to the company's assets as the courts think proper." Section 304(1), on the other hand, stipulates that the person "shall be personally responsible, without any limitation for all or any of the debts or other liabilities of the company as the Court directs."

Section 213 does not explain the extent of contributions a director has to make compared to section 304(1) where a director can be made personally liable for an

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See also section 304(5) of the Malaysian Companies Act 1965: "Where any business of the company is carried on with the intent or for the purpose mentioned in subsection (1) every person who was knowingly a party to the carrying on of the business with intent or purpose shall be guilty of an offence against this Act.  
Penalty: Imprisonment for three years or ten thousand ringgit."

unlimited amount. It is submitted that the ‘contribution’ in this section refers to the loss suffered by the company as a result of fraudulent trading<sup>114</sup> while in section 304(1) a director may be responsible for all liabilities or losses incurred from the date of fraudulent trading.

The punitive element in the Malaysian provision is expected since it originated from the old UK fraudulent trading section which was based on criminal liability.<sup>115</sup> The main purpose of imposing a duty on directors at that time was to curb the incidents where those who had been entrusted with public funds misused them; hence the punishment.

#### **11.3.4 Civil Liability for Wrongful Trading, Reckless Trading and Insolvent Trading**

The civil effect of breaching wrongful trading in section 214 of the UK Insolvency Act 1986 is similar to the fraudulent trading in section 213 of the Insolvency Act 1986; namely ‘the court may declare that person is to be liable to make such contribution (if any) to the company’s assets as the court thinks proper’. The New Zealand reckless trading provisions in section 135 and section 136 (duty in relation to obligation) of the Companies Act 1993 do not specify any consequences of the breach and therefore reference has to be made to other provision(s) in the Act.

In *Mason v Lewis*,<sup>116</sup> the Court of Appeal held that if there is a breach of section 135, the court has the discretion to decide as to what recovery should be required under section 301. Hence, it indicates that section 301 should be used to claim for a remedy. Although sections 135 and 136 are usually initiated when the company is wound up and creditors are specifically mentioned, the section, in principle, could

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<sup>114</sup> Courts' interpretation will be looked at later in section 11.3.7 below.

<sup>115</sup> This is one of the problems found by the Cork Committee - See Cork Report: *Report of the Review Committee on Insolvency Law and Practice*, Cmnd 8558 (1982) at [1776] [“Cork Report”].

<sup>116</sup> [2006] 3 NZLR 225, 234.

also be enforced by the company.<sup>117</sup> This is because, under section 169(3), duties under sections 135 and 136 are owed to the company and not to shareholders. This suggests that the company can bring direct action against directors for remedies and is not limited to the liquidator's proceeding under section 301. In addition, shareholders could enforce these duties under a derivative action stated in section 165.<sup>118</sup> In contrast, only a liquidator can bring an action under section 214 of the UK Insolvency Act because the section is only applicable when the company is wound up.

Section 301 provides for a series of circumstances where a liquidator, a creditor or a shareholder can apply for relief. Reckless trading and duty relating to obligation fall under the 'breach of duty or trust in relation to the company' in section 301.<sup>119</sup> Under this heading, the appropriate order a court can make is given in section 301(1)(b)(ii)- "to contribute such sum to the assets of the company by way of compensation as the Court thinks just" because the general damage has been caused to the company.<sup>120</sup>

As such, the civil remedies provided in both the UK and the New Zealand statutes are the same; the court has discretion to order directors to make a contribution to the assets of the company. However, the UK statute is silent as to the aim of making contributions while in New Zealand it is clearly stated that compensation is the

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<sup>117</sup> Chris Noonan and Susan Watson "Rethinking the Misunderstood and Much Maligned Remedies for Reckless and Insolvent Trading" (2004) 24 NZULR 26 at 29.

<sup>118</sup> Ibid.

<sup>119</sup> Section 301(1) of the New Zealand Companies Act 1993 states: "If, in the course of the liquidation of a company, it appears to the Court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or *breach of duty or trust in relation to the company*, the Court may, on the application of the liquidator or a creditor or shareholder,-

(a)...  
(b)...."

<sup>120</sup> See the decision of Master Venning in *Mitchell v Hesketh* (1998) 8 NZCLC 261,559 at 261562 (HC). See also Noonan and Watson above n114 at 30.

reason. In Australia, section 588M of the Corporations Act 2001 specifies, as in New Zealand, that the purpose of recovery under the section is compensation for loss suffered as a result of insolvent trading. The Australian section, like both the UK and New Zealand sections, allows for the court's discretion in determining the amount although section 588(2) and section 588(3) limit the maximum amount to be recovered to the amount equal to the loss or damage. It is submitted that the maximum amount to be obtained under section 301(b)(ii) of the New Zealand Companies Act 1993 should also equal the amount of loss or damage since the Act provides that the purpose of contribution is compensatory. This is because the purpose of compensation is to put parties in the position they would have been in if the breach had not occurred.

Section 588M(3) of the Australian Corporations Act 2001 allows creditors, in addition to a liquidator, to commence action against directors for recovery.<sup>121</sup> Creditors' right to initiate an action under section 588M, however, is subject to the requirement in Subdivision B of the sections.<sup>122</sup> The right to compensation under the section is available to liquidators or creditors, regardless of whether the director has been convicted of an offence in relation to contravention of the sections<sup>123</sup> or whether a civil penalty has been imposed on him or her.<sup>124</sup>

The Malaysian insolvent trading provision in section 304(2) of the Companies Act 1965 allows for a liquidator, creditor or contributory of the company to apply to the court for a declaration of personal responsibility.

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<sup>121</sup> See *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.

<sup>122</sup> See section 588R of the Australian Corporations Act 2001 which requires the liquidator's written consent before a creditor can proceed to take action against directors. See also section 588T and section 588U of the Act.

<sup>123</sup> See section 588M(e) of the Australian Corporations Act 2001.

<sup>124</sup> See section 588M(f) of the Australian Corporations Act 2001.

The court has the power if it thinks proper to grant an order for personal liability without any limitation for the payment of the whole or any part of the debt.<sup>125</sup> The objective of this section is presumably to punish the directors, notwithstanding it is a civil provision. It must be noted that the remedies for insolvent trading under section 303(3) are similar to the remedies for fraudulent trading under section 304(1) of the Malaysian Act 1965. The availability of a civil remedy for insolvent trading in Malaysia depends on criminal conviction under section 303(3). The existence of this pre condition has created an obstacle for liquidators or creditors to make use of this section. This is evident from the absence of any decided cases on this section since it was enacted in 1965.

### **11.3.5 Civil Penalty under the Australian Insolvent Trading Provisions**

In addition to civil remedies in section 588M, the Australian Securities and Investments Commission (ASIC) can bring proceedings under Part 9.4B for a civil penalty order against directors who have breached section 588(2).<sup>126</sup> On a declaration of breach of section 588G, ASIC may seek an order for compensation, a pecuniary penalty order or a disqualification order. A company also has the right to a compensation order but not the pecuniary penalty order or the disqualification order. The court may order against a person, who has contravened the section, to pay to the Commonwealth a pecuniary sum of up to \$200,000.<sup>127</sup> The court also has the power to make a compensation order for any damage suffered under section 1317H. When the court determines the amounts under the section, factors listed in sections

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<sup>125</sup> Section 304(2) states: “Where a person has been convicted of an offence under subsection 303(3) in relation to the contracting of such debt as is referred to in that section the Court, on the application of the liquidator or any creditor or contributory of the company, may, if it thinks proper to do, 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.”

<sup>126</sup> See section 1317E (1) (e) of the Australian Corporations Act 2001.

<sup>127</sup> Section 1317G of the Australian Corporations Act 2001.

1317H(2) and (3) must be taken into consideration; namely the profits,<sup>128</sup> or diminution of the property value.<sup>129</sup> The court may make this compensation order even though a pecuniary penalty order has been made under section 1317G.

Apart from the compensation order under section 1317H, the court has the option to make the same order under section 588J. It would seem that there is an overlapping of compensation orders for civil penalties against directors who contravene section 588G(2), although under section 588J there are no guidelines as to how damages should be assessed. Since there are two sections providing the same remedies, the applicant has the option to choose which provisions to use.<sup>130</sup> To avoid double recovery, due to numbers of compensation orders available against directors for contravening the same section, the courts when considering the appropriate amounts, must take into consideration the compensation made under section 588M.<sup>131</sup>

### **11.3.6 Criminal Liability for Insolvent Trading**

Only Australia and Malaysia provide for criminal penalties for insolvent trading. ASIC may institute criminal proceedings against directors for insolvent trading under section 1317P of the Corporations Act 2001. Directors can still be found responsible for criminal liability even though a compensation order or a declaration of

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<sup>128</sup> Section 1317H(2): “In determining the damage suffered by the corporation or scheme for the purposes of making compensation order, include profits made by any person resulting from the contravention or the offence.”

<sup>129</sup> Section 1317H(3): “In determining the damage suffered by the scheme for the purposes of making compensation order, include any diminution of the value of the property of the scheme.”

<sup>130</sup> See section 588P of the Australian Corporations Act 2001. See also John Farrar *Corporate Governance Theories, Principles and Practice* (3rd ed., Oxford University Press, South Melbourne, 2008) at 167.

<sup>131</sup> Section 588N: “An amount recovered in proceedings under section 588M in relation to the incurring of a debt by a company is to be taken into account in working out the amount (if any) recoverable in:

- (a) any other proceedings under that section in relation to the incurring of the debt; and
- (b) proceedings under section 596AC in relation to a contravention of section 596AB that is linked to the incurring of the debt.”

contravention or pecuniary penalty order has been granted against them. However, this section only be invoked if the dishonest intention specified in section 588G(3) has been proven.

The Malaysian Companies Act imposes a penalty of imprisonment for one year or five thousand ringgit on any person who is found guilty of an offence under the Act.<sup>132</sup> This provision is regarded as the main remedy for insolvent trading in the legislation because a liquidator could only bring a civil action if there has been a successful conviction under the section. In contrast, the Australian provisions, i.e. the civil remedy, civil penalty and criminal penalty are independent of each other and each section can be brought against the directors regardless of the outcome of the other.

### **11.3.7 Judicial Analysis of Remedies**

This section will focus on judicial interpretations of statutory provisions, examined in Part 11.3.2. Cases from each jurisdiction will be examined for the purpose of comparison. The analyses will centre on the nature of the court's order, how the quantum of each award is determined, and the factors which influence the court's decisions and ultimately who benefits from such rewards. Problems which hinder the enforcement (if any) of the sections will also be examined.

The fraudulent trading in section 213 and wrongful trading in section 214 of the Insolvency Act 1986 will be explained together because the provisions of the sections are similar. Likewise, the Malaysian fraudulent trading and insolvent trading provisions will be grouped together for the purpose of analysis. Because few cases are being brought before the Malaysian courts under both provisions, reference will

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<sup>132</sup> Section 303(3) of the Malaysian Companies Act 1965: "If in the course of the winding up of a company or in any proceedings against a company it appears that an officer of the company who was knowingly a party to the contracting of a debt had, at the time the debt was contracted, no reasonable or probable ground of expectation, after taking into consideration the other liabilities, if any, of the company at the time, of the company being able to pay the debt, the officer shall be guilty of an offence against the Act.

Penalty: Imprisonment for one year or five thousand ringgit."

be made to English cases as well as Australian cases whenever necessary in order to determine how courts may interpret the sections. Despite judges' tendency to adopt in verbatim the English and Australian decisions, it is important to bear in mind that these decisions are not binding on the Malaysian courts, but have merely persuasive value. The examination of New Zealand's section 301 will cover both reckless trading and the duty relating to obligations.

### 11.3.7.1 Court's Order

Once the court has determined that a director is liable under relevant provisions, the next task is to decide what order should be granted against such director. The courts have been given wide discretion by statutes to decide on what order should be made. With the exception of Australia, which specifies the extent of compensation that can be recovered from directors,<sup>133</sup> the other statutes merely state that directors are 'liable to contribute.'<sup>134</sup> Courts in the UK, New Zealand and Malaysia are given wide discretion to fix the amount as 'they think just.'<sup>135</sup> New Zealand's section 301(1)(b)(ii) mentions that contribution is by way of compensation while the other two statutes are silent as to the purpose. Based on these provisions, courts are expected to decide on what orders should be made.

In the past, courts in the UK have always associated fraudulent trading with punitive orders. This can be seen in the judgments of the courts dealing with the matter. In *Re William C Leitch Brothers Ltd*,<sup>136</sup> Maugham J was inclined towards the view that the breach of section 275<sup>137</sup> was punitive in nature. The court therefore may exercise its

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<sup>133</sup> See sections 588J, 588K, 588M of the Australian Corporations Act 2001.

<sup>134</sup> See sections 214 and 213 of the UK Insolvency Act 1986; 301(1)(b)(i) of the New Zealand Companies Act 1993 and sections 304(1) and 304(2) of the Malaysian Companies Act 1965.

<sup>135</sup> See sections 214 and 213 of the UK Insolvency Act 1986; 301(1)(b)(i) of the New Zealand Companies Act 1993 and sections 304(1) and 304(2) of the Malaysian Companies Act 1965.

<sup>136</sup> (1932) 2 Ch71 at 79-80.

<sup>137</sup> The then fraudulent trading provision in the UK Companies Act 1929.

discretion to order the director's liability to pay more than the losses suffered by creditors who have been defrauded within the meaning of the section.

Lord Denning in *Re Cyona Distributors Ltd*<sup>138</sup> commented that section 332 was deliberately framed in wide terms so as to enable the court to bring fraudulent persons to book. If a man has carried on the business of a company fraudulently, the court can make an order against him for the payment of a fixed sum. The Master of the Rolls then stated that the sum may be compensatory or it may be punitive.<sup>139</sup> The decision signified that the court had wide discretion to determine the amount, which could be varied depending on the purpose of awarding the remedy.

Nevertheless, in *Re Gerald Cooper Chemicals Ltd*<sup>140</sup> the application was made under section 332 by a creditor and the court warned that in making a decision the respondent should not be placed in double jeopardy by the possibility of further action by a liquidator under the same section. It can be presumed from the court's decision that despite the nature of their wrongful act, directors must not be subjected to liability more than they are liable to pay. In other words, the punishment meted out to a director should be proportionate to his culpability or dishonesty. This issue is now a moot point in the UK since section 213 of the Insolvency Act 1986 came into force as it empowers only a liquidator to bring a fraudulent trading action. The current civil fraudulent trading section has shifted its focus from punishing directors to compensating creditors.

This can be seen in *Morphitis v Bernasconi and others*,<sup>141</sup> where the court concluded that the power to grant an order under the section did not include a

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<sup>138</sup> [1967] Ch 889 at 902.

<sup>139</sup> *Lower v Traveller* [2005] 3 NZLR 479 at 498.

<sup>140</sup> [1978] Ch 262 at 268.

<sup>141</sup> [2003] Ch 552 at 579.

punitive element and any contributions made by directors should only compensate creditors for the loss they suffered. To include a punitive element into the amount of the award, the judge reasoned, would not be consistent with the established principle of limited liability, and could not have been the intention of Parliament.<sup>142</sup> Moreover, the criminal liability which aims to punish the wrongdoer has been provided for in section 458 of the Companies Act (now in section 993 of the Companies Act 2006).

It should be noted that the contrast in the decisions of *Re Cyona Distributors Ltd*<sup>143</sup> and *Morphitis v Bernasconi and others*<sup>144</sup> was due to the difference in the provisions used. The former was based on section 332 of the Companies Act 1948 which has both criminal and civil elements, while the latter was decided under section 213 which only provides for civil liability. In *Re Bank of Credit and Commerce International SA (in liquidation) (No 15), Morris v Bank of India*,<sup>145</sup> the bank was held liable to contribute to losses of creditors which would have been avoided but for the transaction. From the decision, it seems the court borrowed the ‘but for’ test from torts of negligence to ascertain the amount of contribution. In other words, it must be shown that damages suffered are a result of directors engaging in fraudulent trading although the award would merely be a reasonable approximation.<sup>146</sup>

The same approach is adopted by the court in relation to remedies of wrongful trading. It seems appropriate for wrongful trading not to include a punitive element into the judgment because the court does not have the power to do so for fraudulent trading which requires intention to defraud. The decision of Knox J in *Re Produce*

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<sup>142</sup> *Morphitis v Bernasconi and others*[2003] Ch 552 at 579.

<sup>143</sup> [1967] Ch 889.

<sup>144</sup> [2003] Ch 552.

<sup>145</sup> [2004] 2 BCLC 279 at 355.

<sup>146</sup> *Re Bank of Credit and Commerce International SA (in liquidation) (No 15), Morris v Bank of India*[2004] 2 BCLC 279 at 355.

*Marketing Consortium (No 2)*<sup>147</sup> clearly stated that the jurisdiction under section 214 is primarily compensatory rather than penal. Hence, the appropriate contribution from a director would be the amount of the company's assets depleted as a result of a director's wrongful trading.<sup>148</sup> The relevant time the court must consider in order to calculate the net deficiencies of the company assets would be from the date wrongful trading occurred until the company is wound up.

Therefore, it is essential for companies to prepare and maintain proper accounts since financial statements will be the court's primary sources in determining the loss suffered by creditors. In *Re Purpoint Ltd*,<sup>149</sup> the court faced difficulty in ascertaining the net deficiencies of the company assets because of the company did not keep proper accounts, and concluded that the director's liability would be the aggregation of both trading and crown debts calculated from the time the company should cease trading until being wound up.<sup>150</sup>

The approach adopted by the Malaysian courts in relation to fraudulent trading is similar to the current position in the UK; that the award should comprise only the amount of loss suffered by the creditors, and should not include a punitive element. In this respect, the court did not follow cases which were decided under section 332 of the Companies Act 1948 which allowed both compensatory and punitive elements in the contribution order, although section 304(1) contains both criminal and civil liability. Although section 304(1) originates from section 332 of the Companies Act 1948, the courts in Malaysia did not adopt the principle in UK cases which are decided under similar sections, such as *Re Cyona Distributors Ltd*.<sup>151</sup> The courts

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<sup>147</sup> (1989) BCLC 520 at 553.

<sup>148</sup> *Re Produce Marketing Consortium (No 2)* (1989) BCLC 520 at 553.

<sup>149</sup> (1991) BCLC 491 at 498.

<sup>150</sup> See also *Re Brian D Pierson* [2001] BCLC 275 at 310-311, the relevant time is stated as between the time when company should have gone into liquidation and the when it actually did.

<sup>151</sup> [1967] Ch 889.

have, in the circumstances, adopted the compensatory approach by awarding the creditors the amount they have suffered as a result of fraudulent trading.

In *Siow Yoon Keong v H Rosen Engineering BV*,<sup>152</sup> the court granted an order against the director of the company to be personally liable for the judgment sum obtained by Rosen against the company. Likewise, in *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong*,<sup>153</sup> a company applied for a declaration against its director the defendant, for the sum of RM115,000, the amount being the judgment sum entered against the company by its creditor for non-payment of the purchase price. However, the court in this instance found the director liable for the amount under section 132(1) for breach of director's duty for failure to act in the best interests of the company instead of the fraudulent trading section in section 304(1).

The court did not make any order of contribution under section 304(1) despite finding that fraud existed under the provision. It can be presumed from the decisions that the court did not grant any contribution order under section 304(1) because to do so would have overcompensated the company. The court's refusal to make an order under the section indicates the court's attitude towards inserting a punitive element into the order despite having the authority to declare the person 'personally responsible without any limitation of liability.' Punitive orders signify an element of punishment and therefore require strict interpretations of the section, but in these cases the court applied the civil standard.

Although section 304(1) was originally derived from section 332 of the UK Companies Act 1948, there is a slight difference in the wordings of the former, namely the additional requirement "... or in any proceedings against a company...". Therefore in Malaysia, the application of the fraudulent trading provision is not limited to situations where the company is insolvent; liquidators, creditors or contributors of the company may bring an action if during the proceeding it was

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<sup>152</sup> [2003] 4 MLJ 569.

<sup>153</sup> [2009] 1 MLJ 723.

discovered that the director had engaged in fraudulent trading. However, it is also possible for a company to commence proceedings under section 304(1) of the Companies Act 1965 as shown in *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong*<sup>154</sup>

In *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors*,<sup>155</sup> during the subsistence of the creditor's civil action against the company it was found that directors had unlawfully dissipated the assets and funds of the company. Subsequently, the creditor was left with a mere paper judgment. The creditor then commenced an action under section 304(1) to make the directors personally liable for the judgment sums obtained for unpaid goods. The court, after finding that fraud existed, ordered the directors to be jointly and severally liable for the judgment sums. This case illustrated the situation when section 304(1) has been invoked "in any other proceedings against the company," when fraudulent trading was discovered during a civil action against the company. From the few cases being brought before the court, it seems section 304(1) has been used by creditors as means to enforce unsatisfied judgment sums against directors when the company is insolvent.

The position in New Zealand is not much different from that in the UK and Malaysia. This can be seen in *Mason v Lewis*,<sup>156</sup> where the court held that the standard approach in quantifying the amount of contribution under section 301 starts by looking at the deterioration in the company's financial position between the date of the breach and the date of liquidation. In analysing the relationship between section 301 and section 135, the court observed that it is important not to conflate the two sections because they deal with two separate issues. Section 135 is concerned with liability, while section 301 is the appropriate relief. Further, when deciding on director's liability for reckless trading under section 135, the court has to apply an

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<sup>154</sup> [2009] 1 MLJ 723.

<sup>155</sup> [2010] 1 MLJ 185.

<sup>156</sup> [2006] 3 NZLR 225 at 241.

objective test but has a wide discretion as regards the amount of remedy to be granted under section 301.<sup>157</sup>

The Court of Appeal in *Lower v Traveller*<sup>158</sup> looked at the increase in the company's liabilities between the dates when trading should cease and the date that trade finally ended, to decide on the suitable amount. The purpose of awarding the sum was compensatory and the figure determined was fixed as the ceiling, which the court could reduce depending on the three factors it should consider. The court acknowledged that the method of assessing loss used in the case was not the only option available and its decision was reached after considering other factors involved. Due to uncertainties faced by the judge in estimating the company's financial position had it ceased trading at the time it should, the calculation adopted should be conservative.<sup>159</sup> As such, the court uses a broad sum approach and made discounts for any uncertainties such as unproven claims.

The calculation in *Fatupaito v Bates*<sup>160</sup> is made by referring to a statement of assets and liabilities between the date of receivership (or date of reckless trading) and the date of liquidation. The court regarded the sum based on erosion of capital of the company as being appropriate because it yielded the net figure and excluded the deficit which existed prior to the involvement of the receiver/shadow director.

Anderson J in *Nippon Express (New Zealand) Ltd v Woodward*,<sup>161</sup> regarded section 275(1)(b)(ii)<sup>162</sup> as essentially penal in nature although the aim of the provision is

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<sup>157</sup> *Mason v Lewis*[2006] 3 NZLR 225 at 234.

<sup>158</sup> [2005] 3 NZLR479 at 498.

<sup>159</sup> [2005] 3 NZLR479 at 498.

<sup>160</sup> [2001] 3 NZLR 386 at 407.

<sup>161</sup> (1998) 8 NZCLC 261,765 at 261,778

<sup>162</sup> Section 275(1)(b)(ii) is a predecessor to section 301.

compensatory.<sup>163</sup> Damages are assessed on a broad global approach and apportioned to defendants based on the principle of just deserts. The method of assessing the amount of contribution requires a broad global approach with the final sum remaining at the discretion of the court. As such, the court held the defendants liable to contribute to the assets of the company and considered this to be just deserts.

The court in *Vinyl Processors (New Zealand) Ltd v Cant*<sup>164</sup> made reference to *Maloc Construction Ltd v Chadwick Lovegrove and Burr*<sup>165</sup> in a situation where the company failed to keep proper financial reports which stated that in the event that arithmetical assessment is impossible, the court should use the broad global method. However, if detailed information as to the amount of deficiencies is available, the court must still exercise its discretion and come to conclusions after careful considerations of necessary factors.

In Australia, the statute clearly stated that the amount of compensation a court can award the company is equal to the loss or damage suffered.<sup>166</sup> The loss or damage suffered by creditors in this context, however, must be as a consequence of the insolvent trading. In section 1317H, a civil penalty provision, the statute provides guidelines to court when awarding damages. It is important to note that, unlike other provisions in the Corporations Act, section 1317H specifies that damage must be a result of the contravention, i.e. engaging in insolvent trading.<sup>167</sup> The court has to take into consideration the amount of profits made by the person who contravenes the insolvent trading provision when ascertaining the amount of damages suffered by the corporation. This requirement is absent in section 588J which also provides for

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<sup>163</sup> See also *Re Gellert Developments Ltd (in liq); McCullagh & Anor v Gellert & Anor* (2002) 9 NZCLC 262,942.

<sup>164</sup> (1990) 5 NZCLC 66,592.

<sup>165</sup> (1986) 2 BCR 217.

<sup>166</sup> See sections 588J, 588K, 588M; see also section 1317H of the Australian Corporations Act 2001.

<sup>167</sup> Section 1317H(1)(b) of the Australian Corporations Act 2001.

civil penalty compensation. As such, an applicant for civil penalty compensation for breach of section 588G(2) has a choice between the two different measures of award.

### 11.3.7.2 Factors Influencing Quantum of Award

There is general consensus in all jurisdictions that the court's power to grant a maximum contribution order is based on the net deficiencies between the date of the act and the date of liquidation for insolvent trading,<sup>168</sup> or in the case of fraudulent trading, the amount equivalent to the assets misappropriated.<sup>169</sup> Once the maximum amount has been determined by the court, it is not obliged to make the maximum amount and is given a wide discretion to decide whether to reduce the final award.

There are various factors which the court considers when determining the correct sums. Courts in New Zealand rely on three matters in reaching the quantum of relief; causation, culpability and duration.<sup>170</sup> In UK and Malaysia, a similar attitude can be glimpsed from the courts' decisions. In Australia, in addition to causation, there has to be a link between the company's liquidation and the loss suffered by the company.

#### 11.3.7.2.1 Causation

A director's liability to contribute to the assets of the company depends on the connection between the carrying on of the business recklessly/wrongfully, and the loss creditors' suffer as a consequence.<sup>171</sup> The court in the UK adopted the principle

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<sup>168</sup> See *Re Produce Marketing Consortium (No 2)* [1989] BCLC 520, *Re Brian D Pierson* [2001] BCLC 275 in the UK; for New Zealand see *South Pacific Shipping Limited (in liq); Lower v Traveller* [2005] 3 NZLR 479; *Mason v Lewis*[2006] 3 NZLR 225.

<sup>169</sup> *Morphitis v Bernasconi and others*[2003] Ch 552; *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569; *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong* [2009] 1 MLJ 723; *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors*[2010] 1 MLJ 185.

<sup>170</sup> *Fatupaito v Bates* [2001] 3 NZLR 386; *Lower v Traveller* [2005] 3 NZLR 479; *Mason v Lewis*[2006] 3 NZLR 225.

<sup>171</sup> *Lower v Traveller* [2005] 3 NZLR 479 at 498.

of causation similar to torts in assessing the amount of damages. The court said that the wide discretion given in section 214(1) is intended to enable allowance to be made for questions of causation and to avoid unjust results.<sup>172</sup> The court uses the ‘but for’ test in order to establish whether there is a link between the director’s action and the indebtedness which is going to be imposed on him or her.

In *Nippon Express (New Zealand) Ltd v Woodward*,<sup>173</sup> the court emphasized the link between the director’s conduct and the loss incurred by the company, though creditors may have also contributed to the damage. The duty to the company is owed by the director and not by the creditors. The law expects the director and not the creditor to be the company’s keeper and not to cause substantial risks which could result in claims against the company. The court, without disregarding the principle of contributory negligence, held although there was evidence to show that the plaintiff creditor’s action also caused damage to the company, the duty was not owed by the plaintiff to the company.

In relation to fraudulent trading, the court in *Morphitis v Bernasconi and others*<sup>174</sup> concluded there must be some nexus between the loss caused to the company’s creditor from the trading, and the contribution sought from the party who has breached the section. In this aspect, the remedy awarded to the applicant would depend on the nature of the dishonest act, for example, whether it causes the person to misappropriate the company’s assets, the amount of the contribution is equal to the value of assets misapplied. If, for example, the person’s act leads to a claim against the company by those defrauded, such as a creditor, the relief should reflect the amount which would diminish the assets available for distribution to creditors generally.

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<sup>172</sup> *Re Produce Marketing Consortium (No 2)* [1989] BCLC 520, 553; See also *Re Brian D Pierson* [2001] BCLC 275.

<sup>173</sup> (1998) 8 NZCLC 261,765 at 261,777.

<sup>174</sup> [2003] Ch 552 at 578.

Similar arguments were made by the court in *Re Bank of Credit and Commerce International SA (in liq) (No 15); Morris and others v Bank of India*.<sup>175</sup> Patten J concluded that the award can only be estimated for the damages to which the director has contributed or caused. Despite the compensatory nature of the award, it is essential for the court to assess the degree of the director's fault or culpability for the purpose of calculating the quantum.

In Malaysia, debts which directors are held to be liable for are those incurred prior to fraudulent trading, while in other jurisdictions, only loss suffered after the act is considered. The fraudulent action was discovered while creditors were taking an action or enforcing judgments which already existed against the company. The creditors then brought an action under section 304(1) for a declaration of personal liability.<sup>176</sup> The link in these cases is that, due to the fraudulent act, the company could not pay for the existing claims or judgment sums.

In Australia, the statute requires the court to be satisfied that there is a link between loss and insolvency before an order for compensation can be made.<sup>177</sup> The emphasis on the company's insolvency in the Australian statute indicates that the amount of award should be sums not recoverable from the company's pools of assets when it is in liquidation.<sup>178</sup>

This is illustrated in the decision of *Metropolitan Fire Systems Pty Ltd v Miller*<sup>179</sup>, where Metropolitan was able to recover the whole debt due to it from the director

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<sup>175</sup> [2004] 2 BCLC 279 at 356.

<sup>176</sup> *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569; *LMW Electronics Pte Ltd v Ang Chuang Juay & Ors*[2010] 1 MLJ 185.

<sup>177</sup> See sections 588J(1)(c); 588K(b) (ii); 588M(1) (b) of the Australian Corporations Act 2001 “ the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency”.

<sup>178</sup> Austin and Ramsay above n22 at [20.150].

<sup>179</sup> (1997) 23 ACSR 699.

because the court considered that it was unlikely for it to receive anything in winding up. The quantum recoverable from the directors by ASIC or the liquidator who initiated proceedings is therefore the loss or damage suffered by all unsecured creditors in relation to their debts as a result of the insolvency.

As such, it is not necessary to consider whether there is a need for a creditor to mitigate his or her loss.<sup>180</sup> In *Official Trustee in Bankruptcy v CS & GJ Handby Pty Ltd*,<sup>181</sup> a claim under section 566 of the Companies (Tasmania) Code 1981, a predecessor to section 588G, the court interpreted the provision strictly and held that it was not a claim for damages at large. It should be noted, however, that the provision in section 566 allows for “recovery for a debt” while the compensation under section 588M allows for “loss or damage.” Section 588M gives a right to a liquidator or creditor to recover for loss or damage arising from the company’s insolvency though the question of quantum remains unclear.<sup>182</sup> In *Powell v Fryer*,<sup>183</sup> the court concluded that the loss or damage would normally be quantum of the relevant unpaid debts.

#### **11.3.7.2.2 Culpability**

Courts have discretion to apportion liability to contribute depending on the culpability of its directors. This factor requires the court to examine the blameworthiness of a director’s conduct ranging from blind faith at one end to plain dishonesty at the other end.<sup>184</sup> Hence, from the evidence available before it, the court

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<sup>180</sup> Austin and Ramsay above n22 at [20.150].

<sup>181</sup> (1989) 87 ALR 734.

<sup>182</sup> Niall F Coburn “*Insolvent Trading in Australia: The Legal Principles*” in Ian Ramsay (Ed.) *Company Directors’ Liability for Insolvent Trading* (CCH Australia Centre for Corporate Law and Securities Regulation, University of Melbourne, 2000) 73 at 119.

<sup>183</sup> [2000] SASC 97.

<sup>184</sup> *Lower v Traveller* [2005] 3 NZLR 479 at 498; see also *Thompson v Innes* (1985) 2 NZCLC 99,463.

has to decide at which end the director stands and the contribution ordered will increase with the degree of culpability. By granting an order which is both punitive and compensatory on directors whose blameworthiness is high, directors are deterred from committing the reckless/wrongful trading.<sup>185</sup>

Commentators have expressed their reservations on culpability as a factor relevant for the purpose of determining the amount of the contribution.<sup>186</sup> Culpability is associated with intention and there is a possibility for the court to include a punitive element in making the award. This, critics argue, should not be so since the purpose of the section is compensatory and therefore only causation matters. Adrian Walters suggests that the court should not automatically award a nominal sum if the director lacks blameworthiness, instead it should be taken as a mitigating factor.<sup>187</sup> This can be seen in the decision of *Re Produce Marketing Consortium (No 2)*<sup>188</sup> when the court awarded the sum of £75,000 owing to the director's lack of culpability instead of the whole sum of £107,946 as claimed.

In New Zealand, shareholders can also initiate a derivative action against a director for breach of sections 135 and 136, under section 165. The director's liability if it is brought as a derivative, will be higher than if it is brought under section 301. This is because section 301 confers discretion on the court and once the court has determined the link between the loss and the director's action, it would reduce the amount depending on the degree of culpability.<sup>189</sup> On the other hand, such discretion is absent in a shareholder's derivative action and the court would have to compensate the creditors based on the amount of the loss.

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<sup>185</sup> *Lower v Traveller* [2005] 3 NZLR 479 at 498.

<sup>186</sup> Adrian Walters "Enforcing Wrongful Trading - Substantive Problems and Practical Disincentives" in Barry A K Rider (Ed.) *The Corporate Dimension* (Jordon Publishing Ltd, Bristol, 1998) 145 at 152-153; Noonan and Watson above n117 at 41-42.

<sup>187</sup> Walters, *ibid* at 152.

<sup>188</sup> [1989] BCLC 520.

<sup>189</sup> Noonan and Watson above n117 at 42.

It should be noted that *Re Cyona Distributions Ltd* was decided under section 332 of the UK Companies Act 1948 which had both criminal and civil liability. Therefore, it was appropriate to include culpability and the deterrent concept in the order. The reckless and wrongful trading provision (including fraudulent trading in section 213 of the UK Insolvency Act 1986), on the other hand, involves civil liability and cases have stated that the aim of these provisions is compensatory. Malaysia adopts the same compensatory approach and awarded the equivalent to creditor's loss although its provision is derived from section 332 of the Companies Act 1948

The purpose of compensation is to put a person in a position that he or she would have been in had if breach had not occurred. Hence, the judge in interpreting the reward order should only look at the creditor's loss and not the blameworthiness of the director. Instead, in *Mason v Lewis*,<sup>190</sup> the directors were held to be responsible for monitoring the business and guiding the management, and failure to do so amounted to recklessness.

The contribution awarded against the director, therefore, should be just deserts, reflecting the director's irresponsible behaviour. It was mentioned in the case that the court has an equitable character in deciding the issue which gives the indication in order to give justice to the director, the contribution order should include culpability. This decision can be reconciled with the view that culpability can be used as a mitigating factor as long as the court is aware that it could not exceed the maximum amount, namely the loss or damage sustained by creditors owing to the trading.<sup>191</sup>

Director's culpability was also highly relevant in *Lower v Traveller*<sup>192</sup> in determining the contribution award. In that case, there was an element of recklessness when the

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<sup>190</sup> [2006] 3 NZLR 225.

<sup>191</sup> Walters above n186 at 152.

<sup>192</sup> [2005] 3 NZLR 479.

director put his own interests ahead of creditors by unreasonably putting the company at risk through its expansion programme. Likewise, in *Nippon Express (New Zealand) Ltd v Woodward*,<sup>193</sup> it was stated that the relevant debt was attributable to the defendants' fault which connotes the degree of culpability on the part of the director.

In the UK, culpability is also an element which the court takes into consideration when making decisions. This can be seen from the case of *Re Produce Marketing Consortium (No 2)*<sup>194</sup> where the court took into consideration whether wrongful trading was caused by the director's failure to appreciate the warning signs or whether it was a deliberate wrongdoing.

In addition, the court looks at whether directors have been given any warning regarding the impending collapse, whether their conduct has shown proper regard to accuracy, as well as their involvement in the management, their reliance on others or their lack of experience. From these it can be presumed that the court is gauging the extent of fault which should be attached to the director in order to ascertain the contribution to be imposed.<sup>195</sup>

In Australia, culpability is only relevant in respect of a civil penalty order which has the aim of protecting the public from unscrupulous directors.<sup>196</sup> For compensation orders under different statutory provisions, the nexus is between the loss suffered and the company's insolvency. Therefore, a director's blameworthiness is immaterial because compensation depends on the damage which is not recoverable through distribution made by the liquidator.

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<sup>193</sup>(1998) 8 NZCLC 261,765 at 261,777.

<sup>194</sup> [1989] BCLC 520 at 553-554.

<sup>195</sup> See also *Re Brian D Pierson* [2001] BCLC 275.

<sup>196</sup> Section 588J and section 1317H of the Australian Corporations Act 2001.

### 11.3.7.2.3 Duration

The court also considers the length of time the company continues trading from the date it should have ceased, and the amount of the contribution will increase the longer the director waits.<sup>197</sup> Therefore, it is crucial for the court to determine the date the company should stop trading and warnings from professionals would be relevant to assist the court.

### 11.3.8 The Effects of the Court's Order

In order for the law to be effective, it must provide an avenue for the aggrieved party to take action against the wrongdoer or else the legal duty would be deemed as nonsense.<sup>198</sup> The liability provision must be clear and assessable to the person who wishes to bring action under the law. The law must not be cumbersome and difficult to enforce which may deter the aggrieved party from bringing the action. Imposing liability alone is not sufficient to make an effective law if it is not backed up by adequate remedies. To have an adequate remedy means it must reach the person intended to benefit from it and if there is any failure to comply with the contribution order, the law must then provide an avenue to enforce the judgment.

The aim of enacting the fraudulent and wrongful trading provisions in the UK is mainly to give remedies to creditors who have suffered losses or damages as a result of the director's action. The Cork Committee, in its report, was also concerned with the action of charge holders who would enforce their rights under the debenture at the slightest hint of insolvency at the expense of the unsecured creditors.<sup>199</sup> The

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<sup>197</sup> *Lower v Traveller* [2005] 3 NZLR 479 at 499.

<sup>198</sup> See Len Sealy "“Wider” Responsibility: Problems Conceptual, Practical and Procedural” (1987) 13 Monash Uni LR 164 at 177 “A supposed legal duty which is not matched by a remedy is nonsense.”

<sup>199</sup> Cork Report above n115 at [497-498].

law<sup>200</sup> states the court has the power to order a director to make a contribution ‘to the company’s assets.’

The usage of the terms "contribution to the company’s assets" in both sections indicates that the sums should be paid to the liquidator for distribution among the creditors, and not to any specific creditor.<sup>201</sup> This argument is further enhanced by the requirement that only a liquidator is allowed to bring an action. Prior to the enactment of civil liability for fraudulent trading in section 213, the courts’ power to grant an order should be exercised for the benefit of creditors as a class and not on individual creditor.<sup>202</sup> In *re Cyona Distributors Ltd*,<sup>203</sup> Lord Denning M.R. decided that the wording of the section<sup>204</sup> is quite general and it grants authority to the court to decide on the destination of the award depending on who made the application. Therefore, it was possible for the court to award relief to an individual creditor. The decision, however, was made under the old provision which allowed an application by a liquidator or a creditor or a contributory.<sup>205</sup> The matter has since been settled by the enactment of section 213 of the Insolvency Act 1986 and is reflected in courts’ decisions.

It is settled law in the UK for both section 213 and section 214 that the court has jurisdiction in exercising its power to grant an order of contribution to creditors as a whole, regardless of whether they existed before or after the trading.<sup>206</sup> This

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<sup>200</sup> Section 214 and section 213 of the UK Insolvency Act 1986 both contain the same wording.

<sup>201</sup> *Morphitis v Bernasconi and others*[2003] Ch 552; *Re Purpoint Ltd* (1991) BCLC 491; *Re Produce Marketing Consortium (No 2)* [1989] BCLC 520.

<sup>202</sup> See Eve J in *Re William Leitch Bros Ltd* (No 2)[1933] 261at 266.

<sup>203</sup> [1967] Ch 887.

<sup>204</sup> “all or any of the debts or liabilities of the company as the court shall direct” in section 332(1) of the UK Companies Act 1948.

<sup>205</sup> See comment by Professor John Farrar “Corporate Insolvency Law and the Law” (1976) JBL 214 at 226- “the view of Lord Denning could lead to anarchy.”

<sup>206</sup> See judgement by Vinelott J in *Re Purpoint Ltd* (1991) BCLC 491 at 499, the judge stated that the purpose of section 214 is to recoup the loss to the company so as to benefit the creditors as a

contribution order is made to the “company’s assets.” These company’s assets are sometimes subjected to a floating charge including future assets, and contributions from directors under both sections are regarded as such. Floating charge holders hold security on the assets of the company and have the right to appoint a receiver to realize those assets if the terms of the charge are breached. Their debts are ‘secured’ to the extent of the value of the property realized and if the property is worth less than the debts, they will have to prove the balance as unsecured creditors. Alternatively, the secured creditors can surrender their securities and prove the whole balance as unsecured creditors.

It is important to determine whether a contribution forms part of the charge because if it does, the secured creditors will be able to claim the amount to discharge the debts owed. Consequently, the amounts available for distribution among unsecured creditors will be less, thus reducing or eliminating their chances of getting paid. Knox J in *Re Produce Marketing Consortium (No 2)*<sup>207</sup> indicated that the contribution sums form part of the assets of the company and are subject to a claim by the secured creditor. The judge then stated that the judgment must be exercised in a manner which will benefit the unsecured creditors.

This decision, however, is not consistent with the aim of section 214 to protect the unsecured creditors by preventing wrongful trading when the company’s finances are doubtful.<sup>208</sup> Further, the decision was seen as flimsy; based on ambiguous authorities

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whole. The judge went further and mentioned that the court has no jurisdiction to declare payments to be made to specific creditors or payment made to the company should be applied to a class of creditors in preference over the others. It was also pointed out that the position of creditors prior to the wrongful act and those after was similar because everyone suffered to the extent that the assets of the company were depleted.

<sup>207</sup> [1989] BCLC 520 at 554a.

<sup>208</sup> See Andrew Keay *Company Directors’ Responsibilities to Creditors* (Routledge-Cavendish, London, 2007) at 104-108 [“Company Directors Responsibility”]; see also Andrew Hicks “Advising on Wrongful Trading: Part 1” (1993) 14 Co Law 16 at 19 Rebecca Parry “The Destination of Proceeds of Insolvency Litigation” (2002) 23 Co Law 49.

of misfeasance summonses.<sup>209</sup> The decision based on misfeasance is thought by critics to be misplaced because the right of action does not solely arise in insolvency compared to wrongful trading which specifically arises when the company is wound up.

Further, a misfeasance action is taken against directors or others in various circumstances amounting to breach of duty, while wrongful trading provides for an action for failure to take steps to minimize loss to creditors. The wording of section 214(1) is said to resemble preferences provisions rather than misfeasance, and it would be appropriate to adopt its position into wrongful trading. Moreover, the general defences for misfeasance actions in section 1157 Companies Act 2006 are not applicable to wrongful trading which has its own defence in section 214(4) Insolvency Act 1986.<sup>210</sup>

The matter was settled in *Re Oasis Merchandising Services Ltd (in liq), Ward v Aitken and Others*,<sup>211</sup> when the Court of Appeal stated that the fruits of wrongful trading were to be available to unsecured creditors. The court made a distinction between the property of the company at the time of the commencement of the liquidation, and assets which arise after liquidation which are recoverable by a liquidator pursuant to the power conferred on him or her. Therefore, fruits of action from misfeasance will be available to a debenture holder because the right under section 212(misfeasance) existed prior to the winding up of the company, and the liquidator enforces such right on behalf of the company. In contrast, proceeds from fraudulent and wrongful trading are not part of the assets of the company and thus could not be subjected to a charge.<sup>212</sup>

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<sup>209</sup> Hicks, *ibid.*

<sup>210</sup> *Re DKG Contractors Ltd* [1990] BCC 903.

<sup>211</sup> [1997] 1 BCLC 689 at 698-699.

<sup>212</sup> *Re Oasis Merchandising Services Ltd (in liq), Ward v Aitken and Others*[1997] 1 BCLC 689 at 698-699.

This is similar to the case of fraudulent preference and the Court of Appeal followed the authority in *Re Yagerphone*,<sup>213</sup> which stated that money recovered by a liquidator under fraudulent preference was never part of the company's assets and hence would not fall under a debenture which created a charge on all present and future assets. The liquidator, nevertheless, held the proceeds which came to his or her hand on trust for the benefit of unsecured creditors. Likewise in *Re MC Bacon (No 2)*,<sup>214</sup> the court regarded the claim for voidable preference and wrongful trading as rights which are only available to a liquidator at the time when the company is in liquidation and therefore could not form a part of assets subject to floating charge.

Unlike the UK, New Zealand does not have separate provision on remedies for misfeasance and insolvent trading.<sup>215</sup> As a result of this, it provides remedies for different types of liabilities including reckless trading and breach of the duty in relation to obligations. Section 301 does not provide for a new course of action but a mere procedural mechanism; hence liability in sections 135 and 136 should arise independently from it.

Section 301 does not of itself impose any duties on directors, but is rather a means of enforcement against directors.<sup>216</sup> In order to pursue claims under section 301, the Court must first consider whether there has been breach of duty under section 135 or 136.<sup>217</sup> Secondly, the Court should, in its discretion, determine whether and to what

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<sup>213</sup> [1935] Ch 392; see also William Gough *Company Charges* (Butterworths, London 1996) at 122-123.

<sup>214</sup> [1990] BCLC 607

<sup>215</sup> See the historical origins of section 301 of New Zealand Companies Act 1993 in Noonan and Watson above n117 at 38-39.

<sup>216</sup> *Peace and Glory Society Ltd (in liq) v Samsa* [2010] 2 NZLR 57 at [48].

<sup>217</sup> *Peace and Glory Society Ltd (in liq) v Samsa* [2010] 2 NZLR 57 at [48].

extent a director should be required to contribute to the assets of the company.<sup>218</sup> At this stage, the court should refer to section 301 and the degree of director's culpability will be relevant.<sup>219</sup>

It is important that the court's order should reflect the nature of liability of each duty it intends to remedy. For insolvent trading, the essence of liability is to ensure creditors would be able to claim as much as possible for the loss they have suffered. Hence, it was apt that courts had stated that the amount of contribution should be the net deficiencies between the date of liquidation and the date that trading should have stopped.<sup>220</sup> By contributing to the assets of the company, it increases the pool of assets for creditors' claims.

The case of *Fatupaito v Bates*<sup>221</sup> illustrates the same position when the High Court held that the duty under section 135 is owed to the company rather than to any particular creditor.<sup>222</sup> Cases have decided that the interests of the company are the interests of the shareholders.<sup>223</sup> In this respect, it is essential to ascertain whether the imposing of a duty to prevent insolvent trading or reckless trading when the company is insolvent is in the interests of shareholders. Much literature has been written on this subject which concludes that it would not be in the interests of shareholders to stop trading when the company is insolvent because at this stage the

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<sup>218</sup> *Peace and Glory Society Ltd (in liq) v Samsa* [2010] 2 NZLR 57at [48]; the same approach was adopted in *Mason v Lewis* [2006] 3 NZLR 225.

<sup>219</sup> *Peace and Glory Society Ltd (in liq) v Samsa* [2010] 2 NZLR 57at [64].

<sup>220</sup> See *Re Produce Marketing Consortium (No 2)* [1989] BCLC 520; The decision in *Lower v Traveller* [2005] 3 NZLR 479 and *Mason v Lewis* [2006] 3 NZLR 225 also reveals the same approach.

<sup>221</sup> [2001] 3 NZLR 386.

<sup>222</sup> See also section 169(3)(f) and (g) of the New Zealand Companies Act 1993 which states duty in section 135 and section 136 are owed to the company and not shareholders.

<sup>223</sup> *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286 the duty is owed to general body of shareholders and not to any particular shareholders. See *Perceival v Wright* [1902] 2 Ch 421. However, in *Coleman v Myers* [1977] 2 NZLR 297, the court held where there are special circumstances, the directors may owe duty to individual shareholder.

company is using funds belonging to creditors. Rather, it would be in the interests of shareholders to continue trading with the hope of gaining profits at the expense of creditors.<sup>224</sup>

Therefore, the duty to prevent insolvent trading would not be in the interests of shareholders but of the creditors. The court then clarified, in the judgment, that section 135 requires an assessment of the position of creditors as a body rather than individual creditors.<sup>225</sup> It seems that the court has incorporated the position in common law into section 135.<sup>226</sup> A similar thought is echoed in *Re BM & C B Jackson (in liq)*<sup>227</sup> in which the court stated that any remedy payable to the company under section 301(1)(b) will be distributed pro rata among the unsecured creditors, although the action is brought by an individual creditor.

The case of *Lower v Traveller*<sup>228</sup> also interprets the duty to the company in section 135 as a duty to a general body of creditors. This is shown in the judgment when the court stated “one measure of the worsening of the company’s position is of course the increase in its creditors. As the duty under the statute is one owed to the company, the assessment is properly related to the claimants on it rather than individual complainants.”<sup>229</sup>

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<sup>224</sup> See details in Chapter 5 of this thesis.

<sup>225</sup> *Fatupaito v Bates* [2001] 3 NZLR 386 at 404.

<sup>226</sup> See *Walker v Wimborne* (1976) 3 ACLR 529; *Kinsela v Russell Kinsela Pty Ltd* (1986) ACLR 395; *Nicholson v Permakraft (N.Z) Ltd* [1985] 1 NZLR 243. see also discussion in Chapter 2 of the thesis.

<sup>227</sup> (2001) 9 NZCLC 262, 612.

<sup>228</sup> [2005] 3 NZLR 479.

<sup>229</sup> *Lower v Traveller* [2005] 3 NZLR 479 at 499.

*Mason v Lewis*<sup>230</sup> also followed the same approach that the duty is owed to the general body of creditors rather than to any particular creditor. The decision in the case denotes that the term ‘creditors’ also includes secured creditors which is illustrated when the court said “There is nothing wrong, in principle, in liquidators bringing a claim such as this, even though only a secured creditor or secured creditor will benefit from it.” The legislation itself does not distinguish between secured and unsecured creditors.”<sup>231</sup>

This is because section 301 is regarded as misfeasance proceedings in which secured creditors are entitled to the fruits of the actions. Courts in the UK also reached the same conclusions when reliance is made on misfeasance cases but later shifted to preference cases as comparison.

Section 304(1) of the Malaysian Companies Act 1965 provides the power to the court to “declare that any person who is knowingly a party to the carrying on of the business in that manner shall be personally responsible, without any limitation of liability, for all of any of the debts or any liabilities of the company as the Court directs.” The section, however, does not indicate who shall benefit from the order.

Case law in Malaysia has stated that the proceeds of fraudulent trading are available to a specific creditor who brings the action and will not be for the benefit of all creditors; in line with the decision of Lord Denning M.R in *Re Cyona Distributors Ltd.*<sup>232</sup> There is no mention of secured creditors in these cases, but it is likely that they will be able to recover from the action since courts tend to give judgment to the creditor who brings an action. Hence, if a secured creditor brings an action under the section, there is no reason why the court will make an order of contribution for his or her benefit.

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<sup>230</sup> [2006] 3 NZLR 225, 234. The court made reference to O’Regan J’s essential pillars of section 135 in *Fatupaito v Bates* [2001] 3 NZLR 386.

<sup>231</sup> *Mason v Lewis* [2006] 3 NZLR 225 at 234.

<sup>232</sup> [1967] Ch 887.

Since section 304(1) originates from section 332 of the UK Companies Act 1948, reference will be made to the interpretation of the section. The Court of Appeal in *re Oasis Merchandising Services Ltd (in liq), Ward v Aitken and others*<sup>233</sup> mentioned that the effect of recoveries in fraudulent trading of the 1948 Act was to swell the assets of the company to be distributed in accordance with the statutory scheme. It is clear, therefore, that the contributions should be for the benefit of the general body of creditors. Lindsay J in *Re Esal (Commodities) Ltd*<sup>234</sup> held that sums recovered under section 332 of the 1948 Act in a way corresponded to recoveries of a liquidator from fraudulent preference as in the *Yagerphone* case.<sup>235</sup>

It is acknowledged that English cases are not binding but merely persuasive, and Malaysian Courts are not bound to adopt their decisions. However, it is important for the court to grant orders which reflect the aim and purpose of enacting the provision. It is submitted that since fraudulent trading involves the court lifting the corporate veil and holding those responsible for the act liable, there is a tendency of the court to grant orders for the benefit of the creditor who brings the action.

In doing so, courts have failed to take into account that the aim of the provision is to make directors accountable for their acts and to protect public money from unscrupulous directors. The only difference is that fraudulent trading in section 304(1) does not apply to a liquidation situation only, but could be invoked in any proceeding before the court. This, however, does not justify the court's awarding a remedy to a specific creditor because the aim is to make directors responsible for their acts and not as an avenue for creditors to bring action to satisfy judgment sums. Therefore, creditors who wish to enforce judgments or claim for any unpaid goods should bring a civil action rather than one under section 304(1).

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<sup>233</sup> [1997] 1 BCLC 689 at 701.

<sup>234</sup> [1993] BCLC 872 at 883.

<sup>235</sup> [1935] Ch 392.

In Australia, the statutory provisions state that one of the grounds for the court to order compensation is that it has to be satisfied that the debt is wholly and partly unsecured. It seems that the sums paid by directors should be for the benefit of the unsecured creditors. This has further been evidenced in section 588Y which clearly states that the fruits of compensation as a result of insolvent trading are to be distributed to unsecured creditors. Secured creditors will be able to benefit from the order only after all unsecured creditors have been paid off by the liquidator. Nevertheless, any creditor who was aware that the company was insolvent or would become so as a result of incurring debt, gets less priority than all the other unsecured creditors.<sup>236</sup>

In *Quick v Stoland Pty Ltd*,<sup>237</sup> the court explained the destination of the proceeds of the proceedings depends on the person who made the claim. The sums will form part of the company's estate and be available for distribution according to the law of distribution in insolvency if it is the liquidator who recovers, but if it is the creditor who claims, then he or she will retain the benefits of the action.<sup>238</sup>

### **11.3.8.1 Access to the Remedy**

The right to have access to legal redress is one of the important elements to ensure an effective law. Before the court can grant a remedy provided under the law, the person whose right has been affected must first bring the claim. It is not sufficient to have provisions which impose a duty on directors or any other person if they can not be brought before the court. There are many factors that must be taken into consideration by the person who has been given a right under the law to bring the action. Generally, a liquidator has the right to bring an action under the Act on behalf of all unsecured creditors, although in some statutes, creditors and contributories are given the same right.

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<sup>236</sup> Section 588Y of the Australian Corporations Act 2001.

<sup>237</sup> (1998) 29 ACSR 130 at 146.

<sup>238</sup> See also *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.

### 11.3.8.2

### Problems of Enforcement/Procedural

The most important factor which will influence the liquidator's decision whether to enforce the right under the Act is the question of the availability of funding. Since it is an expensive process to bring an action against a director for trading while insolvent, a liquidator will not commence the proceeding unless he or she is certain that the costs are recoverable.<sup>239</sup> In addition, the liquidator needs to consider whether there are funds available to pay costs of the other party should the claim fail.

In the UK, a liquidator can cover the costs under section 214 proceedings from the company funds since they are regarded as part of the liquidator costs and expenses, provided the liquidation takes place after 1 January 2003.<sup>240</sup> Due to lack of funding, a liquidator is forced to find other alternatives in order to fund the proceedings. The liquidator is unlikely to find assistance from the secured creditors on this matter since they are not going to benefit from the claims made. It is further complicated by the rules against maintenance<sup>241</sup> and champerty<sup>242</sup> as illustrated in *Re Oasis Merchandising Services Ltd.*<sup>243</sup> The court held that section 214 vested certain rights in the liquidator and these rights did not constitute the property of the company.

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<sup>239</sup> Andrew Keay "The Duty to Take Account of Creditors' Interests: Has It Any Role to Play?" (2002) JBL 379 at 389-393 ["The Duty"]; Richard Schulte "Enforcing Wrongful Trading as a Standard of Conduct for Directors and a Remedy for Creditors: the Special case of Corporate Insolvency (1999) 20 Co Law 80 at 87-88 Walters above n186 at 153-159; Hicks above n208 at 18; Andrew Keay and Michael Murray "Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" (2005) 14 Int. Insolv. Rev 27.

<sup>240</sup> See the UK Insolvency Rules 1985, r4.218(1)(a)(i) as amended by r23 of Insolvency (Amendment) (No 2) Rules 2002.

<sup>241</sup> Assistance or encouragement of proceedings by someone who has no interest in the proceedings nor any motive recognised by the law as justifying interference in the proceedings- see *Trendtex Trading Corp v Credit Suisse* [1982] AC 679.

<sup>242</sup> Form of maintenance in that assistance or encouragement of proceedings is provided in exchange for a promise to provide a share of the proceeds of the action. (An archaic doctrine which intends to stop a person from intermeddling in other's disputes where he or she has no interests - see *British Cash and Parcel Conveyors Ltd v Lamson Store Service Co Ltd* [1908] 1 KB 1006); see Schulte above n239 at 87-88; Walters above n186 at 153-159.

<sup>243</sup> [1995] 2 BCLC 493.

Accordingly, the fruits of the section 214 action were not capable of assignment under the power conferred on the liquidator.<sup>244</sup>

In contrast, the Australian Federal Court in *Re Motivator Pty Ltd (rec and mgr apptd) (in liq) v Sims*<sup>245</sup> concluded that a liquidator is empowered to enter into an arrangement with an insurer for an action against directors in which the insurer agreed to finance the proceedings in consideration of full reimbursement of the costs and a further 12% of the net recoveries, should the liquidator succeed. The court regarded the arrangement as one of the exceptions to champerty.<sup>246</sup>

Another source of funding which a liquidator can opt for, is to seek indemnities from creditors before commencing an action which any prudent liquidator would have resort to, prior to taking action under section 214. The court in *Re Exchange Travel (Holdings) Ltd (in liq) (No 3), Katz and Others v McNally and others*<sup>247</sup> did not regard the arrangement in which a major creditor agreed to finance the cost of proceedings as champertous. The reason for this was because it did not involve the fruits of litigation being carried on by the liquidator being sold to a party who had no interest in the litigation. Instead, it concerned a major creditor who was vitally interested in the proceedings and the arrangement was allowed.

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<sup>244</sup> The decision was upheld by the Court of Appeal in *Re Oasis Merchandising Services Ltd (in liq), Ward v Aitken and Others* [1997] 1 BCLC 689.

<sup>245</sup> (1995) 19 ACSR 440.

<sup>246</sup> One of the exceptions to the champerty rule is that the trustee in bankruptcy may lawfully assign any of the trustee's bare causes[?causes] of action on terms that the trustee receive a share of the proceeds of the litigation. The judge draws the same analogy to the liquidator's power in Corporations Law s477(2)(c): "A share in the fruits if an action belonging to an insolvent company is 'the property of the company' for the purpose of section 477(2)(c) Corporations Law, that section authorises the liquidator to make an arrangement to pay a percentage of such recoveries in return for assistance in running the action, because the section empowers the liquidator not only to sell but to otherwise dispose of in any manner any part of the company's property"- *Re Motivator Pty Ltd (rec and mgr apptd) (in liq) v Sims*(1995) 19 ACSR 440 at 451.

<sup>247</sup> [1997] 2 BCLC 579 at 588.

However, extracting promise of indemnities could be a difficult task because most creditors are reluctant to do so. Creditors' reluctance in this case is probably justified because the proceeds of such claim will have to be distributed among all unsecured creditors. Hence, creditors may in some cases find it is not to their advantage to provide indemnities.

The combination of both misfeasance and reckless trading remedies in the same section has proven to be problematic in New Zealand in the issue of distribution of the sums claimed. Courts have treated contributions made by directors to be part of the assets of the company and as such they are covered under a floating charge. The secured creditors, therefore, are able to recover the company's assets leaving the unsecured creditors often without any compensation.

Despite the objective of these provisions being mainly to protect creditors when the company's financial health is deteriorating, in most jurisdictions their rights to bring an action is either restricted or not available at all. In the UK, the right to bring an action under section 214 rests with the liquidator, and creditors have no other avenue to seek a contribution from directors should the liquidator decide not to proceed.

In Australia, creditors are allowed to take action against the director for breach of section 588G(2), subject to the restriction in section 588R. Creditors are required to wait at least six months after winding-up and to obtain a written consent from liquidator before they can proceed with their claim.<sup>248</sup> If the liquidator has commenced the proceeding under section 588M or wishes to bring a preference claim, then the creditor's right to take action is extinguished.<sup>249</sup> The approach seems appropriate in order to ensure there is no duplication of action against directors since a liquidator is also taking action on behalf of creditors of the company. This right nevertheless is not available to creditors in respect of the liability of the holding company for insolvent trading by its subsidiary under section 588V.

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<sup>248</sup> Section 588R of the Australia Corporations Act 2001.

<sup>249</sup> Section 588U of the Australia Corporations Act 2001.

In New Zealand, section 301 allows a liquidator, creditor or shareholder to bring an action, although in most cases sections 135 and 136 are invoked at times when the company is already wound up. The requirement that the company has to be in liquidation before the sections can be invoked may result in creditors whose companies are not wound up being left without compensation. Apart from taking action under section 301, shareholders have the right to bring a derivative action under section 165 in respect of a breach of sections 135 and 136. It is argued that if the action against directors is brought under section 165, their liability will be higher than if it is brought under section 301 because the courts do not have discretion to reduce the amount, unlike section 301.<sup>250</sup> Due to the discrepancy in the sums awarded, depending on which statutory provision is invoked, it has been suggested that the relevant factors for the court to consider should be the knowledge and conduct of creditors.<sup>251</sup>

Creditors are reluctant to take proceedings because they would have to pay into the company for distribution according to the insolvency rules. Hence, in most cases it is the issue of costs exceeding benefits obtained. In addition, a company may also bring an action for breach of section 135 against the director on the basis that he or she has breached a duty owed to the company.

In Malaysia, an individual creditor has a cause of action under section 304(1) which means that in order for all creditors to be compensated, multiple proceedings are unavoidable. This also indicates that only creditors with adequate means will be able to recover losses from directors since court proceedings are costly. In this situation, it can be argued that the objective to protect unsecured creditors is not met and some creditors may be precluded from receiving any compensation. In this regard, the Australian provision which requires a creditor to obtain a written consent from the liquidator before commencing a proceeding is preferable to prevent multiple actions.

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<sup>250</sup> Noonan and Watson above n117 at 42.

<sup>251</sup> Ibid.

In relation to an action against a holding company for the insolvency of its subsidiary, in Australia the right is vested solely in the liquidator. In New Zealand, the right to apply for a pooling order lies with the liquidator, creditors or shareholders.<sup>252</sup> When compared to the UK and Malaysia, creditors in Australia and New Zealand are in a better position because there are specific provisions in the statute, which requires in certain circumstances, that the holding company be liable for the debts of its subsidiary. Creditors in the UK and Malaysia, on the other hand, have to rely on the common law principle of lifting the corporate veil. Cases have shown that courts are reluctant to depart from the principle of separate legal entity except in cases where fraud exists.<sup>253</sup>

The requirement of liquidation before wrongful trading can be invoked, as in the UK, may prevent some creditors from getting compensation. This is because not all companies will end up in liquidation despite being hopelessly insolvent. In Australia, the company does not have to be in liquidation in order for section 588G to be used, but in calculating the amount of the award to be granted, courts have insisted on the link between recovery and liquidation.<sup>254</sup>

The condition which attaches to liquidation as a pre requisite to recover for compensation could prejudice the rights of creditors. This is because although in the majority of cases insolvency is followed by liquidation of the company, there are circumstances where the company may opt for other insolvency regimes such as administration or receivership. In this circumstance, directors could not be held personally liable under the Act and the protection it confers on creditors would not be available. Another aspect of this stipulation which may cause injustice is when liquidation intrudes; the company normally does not have enough assets to pay creditors in full. Hence it would grant more protection to creditors if the rights are

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<sup>252</sup> See section 271 of the New Zealand Companies Act 1993.

<sup>253</sup> See discussions in Chapter 5 of the thesis.

<sup>254</sup> Justin Dabner "Trading Whilst Insolvent- A Case for Individual Creditor Rights Against Directors" (1994) 17 UNSWLJ 546 at 568.

conferred on to them when the company is insolvent, but is not necessarily in liquidation.

The position of Malaysian fraudulent trading and insolvent trading requires a special mention here because of the deficiencies they inherited from the old English and Australian law. In 2004 there was a case which dealt specifically with fraudulent trading and, to date, there are only three cases on section 304(1). Two of these cases involve actions being brought by an individual creditor who wished to enforce judgment granted against the insolvent company. Another case involved a company taking action against its director for fraudulent trading and for breach of director's duty under section 132.<sup>255</sup>

To date, section 303(3) has never been used to impose liability on directors, rendering it useless. This is because civil liability in this section depends on a criminal conviction in section 304(3). Hence, creditors would have to depend on the prosecution of the action under section 304(3) before they have the right to compensation. Even when there is a prosecution against the director, there is no guarantee that conviction will ensue and since liability depends on successful conviction, creditors are left without any redress.

Another aim of imposing liability on directors is to ensure that they are responsible and accountable for their actions. Creditors, as well as members of the public, will benefit from it because, in order to avoid liability, directors will maximise their efforts to manage the company so that it is profitable. Even though the duty to prevent insolvent trading is mostly a civil liability, there is still a deterrent element which is in the interests of the public. For example, courts in the UK can, on their own initiative, refer directors who are liable under section 214 for disqualification under the Companies Directors Disqualifications Act 1986. (This topic will be explored in the next section). Likewise in Australia, the Australian Securities and

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<sup>255</sup> *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong* [2009] 1 MLJ 723.

Investments Commission is entitled to bring an action for criminal liability under insolvent trading.

### **11.3.8.3 Substantive Problems**

The liquidator may have difficulties in proving the elements required in the sections. One of the problems commonly faced by the liquidator is to determine the relevant time for the purpose of establishing when trading should have stopped.<sup>256</sup> It is important for a liquidator to determine the relevant time since it is closely connected with how the remedy is appraised.

Matters are further complicated if the insolvent company did not maintain and keep proper, as well as sufficient, financial information. The liquidator may, in these circumstances, find that he or she must find evidence to the satisfaction of the court that the company is insolvent. Nevertheless, the liquidator is equipped with statutory power to assist him or her in gathering evidence.

Once the liquidator takes charge of the assets of company, he or she can have access to all books, reports, records and other information. If necessary, the liquidator is empowered to ask for a court order to compel the person in charge of the company to surrender these documents. In addition, the liquidator has the power to seek required information from past or present officers or employees. However, the court may refuse to make an order if it feels that the liquidator has obtained sufficient information to make a decision on whether to proceed with further action and to order otherwise may prejudice the defendant's position in litigation.<sup>257</sup>

The main aim of these provisions is to provide protection to creditors in situations where they are most vulnerable, when the company is insolvent. By imposing a duty on directors to prevent insolvent trading, the legislatures hope to compensate creditors for losses or damage they suffered as a result of director's actions. This

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<sup>256</sup> Walters above n 186 at 148-152; Keay "The Duty" above n239 at 388.

<sup>257</sup> *Re Cloverbay Ltd* (No 3) [1990] BCLC 471; see also Hicks above n208 at 18.

section will analyse the extent protection is granted to creditors, and whether the unsecured creditors who need it the most really benefit from the imposition of such duty.

The basis for protection to be given to creditors is that they are vulnerable and the market is not sufficient to safeguard their interests, especially unsecured and involuntary creditors. In the UK, what actions constitute wrongful trading are not defined, the courts are concerned with director's knowledge of whether the company can avoid insolvent trading and if so what steps were taken to minimise the losses.

Therefore, if a certain action is committed on a creditor, and as a result of that, the company's insolvent liquidation is inevitable, a director has to take steps to minimise the potential loss to the company's creditors. It is submitted that the action could include a tort committed by the company. It is also important to note that the definitions of wrongful trading recommended by the Cork Committee were wide enough to cover all types of liabilities.<sup>258</sup>

As for New Zealand, the reckless trading provision concentrates on whether the manner in which business is conducted creates substantial risks of serious loss to creditors. Although the wording of the statute could include involuntary creditors, judicial decisions have indicated otherwise. This is apparent from the courts' insistence on a company's financial capability to generate profit in order to ascertain whether or not the risk taking is legitimate.<sup>259</sup>

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<sup>258</sup> Cork Report above n115 at [1806] "Responsibility for wrongful trading

(1) A company shall be trading wrongfully within the meaning of this section if:

- (a) any business is carried on with intent to defraud creditors of the company or creditors of any other person or otherwise for any fraudulent purpose; or
- (b) at a time when the company is insolvent or unable to pay its debts as they fall due it incurs further debts or *other liabilities* to other persons without a reasonable prospect of meeting them in full."

<sup>259</sup> *Re South Pacific Shipping Ltd (in liq); Lower v Traveller* (2004) NZCLC 263, 570; see also *Re Group Hub Ltd (in liq); The PC Company v Sanderson*, Unreported case HC Hamilton, CP 18-00 November 2001; Priestly J; *Re Gellert Developments Ltd; McCullagh & Anor v Gellert & Anor* (2002) 9 NZCLC 262, 942.

The position in Australia has clearly indicated that only contractual creditors are governed under the section. The courts in Australia have specifically excluded involuntary creditors from insolvent trading actions, and it is submitted that it produces a result that is inconsistent with the legislative drafting adopted by the statute.

Directors who breach the duty, will have to contribute towards the company's general funds and this will increase the chances of creditors getting paid. When the company is liquidated, the assets are often not enough to pay off all creditors in full, and contributions from directors in this event would have increased the general funds available for distribution. Although it is very unlikely that creditors will be paid in full, the distribution based on the *pari passu* principle would at least provide them some equitable distribution.

Another criticism on distribution is that the rewards are available for all past and present creditors when the real victims in this situation are those who become creditors after trading occurred. However, the overall effect of the wrongful/reckless/insolvent trading provision would be the reduction of the company's net assets and therefore it could be argued that all creditors will be affected because the likelihood of their obtaining their payment in full is doubtful. In Malaysia, the proceeds of the claim are not to be paid to the company but to the creditor who made the application, hence only the one who suffers losses will be compensated. Likewise in Australia, if a creditor brings an action under section 588M, then only he or she is entitled to the sums.

## **11.4 Disqualification of Directors**

### **11.4.1 The Statutory Provisions**

#### **11.4.1.1 Introduction**

This part of the thesis will look at director's disqualification as a consequence of his or her actions in the company. The analysis of this issue will focus on section 6 of

the UK Company Directors Disqualification Act 1986 (CDDA), section 385 of the New Zealand Companies Act 1993, sections 206C and 206D of the Australian Corporations Act 2001 as well as section 130A of the Malaysian Companies Act 1965.

In addition to these provisions, there are provisions which allow disqualification either automatically or by a court order on other grounds. Automatic disqualification is reserved for circumstances where the directors have been convicted of an offence or the company is bankrupt. Due to the constraints of the thesis, the discussion will only address issues relating to a director's conduct which resulted in the company's insolvency, and its effect on creditors.

#### **11.4.1.2 Statutory Provisions**

The disqualification of directors in the UK CDDA injects a public interest element for breach of sections 213 and 214 Insolvency Act 1986. The current law on disqualification of directors is provided for in the Company Directors Disqualification Act 1986 as amended by the Insolvency Act 2000 and the Enterprise Act 2002.

Section 6 of the CDDA 1986 provides that the court shall make a disqualification order if certain conditions are satisfied. The use of the word 'shall' in the provision indicates that the order is mandatory and the court has no discretion in the matter.

The elements are:

- a) The person is or has been a director of a company which has at any time become insolvent; and
- b) The director's conduct in that company either taken alone or taken together with his conduct in any other company or companies makes him unfit to be concerned in the management of a company.

Disqualification on the grounds of unfitness can also be made under section 8 if it appears to the Secretary of State as a result of an investigation of the company that it is expedient to protect the public from the director. The court also has the power on its own accord to make a disqualification order for up to a maximum period of 15 years against a director who has been ordered to make a contribution to the company.<sup>260</sup>

The Australian Companies legislation provides for disqualification of directors in a number of circumstances. The two circumstances relevant to the discussion of this thesis are stated in section 206C and section 206D. Section 206C allows the court to make a disqualification order on the application of ASIC for contravention of a civil penalty if a declaration has been made under section 1317E that the person has contravened a corporation/scheme civil penalty provision and the court is satisfied that the disqualification is justified.<sup>261</sup> In section 588G, disqualification of a director is one of the civil penalties for breach of trading whilst the company is insolvent, in addition to compensation and a pecuniary penalty discussed in the previous section.

The disqualification order can also be granted by the court if the person is an officer of two or more corporations which have failed within the last seven years.<sup>262</sup> The court must also be satisfied that the manner in which the corporation was managed wholly or partly contributed to the failure, and that the disqualification is justified.<sup>263</sup>

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<sup>260</sup> Section 10(1) of the UK Company Directors Disqualification Act 1986: "Where the court makes a declaration under section 213 or 214 of the Insolvency Act that a person is liable to make a contribution to a company's assets, then, whether or not an application for such an order is made by any person, the court may, if it thinks fit, also make a disqualification order against the person to whom the declaration relates."

<sup>261</sup> Section 206C(1) of the Australian Corporations Act 2001.

<sup>262</sup> See section 206D (1)(a) of the Australian Corporations Act 2001: "On application by ASIC, the Court may disqualify a person from managing corporations for up to 20 years if:  
(a) within the last 7 years, the person has been an officer of 2 or more corporations when they have failed; and..."

<sup>263</sup> See section 206D (1)(b) of the Australian Corporations Act 2001: "On application by ASIC, the Court may disqualify a person from managing corporations for up to 20 years if:  
(a) ...  
(b) the Court is satisfied that:

In New Zealand, the law on disqualification is contained in section 385 of the Companies Act 1993. Section 385 empowers a Registrar to prohibit a person from managing the company in relation to a company which is in insolvent liquidation:

- a) has ceased carrying on business due to its inability to pay its debts when they become due;
- b) has execution return unsatisfied in whole or in part;
- c) is in receivership; or
- d) has entered into arrangement or compromise with creditors.

The conditions that must be satisfied before a Registrar can exercise a disqualification order are provided in section 385(4) Companies Act 1993. The Registrar can invoke the section if within five years prior to the notice of disqualification, the person is a director or took part in the management of the company and is satisfied that the person is wholly or partly responsible for the company being in a state referred to in section 385(1) above.<sup>264</sup>

Alternatively, a Registrar can issue a notice of disqualification if he or she is satisfied that within five years before the notice given, the director is a person who took part in the management of two or more companies to which the section applies.<sup>265</sup> The director or the person responsible for the management of the company has a defence under the section if he or she can satisfy the Registrar that the mismanagement did not cause the failure<sup>266</sup> or that it would not be just and equitable to exercise the disqualification order.<sup>267</sup>

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- (i) the manner in which the corporation was managed was wholly or partly responsible for the corporation failing; and
  - (ii) the disqualification is justified."

<sup>264</sup> Section 385(4)(a) of the New Zealand Companies Act 1993.

<sup>265</sup> Section 385(4)(b) of the New Zealand Companies Act 1993.

<sup>266</sup> Section 385(4)(a)(i) of the New Zealand Companies Act 1993.

<sup>267</sup> Section 385(4)(a)(ii) of the New Zealand Companies Act 1993.

As a result of the recommendations by the Corporate Law Reform Committee (CLRC)<sup>268</sup> amendments have been made to section 130A. The current section states that the person must be a director of a company that went into insolvent liquidation<sup>269</sup> and is also a director of other companies which went into insolvent liquidation within five years of the first-mentioned company doing so.<sup>270</sup> Further, it must be shown that the director's conduct in the company makes him unfit to be concerned with its management.<sup>271</sup> This section is similar to section 300 of the UK Companies Act 1985 and, to a certain extent, to section 206D(1)(a) of the Australian Corporations Act 2001.<sup>272</sup>

Generally the disqualification provisions in all jurisdictions aim to prevent a director who is responsible for the company insolvency from acting in the same capacity in another company. As a result of this order, the public interest element has also been addressed since the public as well as the creditors are being protected from unscrupulous directors. Although the sections have the same intention and in most parts of enforcement are the same, there are some differences which it is essential to look into.

Section 6 of the UK CDDA 1986, deals with a person who is a director of an insolvent company who is deemed to be unfit for the management of the company. In the context of the section, insolvency relates to the liquidation of a company when

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<sup>268</sup> Malaysian Corporate Law Reform Committee "A Consultative Document on Review of Criminal, Civil and Administrative Sanctions in the Companies Act 1965" (2007) at [5.9-5.10] [CLRC "Sanction"]

<sup>269</sup> See section 130A(1) (a)(i) of the Malaysian Companies Act 1965.

<sup>270</sup> See section 130A(1) (a)(ii) of the Malaysian Companies Act 1965.

<sup>271</sup> See section 130A(1) (b) of the Malaysian Companies Act 1965.

<sup>272</sup> Similarity in respect of the court's authority to make a disqualification order against a person who was involved within the last seven (7) years in two (2) or more companies that have failed financially.- see section 206D(1) (a) of the Australian Corporations Act 2001.

its assets are insufficient to pay its liabilities,<sup>273</sup> or an administration order has been made,<sup>274</sup> or an administrative receiver has been appointed.<sup>275</sup>

The same can be said of the New Zealand provision which laid down the circumstances in which the disqualification provision can be used. In Australia, section 206D(1) empowers the court to make the order if it is satisfied that the manner in which the company was managed contributed to its failure, either wholly or partly. The meaning of the word ‘failure’ in this context is described in the following section 206D(2) and generally is similar to those circumstances listed by the UK and the New Zealand Act. In Malaysia, however, the application of the section is restricted to two or more companies which are in liquidation.

In New Zealand, section 385 gives powers to the Registrar to disqualify a person by giving him or her notice informing of such disqualification, if the Registrar is satisfied that the conditions listed in section 385(4) have been fulfilled. In contrast, the other three jurisdictions empower the court to make the disqualification order. In the UK, an application to the court can be made depending on the company’s situation, by the Official Receiver, liquidator, administrator or the administrative receiver.<sup>276</sup> In Australia, the power is exercised by ASIC<sup>277</sup> while, in Malaysia, it is

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<sup>273</sup> See section 6(2)(a) of the UK Company Directors Disqualification Act 1986.

<sup>274</sup> See section 6(2)(b) of the UK Company Directors Disqualification Act 1986.

<sup>275</sup> See section 6(2)(c) of the UK Company Directors Disqualification Act 1986.

<sup>276</sup> Section 7(3) of the UK Company Directors Disqualification Act 1986 – “If it appears to the office-holder responsible under this section, that is to say—

(a) in the case of a company which is being wound up by the court in England and Wales, the official receiver,

(b) in the case of a company which is being wound up otherwise, the liquidator,

(c) in the case of a company in relation to which an administration order is in force, the administrator,  
or

(d) in the case of a company of which there is an administrative receiver, that receiver.”

<sup>277</sup> Section 206C and section 206D of the Australian Corporations Act 2001.

exercised by the Registrar or the Official Receiver.<sup>278</sup> In addition, section 206F also empowers ASIC to disqualify a director for up to five years.<sup>279</sup>

The Australia and New Zealand Acts do not limit the disqualification to directors only, but to any person who manages the company. Even though section 206D mentions any officer and does not specify the person who manages the company, it is presumed as such because section 206D(1) states "disqualifying from managing the company." The UK and Malaysia, by contrast, only allow disqualification to be made against a director.

Section 6 of the CDDA applies to a director's conduct which is deemed unfit in relation to his or her action in a company taken alone, or in any companies. In Australia, the provision can be used in situations where a person has been a director of two or more companies which have failed within the last seven years. The same situation applies in the Malaysian legislation with only a slight difference in relation to the period of directorship, which is five years.

The New Zealand statute, on the other, hand combines both the UK and the Australian conditions and can be utilized if, within the period of five years, the Registrar is satisfied that the director or the person who took part in the management is responsible for the company's failure, either wholly or partly. This is almost

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<sup>278</sup> Section 130A(2) of the Malaysian Companies Act 1965—" An application under this section shall be made by the Registrar or the Official Receiver"

<sup>279</sup> Section 206F of the Australian Corporations Act 2001 empowers ASIC to disqualify for up to 5 years if :

- " (a) within 7 years immediately before ASIC gives a notice under paragraph (b)(i):
  - (i) the person has been an officer of 2 or more corporations; and
  - (ii) while the person was an officer, or within 12 months after the person ceased to be an officer of those corporations, each of the corporations was wound up and a liquidator lodged a report under subsection 533(1) about the corporation's inability to pay its debts; and
- (b) ASIC has given the person:
  - (i) a notice in the prescribed form requiring them to demonstrate why they should not be disqualified; and
  - (ii) an opportunity to be heard on the question; and
- (c) ASIC is satisfied that the disqualification is justified."

similar to section 6 of the UK CDDA in which only the director's unfit conduct in relation to the company is considered. The second situation which may warrant a Registrar to issue a disqualification notice is in a situation similar to Australia and Malaysia, by being a director of two or more companies which had failed. The burden of proof lies on the person to be disqualified that the manner the companies or company were managed did not contribute to the company's condition<sup>280</sup> or that it would not be just or equitable for the Registrar to exercise the power under the section.<sup>281</sup>

In order to utilize the disqualification provision in the statute, the most important criterion is to determine the conduct of the person in question in relation to the company. Although in this context different terms are employed, they generally refer to similar conduct. The UK CDDA 1986 and the Malaysian Companies Act 1965 use 'unfit to be concerned for the management of a company' while in Australia both sections 206C and 206D are applicable if the court is satisfied that the 'disqualification is justified.' The provision of section 206D is similar to the New Zealand section 385, in that it involves the manner the company is conducted which contributed either wholly or partly to the company's failure.

#### **11.4.2 Courts' Approach to Disqualification of Directors**

When interpreting the phrase 'unfit to be concerned with the management of the company,' case law in the UK seems to suggest that a distinction has to be made between conduct due to ordinary misjudgment in the course of business<sup>282</sup> and

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<sup>280</sup> Section 385(4)(b) (i) of the New Zealand Companies Act 1993: "that the manner in which the affairs of all, or all but one, of those companies were managed was not wholly or partly responsible for them being companies in relation to which this section applies."

<sup>281</sup> Section 385(4)(b)(ii) of the New Zealand Companies Act 1993: "that it would not just or equitable for the power to be exercised."

<sup>282</sup> *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 at 492, the Court regarded "Ordinary commercial misjudgment is in itself not sufficient to justify disqualification."

actions which are committed with a degree of culpability<sup>283</sup> or ignorance, undermining the principle of limited liability.<sup>284</sup>

A director could be held as unfit within the meaning of the Act if their conduct involved cynical exploitation of the privilege of limited liability either through disregard for proper responsibility, or gross incompetence.<sup>285</sup> The decision is consistent with *Re Bath Glass*<sup>286</sup> which calls for either culpability on the part of the director on the one hand or ignorance of the facts at the other extreme. In *Re Churchill Hotel (Plymouth) Ltd and others*<sup>287</sup> the court decided that gross incompetence is sufficient to prove unfitness without any breach of commercial morality. Thus, a director who failed to comply with the obligations to file audited accounts and annual returns, even if due to pressure of work, had committed misconduct.<sup>288</sup>

The public is entitled to be protected, according to *Re Stanford Services Ltd and others*,<sup>289</sup> against a director who has failed to appreciate or observe the duties within the limits of the privilege of limited liability, and not only of the most obvious breaches of commercial morality. As such, if a director allows a situation to arise

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<sup>283</sup> *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 at 492, the judge requires the display of “lack of commercial probity, although in extreme case of gross negligence or total incompetence.”

<sup>284</sup> This is also clear from the decision of *Re Bath Glass* [1988] BCLC 329 at 333 which stated “The court must be satisfied that the conduct in question must be sufficiently serious to lead it to the conclusion that the director is unfit and that is emphasized by the mandatory disqualification for at least two years to be imposed by the court if that conclusion is reached. To reach a finding of unfitness, the court must be satisfied that the director has been guilty of a serious failure or serious failures, whether deliberately or through incompetence, to perform those duties of directors which are attendant on the privilege of trading through companies with limited liability.”

<sup>285</sup> *Re Douglas Construction Services Ltd and another* [1988] BCLC 387.

<sup>286</sup> [1988] BCLC 329.

<sup>287</sup> [1988] BCLC 341 at 347.

<sup>288</sup> *Re Churchill Hotel (Plymouth) Ltd and others* [1988] BCLC 341 at 347.

<sup>289</sup> [1987] BCLC 607 at 619.

which results in a breach of his or her duty to be kept properly informed or to trade at the expense of the company or jeopardise money he ought not to use, he is unfit within the meaning of the section.<sup>290</sup>

Dillon LJ in *Re Sevenoaks Stationers (Retail) Ltd*<sup>291</sup> found that statements such as 'lack of commercial probity; 'extreme gross negligence' or 'total incompetence' may be helpful in identifying circumstances in clear cases of unfitness.<sup>292</sup> In other cases, it would result in obscuring the true question to be tried, which is the question of facts. Hence the phrase 'makes him unfit to be concerned in the management of a company' should be given the ordinary meaning of the English language.<sup>293</sup>

The Court of Appeal in *Secretary of State and Industry v Gray*<sup>294</sup> held that whether a person's conduct is "unfit" should be "viewed cumulatively, and taking into account any extenuating circumstances, [it] has fallen below the standards of probity and the competence appropriate for persons fit to be directors of companies." This judgment denotes an objective, reasonable person standard.<sup>295</sup> In *Re Living Images Ltd*,<sup>296</sup> the court had to decide whether giving preference constitutes unfitness and held that in order to justify the order for disqualification, the extent of the director's responsibility for the company giving it must be taken into account, namely it had to be shown that the director had acted in a way which was blameworthy. The courts are also required to have regard to matters mentioned in Part 1 of Schedule 1.<sup>297</sup>

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<sup>290</sup> *Re Stanford Services Ltd and others* [1987] BCLC 607 at 617.

<sup>291</sup> [1991] BCLC 325.

<sup>292</sup> *Re Sevenoaks Stationers (Retail) Ltd* [1991] BCLC 325 at 230.

<sup>293</sup> *Re Sevenoaks Stationers (Retail) Ltd* [1991] BCLC 325 at 239.

<sup>294</sup> [1995] 1 BCLC 276 at 284.

<sup>295</sup> See also *Secretary of State and Industry v Goldberg* [2004] 1 BCLC 597.

<sup>296</sup> [1996] 1 BCLC 348 at 357.

<sup>297</sup> See section 9 of the UK Company Directors Disqualification Act 1986.

The court has to deduce evidence of unfitness in relation to the relevant company only and not to look at his conduct in any other companies.<sup>298</sup> In *Re Barings plc (No 5)*, *Secretary of State and Industry v Baker*,<sup>299</sup> the court stated that it is not the test of ‘unfitness’ for the purpose of section 6 to take into account whether the director could have performed a management role elsewhere. The court, however, accepted that this could be a relevant factor in the context of application for leave in section 17 of the CDDA 1986.

In order to be disqualified under section 206C of the Australian Corporations Act 2001, after a declaration for contravention of section 1317E has been made, the court has to be satisfied that the order is justified. In determining whether disqualification is appropriate, the court will look at the person’s conduct in relation to the management, business or any property of the corporation, or any other factors which the court considers appropriate.<sup>300</sup> Therefore, matters which the court can take into consideration in its decision are non-exhaustive and not limited to the person’s conduct. Cases have indicated factors that the court can consider in deciding whether it is justified to make an order under sections 206C and 206D, including the nature of the breaches, interests of the creditors, shareholders and employees, the person’s intention or state of mind, the person’s appreciation of future breach, magnitude of loss, the period of continuation of series of breach, the deterrence factor and many others.<sup>301</sup> These considerations are also taken into account by the court to calculate the period of disqualification.

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<sup>298</sup> *Secretary of State for Trade and Industry v Gray* [1995] 1 BCLC 276.

<sup>299</sup> [1999] 1 BCLC 433 at 485.

<sup>300</sup> See section 206C(2) and section 206D(3) Australian Corporations Act 2001.

<sup>301</sup> *Australian Securities and Investments Commission v Maxwell* (2006) 59 ACSR 373; *Commissioner for Corporate Affairs v Ekamper* (1987) ACLR 519; *Australian Securities and Investments Commission v Edwards (No 3)* (2006) 75 ACSR 209; *Australian Securities and Investments Commission v Rich* (2004) 50 ACSR 693.

For disqualification under section 206D, in addition to the issues discussed in the preceding paragraph, the court has to ensure that the manner in which the affairs of the company or companies were conducted were what caused the failures.<sup>302</sup> The issue was explored in *Australian Securities and Investments Commission v Maxwell*,<sup>303</sup> where the court observed the causes of the company's liquidation and then determined whether they were aspects of the management of the company. The court concluded that the engagement in illegal fundraising, the application of loan moneys in payments other than to the particular project, the incurring of liabilities in excess of available assets and the resort to borrowing at very high interest rates were aspects of management which contributed to the ultimate insolvency, winding up and failure of the company.<sup>304</sup>

In Malaysia, the provision is relatively new, and it is submitted that since it is derived from section 300 of the UK Companies Act 1985, courts in Malaysia will adopt the UK decisions in their interpretation of the section.

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<sup>302</sup> Failures in this context refers to section 206D(2) of the Australian Corporations Act 2001: " For the purposes of subsection (1), a corporation fails if:

- (a) a Court orders the corporation to be wound up under section 459B because the Court is satisfied that the corporation is insolvent; or
- (b) the corporation enters into voluntary liquidation and creditors are not fully paid or are unlikely to be fully paid; or
- (c) the corporation executes a deed of company arrangement and creditors are not fully paid or are unlikely to be fully paid; or
- (d) the corporation ceases to carry on business and creditors are not fully paid or are unlikely to be fully paid; or
- (e) a levy of execution against the corporation is not satisfied; or
- (f) a receiver, receiver and manager, or provisional liquidator is appointed in relation to the corporation; or
- (g) the corporation enters into a compromise or arrangement with its creditors under Part 5.1; or
- (h) the corporation is wound up and a liquidator lodges a report under subsection 533(1) about the corporation's inability to pay its debts."

<sup>303</sup> (2006) 59 ACSR 373.

<sup>304</sup> *Australian Securities and Investments Commission v Maxwell* (2006) 59 ACSR 373 at [119].

### 11.4.2.1 Standard of Proof

Disqualification of directors under the Act is a civil action, and therefore the standard of balance of probabilities applies.<sup>305</sup> In *Re Living Images Ltd*,<sup>306</sup> it was explained, despite the application of the lower civil standard, cogent evidence is required by the court before a disqualification order under the UK CDDA can be made, because it deals with individual personal liberty. In addition, the Court has to be alert to the danger of hindsight when analysing the position of the company at the time and the signals available to directors in the period before the company had become insolvent.<sup>307</sup>

When a court makes a disqualification order under the CDDA 1986, a director is removed ‘off the market’ and this may have a deterrent effect on both the director in question as well as the future directors. The director who has been disqualified may be deterred from committing the same action again and his or her punishment may also serve as an example to others so that they are not tempted to do the same.<sup>308</sup> Hence, at first glance there seems to be no conflict between punishing a person and protecting public interests.

However, when a person is disqualified as a director, the law is also imposing a restriction on his personal liberty and this is the philosophy which causes tension with the public interest theory. The case of *Re Lo-Line Electric Motors Ltd*<sup>309</sup>

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<sup>305</sup> This is similar in all jurisdictions.

<sup>306</sup> [1996] 1 BCLC 348.

<sup>307</sup> *Re Living Images Ltd* [1996] 1 BCLC 348, 355-356 see also *Secretary of State for Trade and Industry v Gray* [1995] 1 BCLC 276.

<sup>308</sup> The same line of arguments is brought up in Australian case *Australian Securities and Investments Commission v Donovan* (1998) 28 ACSR 583 at [125-127].

<sup>309</sup> [1988] Ch 477; the court stated at 485-486 “What is the proper approach to deciding whether someone is unfit to be a director? The approach adopted in all the cases to which I have been referred is broadly the same. The primary purpose of the section is not to punish the individual but to protect the public against the future conduct of companies by persons whose past records as directors of insolvent companies have shown them to be a danger to creditors and others.

summed up the conflict between an individual's personal liberty and the right of the public to be protected from unscrupulous directors, and held that the individual right should prevail.<sup>310</sup>

From the discussions above, it seems that the personal liberty of the defendant is the first concern of the UK courts, notwithstanding that the aim of the legislation is to protect the public interest. In Australia, on the other hand, the court's focus seems to be on the protection of the public interest and in preventing the corporate structures from being used by individuals in a manner contrary to a proper commercial standard.<sup>311</sup> Protection of the public is also one of the factors that the courts will consider in order to determine the length of a disqualification order.

In *Australian Securities and Investments Commission v Vines*,<sup>312</sup> the making of a disqualification order would have to reflect the seriousness of the contraventions and considerations of the public, retribution and deterrence. In protecting the public from errant directors through disqualification orders, it also has the effect of deterring directors from abusing the privilege of limited liability, although it is not punitive.<sup>313</sup> This decision signifies that the purpose of disqualification is protection against present and future misuse of corporate structures, but it is important to note that it is not punitive in nature.

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Therefore, the power is not fundamentally penal. But if the power to disqualify is exercised, disqualification does involve a substantial interference with the freedom of the individual. It follows that the rights of the individual must be fully protected."

<sup>310</sup> This decision is also consistent with *Re Barings plc (No 5), Secretary of State and Industry v Baker* [1999]1 BCLC 433 which stated although the proceedings are civil, the burden is a 'heavy one.' The reason for that is that disqualification proceedings are serious in being, as is often said, of a penal or quasi-penal nature.

<sup>311</sup> *Australian Securities and Investments Commission v Donovan* (1998) 28 ACSR 583 at [125-127].

<sup>312</sup> (2006) 58 ACSR 298.

<sup>313</sup> *Adler v Australian Securities and Investments Commission* (2003) 46 ACSR 504.

### 11.4.2.2 Court's Order

Section 6 of the CDDA empowers the courts to impose a disqualification for a minimum period of two years and a maximum period of 15 years.<sup>314</sup> The court has to impose a mandatory minimum period of two years if the conditions laid down in the section are fulfilled.<sup>315</sup> Section 6(1)(b) entitles the court to order disqualification either by reference to a director's conduct as director of the insolvent company alone or by reference to his conduct of other companies as well. The section does not give the court discretion to refuse to make a disqualification order on the basis that the conduct of a director in relation to companies other than the insolvent ones is appropriate.<sup>316</sup>

The maximum period of disqualification a court can impose on a person who had been found liable to contribute to the company under section 213 or section 214 of the Insolvency Act 1986, is 15 years.<sup>317</sup> The difference between section 6 and section 10 in this aspect is under section 10, where the court, on its own initiative, can impose the disqualification order on the director and there is no mandatory minimum period of two years.

In Australia, section 206C does not provide any limitation on the period of disqualification. This is evident when the section merely states that "the court may disqualify a person" and does not impose any specific period. Thus, it is possible to impose a permanent disqualification on directors as seen in the case of *Australian Securities and Investments Commission v White*.<sup>318</sup> In contrast, under section 206D, the maximum period a court can disqualify a person is seven years as seen in the

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<sup>314</sup> Section 6 (4) of the UK Company Directors Disqualification Act 1986.

<sup>315</sup> *Re Bath Glass* [1988] BCLC 329 at 333.

<sup>316</sup> *Re Bath Glass* [1988] BCLC 329 at 333.

<sup>317</sup> Section 10(2) of the UK Company Directors Disqualification Act 1986.

<sup>318</sup> (2006) 58 ACSR 261; see also *Australian Securities and Investments Commission v Maxwell* (2006) 59 ACSR 373 where one of the directors was imposed with permanent disqualification.

phrase "the court may disqualify a person...up to 7 years." The New Zealand and the Malaysian provisions share the same period of disqualification, namely 'not exceeding 5 years,' as expressed in section 385(4) and section 130A respectively.

It can be seen from the period of disqualification a court can set on a person, that Australia has the strictest provision in situations where a declaration has been made for breach of a civil penalty provision including insolvent trading, which allows a court to impose a lifetime disqualification. The UK provision on disqualification for participation in wrongful trading in comparison only permits the maximum period of 15 years. Nevertheless, it is noted that the civil penalty provision in section 1317E consists of various circumstances and is not confined to insolvent trading only.

The English Court of Appeal in *Re Sevenoaks Stationers (Retails) Ltd*,<sup>319</sup> laid down guidelines or principles as to the length of disqualification, depending on the seriousness of the director's act. The court provides that the minimum bracket of two to five years should be reserved for cases which were relatively not serious. The top bracket of 11 to 15 years should be reserved for serious cases and the middle bracket of 6 to 10 years should apply to serious cases that did not deserve the maximum sentence.<sup>320</sup>

The Australian case of *Commissioner for Corporate Affairs v Ekamper*<sup>321</sup> indicated that the same principles should be applied when determining the appropriate length

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<sup>319</sup> [1991] BCLC 325at 328

<sup>320</sup> Dillon J in the case confirmed that non-payment of crown debts should not be treated as an automatic ground for disqualification and is no more serious than failure to pay any other debts. His Lordship thus reduced the period of disqualification from seven years to five years. The trial judge had found against the director for failure to make annual returns in respect of all the five insolvent companies when, in fact, only two companies were alleged to have failed to file such documents. Further, the Court of Appeal found that a much more serious error on the part of the trial judge was his failure to appreciate the allegation of failure to keep proper accounting records in respect of one company.

<sup>321</sup> (1987) 12 ACLR 519.

of disqualification.<sup>322</sup> However, these are only guidelines and each case should be decided on its own facts, and courts have wide discretion to impose the length deemed appropriate.

The director in *Re Stanford Services Ltd and others*<sup>323</sup> was disqualified for the period of less than two years (the case was decided under the old law in section 300 Companies Act 1985) for his part in the failure to pay the crown debts. The court did not consider the act to be a breach of commercial morality and that it should not be equated with actions such as trading using money which the director knew belonged beneficially to others or the misuse of the company money for improper purposes.<sup>324</sup>

In *Re Churchill Hotel (Plymouth) Ltd and others*,<sup>325</sup> the court declined to make a disqualification order despite the fact that the conduct of the directors in respect of the four companies' complaint had shown 'unfitness.' This is because the court had taken into consideration the fact that the director was successfully managing eight other companies. It should be noted that the case was decided under section 300 of the UK Companies Act 1985 which confers discretion on the court to make a disqualification order. This discretion, however, is no longer available and the court has to impose a mandatory two years disqualification once the person is found to be 'unfit' under section 6 of the CDDA 1986. Under the section, the court is only obliged to refer to the conduct of the director in respect of the company complaint and not to his conduct in relation to any other companies.<sup>326</sup>

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<sup>322</sup> See also Austin and Ramsay above n22 at [7.191].

<sup>323</sup> [1987] BCLC 607.

<sup>324</sup> *Re Stanford Services Ltd and others* [1987] BCLC 607 at 616.

<sup>325</sup> [1988] BCLC 341.

<sup>326</sup> *Re Bath Glass Ltd* [1988] BCLC 329.

In *Australian Securities and Investments Commission v Edwards (No 3)*,<sup>327</sup> a period of 10 years was imposed on a director who had failed to prevent the company from trading while insolvent in numerous occasions. The factors the court considered in the case were the defendant's knowledge, lack of contrition, amount of losses caused and conduct during the trial.<sup>328</sup>

Likewise, in *Australian Securities and Investments Commission v Vizard*,<sup>329</sup> the court reasoned that the period of disqualification should reflect the need to protect society from the kind of unlawful conduct engaged in by the defendant. The court considered that the defendant's general good character and his expression of remorse can only play a minor role in fixing the punishment for white crime offences, for it is often the good character which facilitates the breach.<sup>330</sup>

Case law has shown that, compared to the UK courts, the courts in Australia have a wider discretion to consider the relevant factors to be taken into account in deciding length of period of disqualification. This is because the courts in Australia are not confined to factors which are alleged in the affidavit, but can also include factors such as the conduct of the defendant during trial and lack of contrition. The courts in the UK, however, are only allowed to consider facts in respect of the alleged conduct in the notice given to the defendant and which have been established.<sup>331</sup> The

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<sup>327</sup> (2006) 57 ACSR 209.

<sup>328</sup> The same consideration was used by the court in *In Re Living Images Ltd*, [1996] 1 BCLC 348; the English court considered the director's educational background and the importance of seeking professional advice. It was found that the director ignored the expert's advice and disregarded the interest of creditors to continue trading. The director therefore was disqualified for six years.

<sup>329</sup> (2005) 54 ACSR 394, see also *Australian Securities and Investments Commission v Sydney Investment House Equities Pty Ltd* (2009) 69 ACSR 648; *Australian Securities and Investments Commission v White* (2006) 58 ACSR 261.

<sup>330</sup> In *Australian Securities and Investments Commission v Rich* (2004) 50 ACSR 693: the court considered the seriousness of the breach, magnitude of loss, the period of time the breach was committed, the objective of deterrence, the contrition expressed and the fact that the defendant did not make any personal gain, as relevant factors when imposing a period of disqualification.

<sup>331</sup> *Re Sevenoaks Stationers (Retails) Ltd* [1991] BCLC 325 at 331.

mitigating factors considered by the court in Australia would be relevant in the application for leave of the court

### 11.4.2.3 Consequences of Disqualification

The laws in all four jurisdictions are the same in terms of effects, the right to apply to court for leave and also the penalty imposed for acting without leave while disqualified. As a consequence of disqualification, a person could not become a director, or be a liquidator or an administrator or be a receiver or take part in any way with the promotion, formation or management of the company.<sup>332</sup> A director who has been subjected to a disqualification order has the right to apply for leave of the court under section 17 of the CDDA 1986.<sup>333</sup> The court can take into account

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<sup>332</sup> See section 1 of the UK Company Directors Disqualification Act 1986 “In the circumstances specified below in this Act a court may, and under section 6 shall, make against a person a disqualification order, that is to say an order that he shall not, without leave of the court—

- (a) be a director of a company, or
- (b) be a liquidator or administrator of a company, or
- (c) be a receiver or manager of a company's property, or
- (d) in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company,

for a specified period beginning with the date of the order.”

See section 206A(1) of the Australian Corporations Act 2001- “A person who is disqualified from managing corporations under this Part commits an offence if:

- (a) they make, or participate in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or
- (b) they exercise the capacity to affect significantly the corporation's financial standing; or
- (c) they communicate instructions or wishes (other than advice given by the person in the proper performance of functions attaching to the person's professional capacity or their business relationship with the directors or the corporation) to the directors of the corporation:
  - (i) knowing that the directors are accustomed to act in accordance with the person's instructions or wishes; or
  - (ii) intending that the directors will act in accordance with those instructions or wishes.”

See section 385(6) of the New Zealand Corporations Act 1993: “ No person to whom a notice under subsection (3) applies shall be a director or promoter of a company, or be concerned or shall take part (whether directly or indirectly) in the management of a company.”

See section 130A of the Malaysian Companies Act 1965: “...the Court may make order that that person shall not, without leave of the Court, be a director of or in any way, whether directly or indirectly, be concerned or take part in the management of the company....”

<sup>333</sup> Section 17(1)- “As regards the court to which application must be made for leave under a disqualification order, the following applies:

factors such as past conduct in relation to other companies, as well as those subsequent to liquidation.<sup>334</sup>

The same Act provides for a criminal penalty to be imposed on any person who fails to observe the disqualification period and such person will be liable on conviction to imprisonment of not more than two years or fine or both.<sup>335</sup> In addition, any person who acts as a director during the disqualification period without leave of the court is personally liable for all relevant debts of the company.<sup>336</sup> In Australia, a person who contravenes section 206A by managing corporations may be subjected to a fine of up to \$5,500 or imprisonment for one year or both.<sup>337</sup> New Zealand imposes a penalty of imprisonment not exceeding five years or a fine not exceeding \$200,000 on a person who has been convicted of an offence under section 385(9) which relates to acting as a director of a company or taking part in the management of the company while prohibited by the Registrar.<sup>338</sup> In Malaysia, for the same offence the penalty is imprisonment for three years or ten thousand ringgit or both.<sup>339</sup>

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- (a) where the application is for leave to promote or form a company, it is any court with jurisdiction to wind up companies, and
  - (b) where the application is for leave to be a liquidator, administrator or director of, or otherwise to take part in the management of a company, or to be a receiver or manager of a company's property, it is any court having jurisdiction to wind up that company."

For Australia, see section 206G of the Australian Corporations Act 2001; see section 385(7) of the New Zealand Companies Act 1993 and section 130A(1) of the Malaysian Companies Act 1965.

<sup>334</sup> *Secretary of State for Trade and Industry v Gray* [1995] 1 BCLC 276; *Re Bath Glass Ltd* [1988] BCLC 329; *Re Barings plc (No 5)*, *Secretary of State and Industry v Baker* [1999] 1 BCLC 433. *Re Living Images Ltd* [1996] 1 BCLC 348.

<sup>335</sup> See section 13(1) of the UK Company Directors Disqualification Act 1986.

<sup>336</sup> Section 15 of the UK Company Directors Disqualification Act 1986.

<sup>337</sup> Austin and Ramsay above n22 at [7.191]

<sup>338</sup> See section 373(4) of the New Zealand Companies Act 1993.

<sup>339</sup> See section 130A(6) of the Malaysian Companies Act 1965.

## 11.5 Other Remedies

### 11.5.1 Mareva Injunction<sup>340</sup>

A Mareva injunction can be a powerful tool in protecting a creditor.<sup>341</sup> It is a temporary measure which allows a court to restrain the company from removing its assets from the company pending the final disposal of a case. This pre-emptive remedy can be adapted in a situation where a company is insolvent prior to winding-up. This is illustrated in the case of *Fawziah Holdings Sdn Bhd v Metramac Corp Sdn Bhd*<sup>342</sup> where the Court of Appeal rejected an application by the plaintiff creditor for an order compelling the company to set aside monies to satisfy the plaintiff's claim in the event of a successful appeal, and instead ordered a *Mareva* injunction restraining the defendant from disposing of and dissipating assets up to the sums asked by the defendant.<sup>343</sup>

The court rejected the application to order the defendant to earmark a certain sum, because it would have the effect of creating a special fund in the plaintiff's favour to meet his unsecured debt. This order would then be ineffective in the event of winding up, since such fund will be void for undue preference.<sup>344</sup>

Another example of a Mareva injunction being used in favour of a creditor is illustrated in *Aspatra Sdn Bhd v Bank Bumiputra Malaysia Bhd*.<sup>345</sup> In this case, the defendant bank sued its director Lorraine for secret profits allegedly made while he

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<sup>340</sup> The term Mareva injunction is derived from the case of *Mareva Compania Naviera S.A v International Bulkcarriers S.A* [1980] 1 All ER 231.

<sup>341</sup> Mareva injunction has been described as one of the 'nuclear weapons of law' per Donaldson L.J in *Bank Mellat v Mohammad Ebrahim Nikpour* [182] Com.L.R. 158 at 159.

<sup>342</sup> [2006] 1 MLJ 435.

<sup>343</sup> [2006] 1 MLJ 435 at 444.

<sup>344</sup> [2006] 1 MLJ 435 at 443, The Court of Appeal distinguished the facts of the case from that in *Polly Peck International Plc v Nadir (No 2)* [1992] 2 Lloyd's Rep 238 because, in the instant case, the relationship between the plaintiff and the defendant was between a debtor and an unsecured creditor compared to fiduciary and a beneficiary.

<sup>345</sup> [1988] 1 MLJ 97.

was the director. The bank filed a writ against Lorraine for breach of fiduciary duty and at the same time applied for a Mareva injunction against Aspatra, a company which was effective or solely controlled by Lorraine, to prevent the company from dissipating its assets. The Supreme Court held that justice required the court to lift the corporate veil and was not prepared to interfere in the finding of the trial judge that Lorraine was the alter ego of Aspatra. Hence, the decision to grant a mareva injunction was upheld.

It is important for the creditor to show that the company will dissipate its assets and the court has to decide, on a balance of convenience, whether the order should be granted. However, if the company goes into liquidation after the order has been granted, the assets subject to the order will form part of the general funds. The creditor, therefore, will receive his or her payment according to the rule of distribution. In addition, unsecured creditors will take the assets subject to the right of any debenture holders.<sup>346</sup> This fact may deter some creditors from applying for a Mareva injunction since they have to bear the costs of proceedings while any benefit reaped from it will be shared with others.

Creditors may also face difficulties in finding evidence to support a claim that the company is dissipating its assets to their detriment.<sup>347</sup> In order to find such evidence, creditors need to know how the company is managed, information which they are not privy to. Further, creditors have to closely monitor the company in order to obtain such information and most creditors are unwilling to do so because it is not cost effective.

### **11.5.2 Misfeasance**

A liquidator who wishes to bring an action against a director for breach of duty in relation to the company may also seek to use the misfeasance proceeding provided

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<sup>346</sup> *Cretanor Maritime Co Ltd v Irish Marine Management Ltd* [1978] 1 W.L.R 966.

<sup>347</sup> See Lord Denning M.R in *Third Chandris Shipping Corporation v Unimarine S.A* [1979] Q.B 645 at 669.

for under the Act.<sup>348</sup> The action pursued under this proceeding is merely procedural and not a new cause of action but a right which a company has against the director prior to the winding-up.<sup>349</sup> Hence, the applicant would have to establish the wrongful act on the part of the director independent of the misfeasance action.<sup>350</sup> There must be actual loss to the company in respect of claim for misfeasance or breach of trust.<sup>351</sup>

Misfeasance covers a broad range of directors' duties which have existed under common law and companies' legislation, and thus, in the UK, the proceeds of these remedies are not specifically available to unsecured creditors.<sup>352</sup> The law in the UK and Malaysia in respect of the proceedings for misfeasance is generally the same. The section can be enforced against any officer, liquidator, administrative receiver or anyone who has taken part in the management of the company as well as any person who has taken part in the formation or promotion of the company.<sup>353</sup> In Malaysia, misfeasance proceedings are seldom used by liquidators to enforce a company's right against the director, but have been utilized against the liquidator for breach of duty.<sup>354</sup>

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<sup>348</sup> See section 212 of the UK Insolvency Act 1986 and section 305 (1) of the Malaysian Companies Act 1965. For New Zealand see section 301 of the Companies Act 1993.

<sup>349</sup> Nigel Furey "The Protection of Creditors' Interests in Company Law" in David Feldman and Frank Meisel (Eds) *Corporate and Commercial Law: Modern Development* (Lloyd's of London Press, London, 1996) 173 at 190; see also *Re Canadian Land Reclaiming and Colonising Co.; Coventry and Dixon's Case* (1880) 14 Ch. D 660.

<sup>350</sup> Keay "Company Directors Responsibility" above n208 at 271 citing Fidelis Odiah 'Misfeasance proceedings against the company directors' [1992] LMCLQ 207 at 208.

<sup>351</sup> *Re Peace Insurance Co Ltd* [1965] 1 MLJ 208.

<sup>352</sup> Contrast from section 213 and section 214.

<sup>353</sup> Note the slight difference in the application of the section, in Malaysia the section can be invoked against any person who has taken part in the formation or promotion of the company, while in the UK it applies to officer receiver and anyone who has taken part in the management of the company.

<sup>354</sup> *Sarawak Timber Industry Development Corporation v Borneo Pulp Plantation Sdn Bhd* [2005] 2 MLJ 74.

In New Zealand, misfeasance is governed by the same section, namely section 301, which also deals with remedy for sections 135 and 136. The section provides for two circumstances where courts can make an order. The first circumstance relates to a director who has misapplied, or retained, or become liable or accountable for, money or property of the company.<sup>355</sup> The second situation refers to a director who has breached his duties to the company and caused loss to the company generally.<sup>356</sup> In respect of circumstance one, the court may make an order to ‘repay or restore the money or property or any part of it with interest.’<sup>357</sup> The court also has the power to order to contribute ‘such sum to the assets of the company’ under section 301(1)(b)(ii) for the breach falls under circumstance two. Consistent with the law on misfeasance in other jurisdictions, an order made under circumstance one could be made directly to the creditor who has made the application as opposed to being made to the company for distribution according to *pari passu*.<sup>358</sup>

The Australian misfeasance proceeding is governed by section 598 of the Corporations Act which replaces the old section 305 in the Uniform Companies Act (UCA) 1961.<sup>359</sup> It covers various liabilities such as fraud, negligence, default, breach

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<sup>355</sup> Section 301 (1) of the New Zealand Companies Act 1993.

<sup>356</sup> Section 301 (1) of the New Zealand Companies Act 1993 states: "... or has been guilty of negligence, default, or breach of duty or trust in relation to the Company, the court may...."

<sup>357</sup> Section 301(1)(b)(i) of the New Zealand Companies Act 1993.

<sup>358</sup> See *Mitchell v Haskell* (1998) 8 NZCLC 216,559. The High Court made a distinction between the two circumstances and stated at page 261,662, "The irresistible inference is the reference to 'the money or property' (in section 301(1)(c) is a reference back to the money or property identified in the first circumstance in the main body of section 301(1) and repeated in section 301(1)(b)(i). No provision is made in section 301(1)(c) for the Court to order a payment by the directors to the creditor of any part of the general damages sum that may otherwise be ordered under section 301(1)(b)(ii)."

<sup>359</sup> Section 598 (2) states: " Subject to subsection (3), where, on application by an eligible applicant, the Court is satisfied that:  
(a) a person is guilty of fraud, negligence, default, breach of trust or breach of duty in relation to a corporation; and  
(b) the corporation has suffered, or is likely to suffer, loss or damage as a result of the fraud, negligence, default, breach of trust or breach of duty;  
the Court may make such order or orders as it thinks appropriate against or in relation to the person (including either or both of the orders specified in subsection (4)) and may so make an order against

of trust or breach of duty in relation to a corporation instead of referring to misfeasance like in the UK and Malaysia. The application for negligence under section 598 can be extended to common law negligence where the person concerned has not breach any fiduciary duty.<sup>360</sup>

Consequent to the application, the court may examine the conduct of the director, liquidator or officer and compel him or her to restore the money or property as the court thinks just, or to contribute such sums to the assets of the company by way of compensation.<sup>361</sup>

## 11.6 Conclusion

Cases have indicated that what constitutes unfitness depends on the circumstances and facts of each case. Directors who are in breach of their duty or commit actions resulting in loss to creditors are guilty of misconduct. The court can find ‘unfitness’ without the need to establish dishonesty or fraud because it is sufficient if a director is negligent or ignorant when committing the act. Despite the different wording of the statutes, cases in Australia have also pointed in the same direction, namely whether the person in question has committed a breach under the Act which causes losses to creditors. Due to similarities in their statutes as well as the motives underlying the passing of the provisions, it submitted that parallel decisions will be made by the Malaysian as well as the New Zealand courts.

Moreover, in the UK, disqualification orders set standards for directors’ conduct, and any person who falls below such standards will be punished. It will compel directors

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or in relation to a person even though the person may have committed an offence in respect of the matter to which the order relates."

<sup>360</sup> See *Property Force Consultants Pty Ltd* (1995) 13 ACLC 1051; *Daniels v Anderson* (1995) ACSR 607.

<sup>361</sup> See section 212 of the UK Insolvency Act 1986; section 305(1) Malaysian Companies Act 1965; section 598 (4) Australian Corporations Act 2001. Section 598 (3) (a)- (d) of the Australian Act states that "no order should be given unless the person has been given opportunity to give evidence and call witnesses."

to be accountable and to be responsible for their actions. Cases on disqualification have often been used to set the bar for the standard of care for directors. Romer J in *Re City Equitable Fire Insurance Company Ltd*<sup>362</sup> stated that directors were not required to possess any special skills or professional qualifications and could only be expected to exercise care and skill to a level commensurate with the knowledge and experience of the individual director. The effect of this decision is that incompetence is seen as a defence and the higher the skill a person has, the more likely he or she will be subjected to liability.<sup>363</sup>

Nevertheless, the standard of directors' skill and care has been raised further by virtue of section 174(2) of the Companies Act 2006. A director's skill and care is to be judged based on the objective standard expected from a reasonable person carrying out the same function and the subjective standards based on the particular individual's care and skill. The director's care and skill, therefore, will be determined on the higher standard of the two.<sup>364</sup>

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<sup>362</sup> [1925] 1 Ch 40 at 428-429.

<sup>363</sup> Eilis Ferran, *Company Law and Corporate Finance* (Oxford University Press, London, 1999) at 213-214.

<sup>364</sup> Section 174(2) of the UK Companies Act 2006: "This means the care, skill and diligence that would be exercised by a reasonably diligent person with—  
(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and  
(b) the general knowledge, skill and experience that the director has."

## CHAPTER 12 CONCLUSION AND RECOMMENDATIONS

### 12.1 Conclusion

Separate legal entity and limited liability intertwine at a point where it involves directors' act contrary to the interests of the company. Separate legal entity allows the person managing the company to hide behind the veil to avoid liability because the purported act belongs to the company which has its own personality. Limited liability on the other hand applies only to shareholders where their liability to contribute to the company's liability depend on the amount of unpaid on their shares.

Separate legal entity also provides opportunity for directors to act in their interests instead of shareholders. The law was developed then to impose duty on directors to act in the interests of the company. Shareholders are protected in this aspect because company's interests have been equated as their interests and hence any director who acts contrary to those interests may be personally liable. Furtherance the company's commercial success will nearly always be in the interests of the shareholders, but the conduct sometimes requires, for example, plant closure or the use of environmentally damaging production processes will often harmful other groups.

Although a company's success although in most cases refers to profit maximisation and in line with shareholders' interests, the primary concern of the directors should be the company and not shareholders. This will avoid conflict of interests among all stakeholders if directors are able to act solely for the best interests of the company as a firm. There will be circumstances where the company's interests may not be parallel to profit maximisation for example; a goal of short term profit maximisation implies conduct different in important respects from that required by a long term profit goal.<sup>1</sup> Long term profitability may depend on investing in research and development, capital equipment and training for example expenditure which will be avoided where the objective is to maximise profits only in the short term.<sup>2</sup> In respect

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<sup>1</sup> John Parkinson *Corporate Power and Responsibility Issues in the Theory of Company Law* (Clarendon Press, Oxford, 1993) at 90

<sup>2</sup> Ibid.

of creditors, the law generally treated them as outsiders who are capable of protecting their own interests although the law recognizes their interests when the company is insolvent or near insolvent.

The underlying theory views the shareholders as having an entitlement that the company be operated for their benefit (or for whatever other purposes they may choose) by virtue of their position as members or owners. The law respects the right of the shareholders to determine the objectives of their association through contracts and accepts that by virtue of their capital contributions they should be regarded as owners of the company. By reason of their ownership rights, and given the 'traditional logic of ownership', it is taken that the shareholders are entitled to have the company run in their interests; it is their company.<sup>3</sup>

However this theory is no longer relevant in a modern economy where a company is mostly viewed as production line and anyone who contributes towards the end/success of the company should have interests in it. The modern definition of capital includes a wide range of assets not necessary capital, employees' skill can be an asset to the company and so is creditors' loan. Directors are held liable for breach of their duty to the company. The law imposes a fiduciary duty on directors to act in the interests of the company and would be held liable even if no loss is suffered by the company. The duty is imposed solely on the ground that a director holds a position of trust and confidence and has breached that position.

Likewise in cases where corporate veil is lifted, directors lose the right to rely on the separate legal entity on the basis they have acted to injure the company, for example in cases where fraud is committed. In groups of companies, cases have shown that where the holding company exercises control over wholly owned subsidiary, courts have lifted the veil and held the holding company to be liable since the wrongful act was committed at the holding company's instruction.

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<sup>3</sup> Ibid, at 75-76.

The separate legal personality concept has been extended to the group of companies situation. New Zealand and Australia have taken radical step to ensure that holding company is liable for the debts of its subsidiary. The provision listed some factors which courts should take into account when ordering the holding company to be liable for the debts if its subsidiary. Although the UK and Malaysia do not have specific provisions, the factors court insisted on before an order is similar, namely the control exercised by the holding company over subsidiary.

Courts will insist on clear evidence that the subsidiary is totally controlled by its holding company and in case of partly owned subsidiary, courts are adamant to hold them separate. The New Zealand and Australian statutes allow directors of subsidiaries to act in the interests of its holding company provided that the subsidiary is solvent. New Zealand provisions also allow directors to act in the interests of the holding company even though it is not in the same interest of the subsidiary.

The courts have been reluctant to pierce the corporate veil to hold the person managing the company responsible for their actions although the courts show tendency to do so when fraud is involved. Relating to creditors' interests, courts only imposed a liability on directors for causing the company to trade when it is insolvent in the 1970's. Due to courts' reluctance to lift the veil, Parliament enacted legislation to impose liability on directors who have breached their duty when the company is insolvent.

The liability imposed on directors for trading whilst the company is insolvent originates from the common law concept of fraud. The current insolvency trading provision was enacted as a result of the difficulty of establishing intention for fraud cases. Parliament therefore extended the familiar concept of fraud to cover situations where directors are merely negligent or reckless.

Each jurisdiction has its own statute and due to the differences in the drafting of the provisions, the time liability can be attached to directors and the elements to be

proven varies. However, one common characteristic of each provision is liability accrues if the company's finance is unhealthy.

Once the company crosses the threshold from solvent to insolvent, and the company continues to trade, whether liability can be imposed depending on the directors' next cause of action. The UK provision requires directors to take positive steps once they knew or should have known the company could not avoid insolvent liquidation. In this circumstance, directors do not have clear guidelines as to what steps should be taken in order to avoid liability and there is a tendency for them to put the company into formal insolvency proceedings. Directors would not take the risk to continue trading in order to bring the company back to liquidity although the prospect to do so is high for fear of liability. Consequently, company with high chance of survival is put into liquidation.

Further, the purpose of insolvent trading should be to protect interests of parties involved as opposed to punishing errant directors or protecting public interests. It is important for this objective to be stated clearly in the provision so as to avoid the earlier confusion as illustrated in cases from the UK and New Zealand. In this aspect, the Malaysian courts have taken the right approach by ordering directors/persons responsible to compensate creditors for their losses.

## **12.2 Recommendations**

Directors have been held to be personally liable in situations where they have breached their duties to the company. The law as it stands now imposes an indirect duty on directors to consider creditors' interests when the company is insolvent or on the verge of insolvent. It is the extent to which the law is willing to compromise and it is very unlikely for both statutes and common law to impose duty on directors to consider the interests of creditors when the company is solvent. To do so means creditors would be able to interfere in the management decision because there is a possibility for creditors to object to the high risk project which will yield high returns to shareholders. The right for creditors to interfere in the management decisions is

deemed to be an alien concept to British company jurisprudence and culture and in this is also true in relation to Malaysia which shares the same structures and legislation relating to company. Therefore any reforms on the area of directors' duty should be made within the ambit of the existing law and would not involve any drastic changes to directors' duty.

The law in Malaysia in relation to whom directors' duties are owed have always been to the shareholders and only in 2009 in *Kawin Industrial Sdn Bhd (in liquidation) v Tay Tiong Soong*<sup>4</sup> that the court indicate there is a duty owe to creditors when the company is insolvent. The Malaysian Corporate Law Reform Committee (CLRC) agreed that a company must be a good corporate citizen and for the long term sustainability of the company, it must foster good relation with its stakeholders although the Committee did not agree to have such a duty incorporated into statute.<sup>5</sup> This reflected similar view to that of the Steering Committee and the traditional approach; that the duty is owed to the company and the interest of the company coincide with shareholders.

Another area which needs to be reviewed is in relation to duty of directors for fraudulent and insolvent trading. The current laws are based on the English Companies Act 1948 and the Australian Uniform Companies Act 1961-2, which the have since repealed. The Malaysian Corporate Law Reform Committee (CLRC) was of the view that the issue has been sufficiently dealt with and hence did not need any further amendments. However, it is submitted that the approach taken by the CLRC on this matter was inadequate and these provisions do not attract any problems probably due to their lack of usage.

In Malaysia, the fraudulent and insolvent trading provisions are governed by section 304(1) and section 303(3) respectively. The fraudulent trading provision imposes liability on 'any person who knowingly a party to the carrying on of the business'

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<sup>4</sup> [2009] 1 MLJ 723.

<sup>5</sup> A Consultative Document on Clarifying and Reformulating the Directors' Role Duties, Corporate Law Reform Committee at [4.7].

and is not limited to directors only. Further the action can be taken under the section if it ‘appears the business has been carried on with intent to defraud creditors or any person or for fraudulent purposes.’ Cases have indicated that the word appear connotes lower standard of proof namely a balance of probabilities and not the criminal standard of beyond reasonable doubt, despite the provision contains both criminal and civil liability.

The imposition of liability under the section is broader because it is not confined when the company is in liquidation only unlike the UK fraudulent trading. Earlier detection of fraud and ability to invoke the section without prior winding up is an advantage to creditors because the likelihood of being defrauded and consequently incurring losses. In contrast, in the UK, the section can only be invoked when the company has been wound-up which is sometimes too late to prevent losses to creditors. Hence, the provision should be retained although for clarity purposes there should be a separation between civil and criminal liability. This is despite courts ability to distinguish the difference of standard of care applicable to civil and criminal cases.

As for insolvent trading, section 303(3) of the Malaysian Companies Act 1965 imposes liability on ‘any officer of the company who was knowingly 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’. This provision is based on the Australian Uniform Companies Act 1961-2.

The insolvent trading provision can be used against any officer of the company which is wider than the UK, New Zealand and Australia provisions which are limited to directors. It is appropriate that liability should be extended to any officers of the company who has knowledge of the act and not only on directors because it will promote better governance of the company. The current law does not require the company to be insolvent before it can be used and therefore it can work as preventive measures to minimize further loss. In addition, directors are not required to take

positive action to minimize losses and company therefore can be traded with the view of returning the company's fortune. This is particularly important if the company is merely facing a temporary liquidity problem. To require otherwise would have pressured directors to put the company into premature liquidation.

As such, the main ingredients of the current framework should be retained. The provisions which apply to any officers instead of directors only and not limited to situation the company is in liquidation should be maintained. Likewise, the provision that directors are not required to take positive steps to prevent losses once the company is insolvent should not be amended. Nevertheless, the main drawback of the provision which requires immediate rectification is the condition that directors should first be convicted before any civil action could be taken. To date, this provision is not enforceable and is as good as not in existence. This is evident from the absence of any decided cases on insolvent trading.

Secondly, the provision should not be limited to contractual debts but to all types of losses suffered by creditors. Instead of contracting debts, incurring liability which is wider should be used.

Australia has the best model on insolvent trading and it is suggested the Malaysian statute should reform its law according to the Australian section 588G. The emulation of the Australian law does not involve many modifications since the current law is also based on the Australian Uniform Companies Act 1961-2. Apart from the prior conviction requirement and replacing contracting debts, it is proposed that the insolvency test to be used to determine liability as well as adopting the specific defences as in section 588H of the Corporations Act 2001.

The availability of specific defences is important for directors to decide on the next cause of action and to plan for the company's future. The requirement that directors should prove that the company was not insolvent or would not become one as result of contracting debts would encourage them to be well-versed and vigilant of

the company's operation which makes easier for them to detect any problem within the company. Directors are also expected to be involved in the preparation of the company's financial statements so that preventive measures can be adopted sooner.<sup>6</sup> Directors are placed with responsibility to be actively involved in monitoring the company's financial in order to ascertain the company's ability to pay for debts as they fall due.

Those who are not actively involved in the running of the business must ensure that proper and appropriate systems are placed for the purpose of determining company's financial status.<sup>7</sup> Directors are also expected to obtain appropriate advice from suitably, qualified and competent third party on the financial status of the company as well as the steps to be taken if the company is insolvent.<sup>8</sup> The engagement of the advice of expert professional to assist directors in the management of the company will be benefit everyone in the company including shareholders and creditors. The extent of the steps need to be taken by directors will depend partly on the circumstances of the company such as the size and complexity of the business.<sup>9</sup> In addition, skills and experiences of the company' management and staff are relevant for that purpose.<sup>10</sup>

The availability of these defences provides clearer guidelines to directors on steps to be taken. This can assist directors on their cause of action and provides for better corporate governance. In New Zealand, the court interpreted that directors are allowed to take risks in trading so long as it is legitimate and this has remove the misconception that company are not allowed to take any risks when the company is

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<sup>6</sup> Australian Securities & Investments Regulatory Guide 217, Duty to prevent insolvent trading: Guide for Directors, RG 217.29. <[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg217-29July2010.pdf/\\$file/rg217-29July2010.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg217-29July2010.pdf/$file/rg217-29July2010.pdf)> at 16 September 2010.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

insolvent. In Malaysia, there is no requirement for directors to take positive action to minimize loss to creditors so they can continue to trade in order to bring the company to liquidity without fear of liability. Hence, directors in Malaysia are less pressured to put the company into premature liquidation compared to their UK counterparts.

On the area of a subsidiary company acting in the interests of a parent company, the principle of separate legal entity should be upheld and directors of each company should act in the interest of its company. In cases the parent company has acted to the prejudice of subsidiary's creditors, it has long been established that in a wholly owned subsidiary, courts will lift the corporate veil and held that the two companies are in fact one.<sup>11</sup> The court has even gone further to hold that in certain circumstances, separate legal entity does not apply and the companies should be treated as one from the beginning.<sup>12</sup> In a partly owned subsidiary, courts have been reluctant to lift the veil in the absence of clear guarantee of liability from the parent company<sup>13</sup>. It is submitted that courts have dealt with the issues sufficiently and no amendments should be made in respect of the matter. For nominee directors, they can act in the interest of the holding provided there is no conflict of interest and the company is not insolvent at the time or is not insolvent as a result of the act.

The concept which keeps on emerging in relation to creditors' protection is the company's solvency. This is because creditors' main concern is the likelihood of getting paid on time and it is jeopardized if the company is insolvent. Directors too need to be aware of when the company's solvency status because their liability depend on it.

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<sup>11</sup> *Golden Vale Golf Range & Country Club Sdn Bhd v Hong Huat Enterprises Sdn Bhd (Airport Auto Centre Sdn Bhd & Anor as third party)* [2005] 5 MLJ 64; *Hotel Jaya Puri Bhd v National Union of Hotel, Bar & Restaurant Workers & Anor* [1980] 1 MLJ 109; *Law Kam Loy & Anor v Boltex Sdn Bhd* [2005] 3 CLJ 355.

<sup>12</sup> *Sunrise Sdn Bhd v First Profile (M) Sdn Bhd & Anor* [1996] 3 MLJ 533; *Kwan Chew Holdings Sdn Bhd v Kwong Yik Bank Bhd* [2006] 6MLJ 544.

<sup>13</sup> *JH Rayner (Mincing Lane) Ltd & Ors v Manilal & Sons (M) Sdn Bhd & Anor* [1987] 1 MLJ 312.

It is submitted therefore in addition to the imposing liability on director or any person managing the company for fraudulent and insolvent trading, the main shift of the Act that should be made is in respect of the solvency requirement. The Act should include the solvency test, namely whether at the time the act in question the company is insolvent or insolvency would ensue from it in any action affecting creditors. This solvency concept has been adopted in relation to company purchasing its own shares during the financial crisis in 1998. It has been included in section 67A of the Act that company is allowed to purchase its own shares provided the company is solvent at the date of the purchase and will not become insolvent by incurring the debts.<sup>14</sup> In other words directors should ensure that their action will not affect the company's solvency or that at the time the act was committed the company is solvent.

The global financial crisis has subjected companies to considerable stress and has exposed the weakness of international financial regulation. At the same time it has sharpened our awareness of the link between credit, liquidity and solvency. It is important that Malaysia has in place laws which reflect these links and monitor directors' and executives' conduct not only in the interests of shareholders and creditors but also in the interest of the economy as a whole.

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<sup>14</sup> See section 67A(2)(a) of the Malaysian Companies Act 1965.

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## APPENDIX 1

### REPLIES TO EXAMINERS

#### **Page 185- clear guidelines should be developed by the court to determine how solvency tests should be applied**

The Malaysian Companies Act 1965 provides that the court may order the winding up of the company under section 218(1)(e) if it is unable to pay its debts. The same Act defines inability to pay debts in three ways-<sup>1</sup>

- a) A creditor by assignment or otherwise to whom the company is indebted in a sum exceeding RM500 then due has served on the company by leaving at the registered office a demand under his hand or under the hand of his agent thereunto lawfully authorized requiring the company to pay the sum so due, and the company has for *three weeks* thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor;
- b) Execution or other proceed issue on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part; or
- c) 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.

The paragraphs above are to be read disjunctively and the company may be wound up by the court on any one of them.<sup>2</sup> Case law seems to suggest that the test applicable to situation (a) is based on commercial insolvency<sup>3</sup> while the proper test for situation (c) is the overall assets and liabilities test.<sup>4</sup> Nevertheless the court in *Syarikat Mohd Noor Yusof Sdn Bhd v Polibina Engineering Enterprise Sdn Bhd* (2008) 3 MLJ 692 (referred to in Chapter 8 – page 183 and page 185) held that the company was held to be solvent

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<sup>1</sup> See section 218(2) of the Malaysian Companies Act 1965.

<sup>2</sup> See *Teck Yeow Brothers Hand-Bag Trading Co v Maharani Supermarket Sdn Bhd* [1989] 1 MLJ 101.

<sup>3</sup> See *Hotel Royal Sdn Bhd v Tina Travel & Agencies Sdn Bhd* [1990] 1MLJ 21.

<sup>4</sup> See *Datuk Mohd Sari Datuk Nuar v Idris Hydraulic (M) Bhd* [1996] 3 CLJ 877.

since the company's paid up capital was higher than the amount claimed. It was a Court of Appeal decision and to date it is still good law.

For certainty of the law and fairness to parties it is essential for the court to have use of only one test to determine insolvency for the purpose of winding up. The current law is uncertain in that the court could have used any of the tests. In New Zealand the case<sup>5</sup> held that the cash flow test was the appropriate test to follow. This is due to the fact that it ties in with the relevancy test, namely no cash flow or poor cash flow means that the company could not pay its debts as they fall due. The law in Malaysia for a while looked certain with cash flow for (a) and balance sheet for (c). The decision in *Syarikat* has two implications:

1. The court may use a different test from the cash flow or balance sheet tests even though it may no longer be used in other jurisdictions and considered as out dated;
2. The effect of this is that it creates uncertainty as to which test is applicable for winding up and in doing so the court often does not take into consideration the size of the business.

There is also difficulty in deciding the relationship between solvency, insolvency and liquidity. The law at the moment is hard on small businesses which often have marginal solvency and have liquidity problems.<sup>6</sup> The law should also to take into consideration the size of the business. It would be ideal in the circumstances to have two separate company law systems- one for small medium business and the other for public listed companies.

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<sup>5</sup> *Commissioner of Inland Revenue v FB Duvall Limited* HC AK CIV 2007-4-4-2708 [2008] NZHC 1748 at [10].

<sup>6</sup> See discussion in the thesis in chapter 8 at page 171-172.

**Page 220-it is asserted that directors should be able to escape liability if they can show their decisions were made in good faith and for the benefit of the company and the concept is wide enough to cover all aspects of directors' duties.**

The duty referred to in this situation is in relation to creditors before winding up and what is suggested that directors should make decisions based in good faith for the benefit of the company. Benefit to the company should not be measured only in terms of profit but also the impact of the decision on the company's wellbeing.<sup>7</sup> Directors should be able to show that proper consideration has been given to all parties involved in the company. It is also important for a director not to take unnecessary risks and risk exposing the company to insolvency. This recommendation is made in relation to Malaysian law which at the moment has an ineffective insolvent trading provision.

In addition the Malaysian Companies Act 1965 has a provision on a business judgment rule<sup>8</sup> whose fundamental purpose is to protect the authority of directors in the exercise of their duties and to clarify their liability. The business judgment rule is aimed at facilitating legitimate business decisions and risk taking and thus encourages commerce.

By widening the application of the common law on this matter to take account of the creditor's interests it hoped that it would encourage directors to be more accountable for the company's financial situation and would improve the insolvent company's creditors by imposing liability on directors for breach of duty. It would also encourage directors to seek advice from competent professionals when financial difficulties are lurking. In the absence of any real deterrence, directors who owe very limited duties to creditors can

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<sup>7</sup> It is acknowledged that in New Zealand is not as such as illustrated in the case of *Robb v Sojourner* [2008] 1 NZLR 493 at [31] (CA). In the case, the Court of Appeal when deciding whether directors have breached their duty of good faith and to act in the best interests of the company looked at whether the sale of the assets of the company to an associated company was at fair value. Despite acknowledging the policy consideration which may favour the ring-fencing of losses and the setting up of the phoenix company to preserve a salvageable business, the court decided that the directors have breached their duty- "Directors who propose to adopt this course however should take care to ensure that the value paid by the phoenix is fair. This is likely to involve , at the very least, a contemporaneous independent valuation of the assets being acquired."

<sup>8</sup> See discussion in the thesis chapter 9 at 207-213.

engage in activities which may benefit shareholders while disadvantaging existing creditors who transact with the company.

**Page 221 the conclusion is offered that directors should not only have a duty to consider the interests of creditors throughout the life of the company (as part of the duty to act in good faith for the benefit of the company) but also suggests right of enforcement**

Malaysian law adopts Canadian law which gives locus standi to creditors (debenture holders) to apply for an order under section 181(1) on the ground that that the affairs of the company has been conducted in a manner oppressive to debenture holders. This section does not involve direct enforcement of breach of duty owed to the company and is predominantly used by minority shareholders.

The law in Malaysia as it stands now is full of contradictions and to date the full implication of section 181 has not been worked out. Since the provision is derived from Canada, it may be useful if reference is made to case law that allows and uses it. The Canadian Supreme Court in *BCE Inc. v 1976 Debenture holders*<sup>9</sup> which concerns the allegation by debenture holders that the directors had acted oppressively when they approved the sale of the company, had to consider the duties of directors in circumstances where their decision would benefit some but not all stakeholders. The court rejected the debenture holder's claim and held that the directors had considered the interests of the debenture holders and if they required better protection, they could require it by contract.<sup>10</sup>

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<sup>9</sup> 2008 SCC 69

<sup>10</sup> Ibid at [81]-[84].“ As discussed, conflicts may arise between the interests of corporate stakeholders *inter se* and between stakeholders and the corporation. Where the conflict involves the interests of the corporation, it falls to the directors of the corporation to resolve them in accordance with their fiduciary duty to act in the best interests of the corporation, viewed as a good corporate citizen.

The cases on oppression, taken as a whole, confirm that the duty of the directors to act in the best interests of the corporation comprehends a duty to treat individual stakeholders affected by corporate actions equitably and fairly. There are no absolute rules. In each case, the question is whether, in all the

## **What are the criteria for determining which creditor protection laws are best for Malaysia?**

Overall this is a question of public policy. Some aspects are focused on economic consideration and some are focused on fairness. From a drafting point of view Australian law is the most suitable in Malaysia because it is clear. The law clearly specifies defences and consequences despite it being draconian in nature. It is acknowledged that the best kind of law is clear but less strict. It is essential for the court to make specific orders in a particular situation. The law in Australia is clear but the consequence is too heavy. There are both civil and criminal penalties. The maximum financial penalty the court can impose is \$200,000 and at the same time the court can also impose personal liability on directors to compensate creditors. It is acknowledged that imposing both penalty and compensation is excessive for someone in financial difficulty.

The New Zealand law does not give clear guidelines to businesses and gives wide discretion to judges to decide. The Malaysian judges are not good at discretion and often are quite literal in their interpretation of legislative provisions. Hence it is important to have a clear law and which sets out the appropriate defences.

The consequences of insolvency can affect many parties such as creditors, shareholders, tax authorities and customers. The law attempts to balance the interests of these various groups who transact with companies in financial distress. At the same time the law

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circumstances, the directors acted in the best interests of the corporation, having regard to all relevant considerations, including, but not confined to, the need to treat affected stakeholders in a fair manner, commensurate with the corporation's duties as a responsible corporate citizen.

Directors may find themselves in a situation where it is impossible to please all stakeholders. The "fact that alternative transactions were rejected by the directors is irrelevant unless it can be shown that a particular alternative was definitely available and clearly more beneficial to the company than the chosen transaction": *Maple Leaf Foods*, per Weiler J.A., at p. 192.

There is no principle that one set of interests — for example the interests of shareholders — should prevail over another set of interests. Everything depends on the particular situation faced by the directors and whether, having regard to that situation, they exercised business judgment in a responsible way."

should also facilitate economic activities more generally by providing deterrent to irresponsible risk taking by directors and contributing to reducing perceptions of counterparty risk in the economy.<sup>11</sup>

The law performs a valuable public function in contributing to combating fraud and in maintaining and fostering ethical commercial behavior and standard.<sup>12</sup> The debtor's inability to pay its debts as they fall due can be a good indication that the debtor may not be able to repay any fresh debts it may incur.<sup>13</sup> Therefore insolvency is a strong indication that any person who transacts with the company during that time may be exposing themselves to increased risk of loss.<sup>14</sup> Such a person's resources would be better applied to activities involving less risk and contributing to economic growth.

Factors that adversely affect perception of credit risk within the market have also potential to adversely affect economic activities.<sup>15</sup> A decrease in the general level of confidence in market solvency may lead to creditors having negative perceptions of the company; the willingness to provide credit (through lending or provide goods and services on credit); the costs of credit and the conditions upon which credit is provided.<sup>16</sup> A clear solvency provision would be able to provide assurance that the company is solvent and would be able to meet its obligations.<sup>17</sup>

Insolvency law may contribute to reducing transaction and monitoring costs.<sup>18</sup> The imposition of liability helps to reduce monitoring costs because it would encourage directors to proactively monitor and address the company's financial position. In

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<sup>11</sup> <[http://www.treasury.gov.au/documents/1713/PDF/Insolvent\\_Trading\\_Safe\\_Harbour\\_DP.pdf](http://www.treasury.gov.au/documents/1713/PDF/Insolvent_Trading_Safe_Harbour_DP.pdf)> at [1.2] 23 September 2011; see also Roy Goode, *Principles of Corporate Insolvency Law* (Thompson, Sweet & Maxwell, 2005) at chapter 2; Vanessa Finch *Corporate Insolvency Law Perspective and Principles* (2<sup>nd</sup> ed, Cambridge University Press, 2009 at chapter 16; Rizwaan Mokal 'An Agency Cost analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain' (2000) 59 CLJ 335.

<sup>12</sup> Ibid, at [3.1]; Finch at 677.

<sup>13</sup> Ibid, at [3.2].

<sup>14</sup> Ibid, at [3.3]-[3.4].

<sup>15</sup> Ibid, at [3.3]-[3.4]

<sup>16</sup> Ibid, at [3.9]

<sup>17</sup> Ibid, at [3.9]-[3.10].

<sup>18</sup> Ibid, at [3.10].

addition it provides incentive for directors to seek independent financial advice.<sup>19</sup> It is also economically efficient since the imposition of liability may encourage directors to place the company into external administration and hence aid and facilitate the business rescue.

Companies with temporary insolvency or illiquidity may respond to the situation by taking some steps. The alternatives available to directors include negotiation with current creditors to delay or suspend payments, or obtaining fresh funding to restore solvency.<sup>20</sup> The fresh negotiation between parties provides an opportunity for them to decide on the allocation of risks.<sup>21</sup> Creditors with existing exposure to risk may decide to provide additional funding in order to mitigate the risk or those without existing risk may do so by determining the price of the funding they provide.<sup>22</sup> Companies unable to find funding may not be able to continue to trade but directors could in this circumstance place the company into external administration.<sup>23</sup>

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<sup>19</sup> Ibid, at [3.11].

<sup>20</sup> Ibid, at [4.1.2]- [4.1.5.]; Goode at [2-10]

<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

## Appendix 2

### Update on the recent case law

#### **De facto directors – referred to in thesis Chapter 9 at page 191**

*Re Kaytech International Plc* [1999] 2 BCLC 351 (CA) at 424- “ the issue was as whether the individual in question has assumed the status and functions of a company director as to make himself responsible...as if he were a de jure director ” .

*Secretary of State for Trade and Industry v Tjolle* [1998] 1 BCLC 333 (Ch) at 343-344- “the issue was the individual part of the corporate governing structure”

See also *Commissioners for Her Majesty’s Revenue & Customs Ltd v Holland* [2010] 1 WLR 2793 (UKSC).

For New Zealand cases; see *Clark v Libra Developments Ltd* [2007] 2 NZLR 709 (SC) where the Majority of the Court of Appeal applied *Re Hydrodam (Corby)* [1994] 2 BCLC (Ch) 180. For Australian cases; see *Emanuel Management Pty Ltd (in liq) v Foster’s Brewing Group Ltd*[2003] 178 FLR 1 at [257]- the key feature of of de facto directorship is that an individual is “properly regarded as part of the governing structure of the company’ See also *Commissioner of Taxation v Austin* (1999) 28 ACSR 565.

#### **Shadow directors- referred to in thesis Chapter 9 at page 191**

See *Lord v Sinai Securities Ltd* [2004] EWCH 1764 (Ch); *Ultraframe (UK) Ltd v Fielding* [2005] EWH 1638 (Ch); *Buzzle Operations Pty (in liq) v Apple Computer Australia Pty Ltd* [2010] NSWSC 233-the cases describe how a company can be a shadow director. There is also no requirement that all directors of a multi-member board must follow a shadow director’s directions or instructions. The act of a governing majority is sufficient.

See also *Secretary of State for Trade and Industry v Deverell & Anor* [2000] 2 All ER 365; for New Zealand; see *Krytolica v Westpac Banking Corporation* [2008] NZCLC 24 (HC)

See also Lynne Taylor '*Expanding the Pool of Defendant Directors in a Corporate Insolvency: De Facto Directors, Shadow Directors and Other categories of Deemed Directors*' (2010) 16 NZBLQ 203- the article surveys the scope of definition of 'directors' in section 126 of the New Zealand Companies Act 1993 and make comparison with the equivalent definitions in the Australian Corporations Act 2001 and the UK Companies Act 2006. The paper also look at the implications of the wide definition under the Act on duties and potential liabilities of deemed directors under the New Zealand Companies Act 1993. The paper concludes that the cases in respect of identifying de facto and shadow directors are not as developed as in the UK and Australia. Nevertheless there is likelihood that the New Zealand courts will have regard to the overseas' developments if and when future cases are brought before them.

### **Receivership- referred to in thesis Chapter 11 at page 308**

A receiver generally owes his or her duty to the debenture holder who makes the appointment. However, the UK Enterprise Act 2002 made amendments to the Insolvency Act 1986, as a result of which substantial reforms have been made. Section 176A(2) of the Insolvency Act 1986 provides that when the assets of the company subject to floating charge are realized, a certain proportion must be set aside for the unsecured creditors. It is possible to vary the rule in subsection (2) by means of voluntary arrangement or a compromise or an arrangement.<sup>1</sup>

See also *Re Hydroserve Ltd* [2007] EWHC 3026 (Ch); *Re Counts* [2009] 1 WLR 1499; *Re Permacell Finesse* [2007] EWHC 3222(Ch); *Re Airbase (UK) Ltd* [2008] 1 WLR 1516

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<sup>1</sup> See section 176A(4) of the UK Insolvency Act 1986

The New Zealand Receivership Act also imposes duty on people other than the debenture holder.<sup>2</sup> The receiver is required under the section to exercise his or her power in good faith and for proper purpose.<sup>3</sup>

### **Insolvency Test - referred to in thesis Chapter 8 at Page 175**

Section 4 of the New Zealand Companies Act 1993 requires that both the balance sheet and the cash flow tests are complied with for the general purpose of the Act. However see also *Commissioner of Inland Revenue v FB Duvall Limited* HC AK CIV 2007-4-4-2708 [2008] NZHC 1748 at [10] where the court stated ‘ In determining whether the liquidation of a company can be justified under section 241(4)(a), it is the cash flow test that counts.’”

### **Third party Litigation funding- referred to in thesis Chapter 11 at page 64**

Development in Australia

*Campbells Cash and Carry Pty Limited v Fostif Pty Ltd* (2006) 229 CLR 386 at [93] -The majority 5:2 decision held that it is not contrary to public policy under Australian law for a funder to finance and control litigation in the expectation of profit and that litigation funded on this basis does not amount to an abuse of the court’s process.

See also *Sons of Gwalia Ltd v Margaretic* (2007) 231 CLR 160; *Jeffery & Katauskas Pty Limited v SST Consulting Pty Ltd* (2009) 239 CLR 75; *Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd* (2009) 180 FCR 11; *Green (as liquidator of Arimco Mining Pty Ltd) v CGU Insurance Ltd* (2008) 67 ACSR 105

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<sup>2</sup> See section 18 (3) of the New Zealand Receivership Act 1993; see also section 19 of the same Act.

<sup>3</sup> See section 18(1) of the New Zealand Receivership act 1993. In exercising good faith and proper purpose, the receiver must act in a manner he or she believes on reasonable ground to be in the interest of the person who appoints him or her- see section 18(2) of the same Act.

Most jurisdictions in Australia have enacted statutes which abolished the criminal and tortious consequences of the doctrine of maintenance and champerty- See s 221 of the *Civil Law (Wrongs) Act 2002* (ACT); sections 3, 4, 6 of the *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW); Sch 11 section 1(3) and section 3 of the *Criminal Law Consolidation Act 1935* (SA); section 32 of the *Wrongs Act 1958* (Vic) and section 322A of the *Crimes Act 1958* (Vic).

The amendment in 2006 to the New Zealand Companies Act 1993 says that a new section 260A is to be inserted. The section allows the liquidator to assign the right under the Act to sue<sup>4</sup> and the application must be made to the court either by the liquidator or the person to whom the right is to be assigned.<sup>5</sup>

### **Remedies referred to in thesis chapter 11 at page 345**

Breach of sections 135 and 136 give claims under section 301 of the Companies Act 1993.

*Lewis v Mason* (2009) 10 NZCLC 264,545- the case referred back to the High Court following the successful claim by the liquidator against the Lewis's in the Court of Appeal. The High Court then made orders under sections 300 and 301 of Companies Act under which Mr Lewis was ordered to pay \$1,261,330 and Mrs Lewis paid \$983,100 as a contribution to the debt of the company (Global) under section 300(1). In addition, Mr Lewis was made to pay \$ 1,168,330 and Mrs Lewis \$890,100 by way of compensation to Global.

In its decision, the Court of Appeal held that the section 301(1) order ought to have required contribution to the assets of the company itself to reflect the fact that both directors have breached their duties owed to the company and not to its creditors.<sup>6</sup> As such the court held that it was untenable for the Lewises to argue that they could have done nothing in this case for they could have in the circumstances "obtain advice on how

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<sup>4</sup> See section 260A(1) of the New Zealand Companies Act 1993.

<sup>5</sup> See section 260A(2) (a) of the New Zealand Companies Act 1993.

<sup>6</sup> *Lewis v Mason* (2009) 10 NZCLC 264,545 at [117]

to manage the dire financial position into which the company had fallen. They could have resolved that the company would stop trading. They could have taken steps to ensure further debts were not incurred in circumstances where the company was not able to pay them. The reality is they took no meaningful action at all. They cannot throw their hands in the air and say it was not their fault.<sup>7</sup>

On the issue of whether the High Court had erred in the assessment of culpability, the Court of Appeal rejected the claim and held that “ the Judge had acknowledged lack of dishonesty on the part of the Lewises, and was entitled as a balancing factor to take into account their steadfast refusal to acknowledge fault and their lack of remorse. There is nothing to indicate that the Judge improperly weighed those matters in the balance: indeed, he was careful to exclude any punitive element from his assessment of the amount payable under section 301.”<sup>8</sup>

See also *Goatlands Ltd (in liq) v Borell* 14/12/06 Lang J, HC Hamilton CIV-2005-419-1643; distinguished from *Vance v Lamb* 2/12/2008 ,Mackenzie J HC Wellington CIV-2007-485-342; *Jordan v O’ Sullivan* 13/5/08 Clifford J, HC Wellington- CIV 2004-485-2611; *Krtolica v Westpac Banking Corporation* [2008] NZCLR 24

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<sup>7</sup> Lewis v Mason (2009) 10 NZCLC 264,545 at [82]

<sup>8</sup> Lewis v Mason (2009) 10 NZCLC 264,545 at [84]-[98].