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Liabilities of Directors under Malaysian Insolvency Laws and Recovery of Assets During Corporate Insolvency

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ABSTRACT

Under the legal regime governing Malaysian companies, insolvency is defined as a state of affairs where the company is unable to meet its financial obligation namely to pay its debt. A board of director is usually entrusted with the responsibilities. Liabilities can in certain circumstances be attached to the directors when the company goes into liquidation. In such situation, the rights of creditors emerge which gave rise to legal issues in relation to duties of directors to creditors. These liabilities can take in the form of personal liabilities for all of the debts or some forms of debts of the company. The director can also be held criminally liable for any failure to observe statutory requirements or for dishonesty and fraudulent conduct with respect to the company. This paper will evaluate the extent of the directors' duties and liabilities during insolvency and issues on recovery of assets and claims by creditors during insolvency.

ABSTRAK

Di bawah regim perundangan berkaitan syarikat di Malaysia, insolvensi ditakrif sebagai suatu keadaan apabila syarikat itu tidak berupaya untuk memenuhi obligasi kewangan atau dalam ertikata lain kegagalan untuk membayar hutang. Lembaga pengarah dipertanggungjawab dengan tanggungjawab tertentu dan dalam keadaan tertentu. Pihak pengarah boleh dikenakan liabiliti apabila syarikat diletakkan di tahap penggulungan. Dalam situasi sedemikian, hak-hak para kreditor akan berbangkit yang mewujudkan isu-isu perundangan tentang tanggungjawab pengarah terhadap para kreditor. Liabiliti ini boleh juga dikenakan liabiliti dari segi jenayah bagi kegagalan untuk mematuhi syarat keperluan yang ditetapkan di bawah statut. Antara liabiliti jenayah yang boleh berbangkit adalah tidak ketidakjujuran dan penipuan yang dilakukan terhadap syarikat. Makalah ini akan membuat penilaian yang kritis tentang setakat mana liabiliti pengarah semasa insolvensi dan isu-isu berkaitan tuntutan aset dan tuntutan oleh kreditor semasa insolvensi.

INSOLVENCY REGIME IN MALAYSIA

In Malaysia, insolvency laws can be regarded as both formally and practically concerned with the collection of debts and the protection of creditors. Insolvency law in Malaysia is designed to help creditors enforce their rights, recover their debts and protect their interests. Primarily, Malaysia has a creditor-focused system. The core of the legislative regulation of corporate insolvency in Malaysia consists of the Companies Act 1965 (revised in 1973) which came into force on 15th April 1966 and the Companies Regulation 1966. The Act was modelled on the English Companies Act 1948 and the Australian Uniform Companies Act 1961. The history and development of company law in England and Australia have therefore had a great impact on the development of the legal principles of Malaysian company and insolvency law. It is also vital to note that Malaysian does not have a specific legislation on insolvency unlike the Insolvency Act 1986 in United Kingdom.

The law governing company insolvency is distinguished from the law of personal bankruptcy, which is governed by the Malaysian Bankruptcy Act 1967 and the Bankruptcy Rules 1969. As in the United Kingdom, Malaysian law differentiates between the winding-up of companies and the bankruptcy of individuals. The terms 'liquidation' and 'winding-up' must not be confused with 'bankruptcy'. Bankruptcy only applies to individuals whereas companies are wound up. The rules of bankruptcy are contained in the Bankruptcy Act 1967, whereas liquidation is governed by the Companies Act 1965. In some instances, however, the Companies Act incorporates provisions of the Bankruptcy Act and applies them to the winding-up of companies. For example, sections 292 and 293 of the Companies Act are incorporated provisions from the Bankruptcy Act which governs the recovery of preferences and undue preferences from creditors.[1]

There are three basic types of insolvency measures. Firstly, creditors have the facility of appointing a receiver and manager.[2] Secondly, an application may be made to the court for a winding up order under three different heads: members' voluntary, creditors' voluntary and winding-up by the court.[3] In addition, in Malaysia, there is potential for making an arrangement to restructure a company.[4] Malaysia does not have any legal provision for the judicial management of companies, unlike in England, where two further measures exist: that are (a) administration,[5] which affords a company, in a potentially insolvent position, as an alternative to automatic liquidation, including the possibility of securing the company's survival.

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[1] Section 292 of the Malaysian Companies Act 1965 deals with such preferences. This section incorporates the provision of section 53 of the Malaysian Bankruptcy Act 1967, by giving the liquidator the power to recover the value of certain pre-liquidation dispositions of the company's property from creditors. Under section 292, dispositions of the company's property made after the commencement of a compulsory winding up are void. In some instances the liquidator of an insolvent company is able to recover dispositions of property made by the company before the commencement of winding up.

[2] Part VIII of the CA 1965.

[3] Ibid., Part X.

[4] Ibid., Part VII.

[5] Part I of the Insolvency Act 1986 (UK).

(b) Another mechanism in England, is a company voluntary arrangement[6] which is pre-insolvency measure leading to creditors being consulted in order to assist in the restructuring of a company.

The impact of insolvency on contractual rights, property rights and equitable interests created pressing legal as well as social issues. Many jurisdiction undertook a fundamental reassessment of their laws relating to insolvency and after various inquiries substantial legislative reforms were enacted.[7]

The Harmer Report identified the following as the major principles in the development of a modern insolvency law:-

1. The fundamental purpose of an insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvent companies.
2. Insolvency law should provide mechanisms that enable both debtor and creditor to participate with the least possible delay and expense.
3. An insolvency administrator should be impartial, efficient and expeditious.
4. The end result of an insolvency administration is the effective relief or release from the financial liabilities of the insolvent.
5. Insolvency law should support the commercial and economic processes of the community.

As in England[8] and Australia, the objective of insolvency law in Malaysia, apart from that of protecting creditors, is to provide a mechanism by which the cause of an insolvency can be identified; and those found guilty of mismanagement are punished, and where appropriate, deprived of their right, through disqualification, from being involved in the management of other companies.

PROVISIONS ON DIRECTOR'S DUTIES AND LIABILITIES DURING INSOLVENCY

Although the Malaysian Companies Act 1965 does not specifically state that directors owe a duty to creditors during insolvency, or when a company goes into liquidation, several sections impose certain standards upon directors which have a positive knock-on effect on the creditors *vis-a-vis* protecting

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[6] Ibid., Part II.

[7] In United Kingdom the *Report of the Review Committee on Insolvency (The Cork Report)* was released in 1982. In Australia, the Australian Law Reform Commission's Report No 45: General Insolvency Inquiry (The Harmer Report) was published in 1988.

[8] See the *Report of the Insolvency Law Review Committee, Insolvency Law and Practice*, paras. 191-199.

their interests. These include provisions which are aimed at preventing directors from diminishing the company assets in such a way which may prejudice the company's creditors and unfairly favour other parties. These are known as the 'avoidance provisions,' which consist of the preference rule and the provisions governing directors liability to creditors. Apart from that, other provisions include fraudulent trading, wrongful trading liability for misfeasance and disqualification of directors.[9]

THE APPLICATION OF THE PREFERENCE RULE IN MALAYSIA

The preference rule operates so as to prevent a creditor from jumping to the front of the queue of the general unsecured creditors, all of whom should be paid equally and to ensure that 'an undignified scramble by creditors over available assets'[10] is avoided.[11] The essence of a preference is that a creditor has received more from a company before it goes into liquidation than they would have otherwise received on liquidation. In Common Law, the true test of a preference is, whether the transaction confer a priority or an advantage on a creditor in relation to the past indebtedness of the company. Further, whether the advantage given is at the expense of other creditors who owed debts at the time of the transaction, thus preventing an equal distribution of the company's property amongst the unsecured creditors? Professor Weisberg[12] put it well when he said that a preference is:

> ...a transfer of money or of some interest in property by a debtor to a creditor to settle an antecedent debt: it occurs when the debtor faces imminent bankruptcy (or liquidation) and it benefits that creditor to the prejudice of other creditors by granting the favoured creditor a greater share of the dismissed assets of the debtor than that creditor would enjoy under the formal system of bankruptcy (or liquidation) distribution.

In relation to undue preference, as in England, Malaysia has also incorporated the common law preference rule in the Companies Act. Under

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9 The provision on fraudulent trading is provided in section 304 of the Malaysian Companies Act. The Malaysian Companies Act does not contain any provide on wrongful trading unlike the position in England. Provisions on disqualification are expressed in sections 125, 130 and S130A of the Companies Act.

10 See O'Donovan, 'Corporate Insolvency: Policies, perspectives and reforms' (1990) 3 *Corporate & Business LJ* 1 11-12.

11 See Broome, Payments on long term debts as voidable preference: The impact of the 1984 Bankruptcy Amendments (1987) 78 *Duke LJ* 78, 82.

12 Weisberg, 'Commercial morality, the Merchant Character and the history of the voidable preference' (1986) 39 *Stanford LR* 3, 3.

section 293 of the Malaysian Companies Act[13] disposal of the company's property made after the commencement of a compulsory winding-up order are void. In some instances, liquidators of insolvent companies are able to recover disposals of property made by the company before the commencement of winding-up. When the business of the company deteriorates, there is often a period of time between the onset of insolvency and the commencement of winding-up proceedings. During this time, an insolvent company may repay debts due to certain creditors in preference over other creditors. Section 293 deals with such preferences, namely undue preferences.

Preferences are regarded as void under the Malaysian Companies Act and it is considered merely voidable at the option of the liquidator.[14] This section, states that the rules of bankruptcy be applied to fraudulent preferences in the winding up of the company.[15] The Act, further, excludes transactions from operation even if they are made in favour of a creditor in good faith and for valuable consideration. As in England, when a preference is recovered from a creditor, a creditor does not lose all his interest in that preference. A creditor will still be able to prove for that amount in the same manner as all other creditors of equal property. This means that a creditor, originally treated to a preference, will have to take place in line with all the other creditors of the same class.

In order to establish an undue preference, in Malaysia, the cases[16] illustrated that, relatively, the onus of proof on the liquidator is not as onerous as demanded by the common law. Malaysian judicial pronouncement provides guidelines for a liquidator as to the features required before a transaction can be void under the Companies Act. These features of a void transaction include that a transaction must have taken place prior to the commencement of winding-up and that it must satisfy the description of one of the type of transactions mentioned in the sub-section (1) of the section. Further, a person in whose favour the transaction was effected must stand, in relation to the company, as a creditor and the effect of the transaction has to confer on that person an advantage over other creditors in the winding-up.

Whether a transfer of property is made in favour of a particular creditor with a view to giving such a creditor a preference over other creditors is a question of fact. For instance, it is necessary to ascertain the dominant motive that led the debtor to make the transfer. Payments made pursuant to an invalid transaction have been held to be fraudulent preference.[17] Further, payments

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13 This section is similar to section 239 of UK Insolvency Act 1986.

14 Section 293(1), Malaysian Companies Act 1965.

15 See *Lian Keow Sdn Bhd (In Liquidation) v. Overseas Credit Finance (M) Sdn Bhd* [1988] 2 MLJ 499.

16 See *Bensa Sdn Bhd v. Malayan Banking Bhd* [1993]1 MLJ 119.

17 See *Re Leong Ah Heng, Official Assignee v. Ho Choo* [1936] MLJ 36.

made by an insolvent debtor who demonstrates that his dominant motive is to prefer the particular creditor also constitute a fraudulent preference.[18]

Once a preference is established, under section 53(1) of the Bankruptcy Act 1967, a creditor is afforded protection if he can show that he received the preference in good faith and for valuable consideration. A person is deemed not to be a creditor of good faith if a transaction is made under such circumstances as to lead to the inference that the creditor knew or had reason to suspect that the company was insolvent, and that the effect of a transaction was to give the creditor a preference to the disadvantage of other creditors. Further, under section 53(1), the onus is on the liquidator to establish that the effect of a transaction is to give a creditor a preference over other creditors and that at the relevant time of a transaction, the company was unable to pay its debts as they fell due. In terms of inability to pay a debt, the test is not whether the debtor's assets exceed his liabilities but whether there is money presently available or forthcoming in time to pay the debts as they become due.[19]

In Malaysia, it can be said that liquidators may be able to recover debts repaid in preference by a company to certain creditors as opposed to others. Section 53(1) of the Bankruptcy Act states that preferences are void. However, they are merely voidable when a creditor are able to prove the amount owing to the rest of the creditors of his class. This section has no application to transactions made in good faith and for valuable consideration. The onus of establishing that a particular transaction is an undue preference lies with the liquidator. It must be noted that not all preferences are caught by section 53. To come within the ambit of section 53, a liquidator must establish that at the time a transaction was entered into, a company was unable to pay its debts.

An undue preference can also arise in the event of a floating charge being created running up to, or during insolvency. A floating charge created to secure past debts in favour of a particular creditor when the company is on the verge of insolvency may constitute a preference. Under section 294 of the Malaysian Companies Act, a floating charge created within six months of the commencement of winding-up is invalid except to the amount of any cash paid to the company at the time or subsequently to the creation of a consideration for the charge, together with interest on the amount paid at 5% per annum, unless it is proven that immediately after the creation of the charge the company was solvent. However, if the charge is created prior to the winding-up, in principle, the holder of the floating charge is entitled to all the assets which are subject to the charge in priority to all unsecured creditors.

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[18] *Re Mok Peng Chia Trading as Chop Chia Moh exp. Official Assignee* [1958] MLJ 200.

[19] *Lian Keow Sdn Bhd (In Liquidation) & Anor v. Overseas Credit Finance (M) Sdn Bhd & Ors* [1988] MLJ 449. With regards to this issue Malaysian courts have also supported Australian authorities by citing amongst *others Bank of Australasia v Hall* [1907]4 CLR 1514 and *Sandell v Porter* [1966]155 CLR 666.

In relation to protection for creditors, the legal authorities on preferences provide precedents that clearly illustrate the circumstances which give rise to undue preference. Further, as to proof, the onus of proof is not as burdensome as in common law since all that is required, under the section, is the dominant motive, which is based on a question of fact. The creditor would still be afforded protection if it can be established that he has acquired the preference under good faith. The difficulty lies in the fact that the action must be initiated by the liquidator, and not by a creditor. This poses a serious problem, and will be elaborated on further in this paper.

LIABILITIES OF DIRECTORS OF INSOLVENT COMPANY IN FRAUDULENT TRADING

The Malaysian law on fraudulent trading is found in section 304 of the Malaysian Companies Act 1965 which unlike section 332 of the United Kingdom Insolvency Act, applies "in any proceedings against a company." Thus it is not solely restricted to the winding-up of a company. One of the problems of section 304 is that it has to be established that the business of a company has been carried out with the intent to defraud creditors or any other fraudulent purpose. The lack of local authorities in this area will mean that reference has to be made according to the common law position. In common law the term 'fraud' has a distinctive meaning. Thus, if a company continues to carry on business and to incur debts at a time when, to the knowledge of the directors that, there is no reasonable prospect for the creditors to receive payments of those debts, than in general there is an inference that the company is carrying on a business with the intention to defraud.[20] Further, "defraud" and "fraudulent" denotes actual dishonesty. Thus the legal problems surrounding section 332 of the Insolvency Act in England also arise in section 304. Apart from the difficulties of onus of proof, there are also problems in identifying who is liable for fraudulent trading. Section 304 describes this group as "any person who was knowingly a party to carrying on the business." This could cover a wide range of parties ranging from receivers, managers, directors and financiers.

In terms of pleadings, Malaysian case law has, to a certain extent, provided guidelines as to how this section should be pleaded. In *Ting Ling Kiew* v. *Tang Eng Iron Works Co Ltd*[21], the Supreme Court held that it was inappropriate to proceed summarily under this section, where fraud was the central issue, and court ordered that pleadings should be filed and the proceedings should be continued as if they had begun by writ. Thus, where

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[20] See *Re William C Leitch Bros Ltd* [1932] 2 Ch 71, 77.

[21] [1992] 2 MLJ 217.

a company is not being wound up, an application under this section should be made by an originating summons.[22] However, where there are conflicts in the affidavit evidence, and in particular where fraud is alleged, it would be more appropriate to continue the proceedings as if they were begun by writ, since the court has the discretion to do so.[23] Where the company is already in liquidation, the Companies (Winding-Up) Rules 1972[24] provide that applications other than those mentioned in Rule 5(1), shall be heard and determined in chambers.[25] An observation that can be concluded is that although guidelines on pleadings are clarified under the law, the procedures involved are more cumbersome when an element of fraud is involved as opposed to a normal cause of action. This might hamper the process of utilizing section 304 to protect a creditor's interest.

LIABILITY WHERE PROPER ACCOUNTS ARE NOT KEPT IN WRONGFUL TRADING

As far as Malaysian law is concerned, there is no equivalent section for wrongful trading in the Companies Act. However, as in the offence of wrongful trading in United Kingdom, the onus of proof has been adopted in section 303 of the Malaysian Companies Act, which imposes liability on directors when proper accounts are not kept. This section specifies that an officer, including a director, will commit an offence if he knowingly is a party to contracting a debt, and at the time the debt is contracted has no reasonable expectation that the company is able to pay the debt.[26] However, the scope of the liability is only limited to the two year period immediately preceding the commencement of an investigation of winding-up.[27]

In contrast to section 304, of the Malaysian Companies Act 1965 on fraudulent trading, the scope of this offence is broader and less difficult to

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[22] Rules of High Court 1980, Order 88 Rule 2(1).

[23] Ibid, Order 28, Rule 8(1).

[24] Companies (Winding-up) Rules 1972, Rule 5(2).

[25] Every application in chambers is made using by using Form 1 of the Rules namely Rule 7(2). However, if there are going to be substantial disputes on the facts, it may be better for the liquidator to bring an action against the malfeasors rather than to invoke the summary jurisdiction of the court under the section.

[26] Comparatively section 214 of the Insolvency Act 1986 introduced the concept of wrongful trading. Accordingly a director or former director of a company which goes into insolvent liquidation may be ordered to make a contribution to the company's asset if at same time before the commencement of winding-up, he knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation unless he then took every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken.

[27] Section 303(1) Companies Act 1965.

prove. The test is objective and does not require the elements of fraud or dishonesty to be found. It can, therefore, be said that this section does impose some form of duty upon directors namely to keep proper accounts of contracting debts and to ensure that further liability is not incurred once the company has gone into insolvency.

Nevertheless, it is suggested that to further enhance and strengthen the position of a creditor's interest it is proposed that a new section should be enacted in the Companies Act, based on section 214 of the Insolvency Act, so that the precise nature of a director's duty to creditors could be stated. Thus, it would also reduce the burden on the liquidator since there would be an alternative procedure against a director, instead of relying on section 304, which has proved to be cumbersome in its nature. Due care, however, must be taken in drafting this new section, as it is important to identify the basis of any liability, as to who are the persons potentially liable under the section. Further, other factors needed to be considered includes who are the persons entitled to bring the proceedings, any defence that directors will be able to rely on and the standards by which directors' conduct is to be judged. It is hoped that prospects on enforcement and funding should also be reviewed as to further enhance this section which could be regarded as one of the major mechanisms to protect creditors' interest.

LIABILITY FOR MISFEASANCE

Section 305 of the Companies Act 1965 also imposes another provision on the liability of directors of insolvent companies. The section is applicable if in the course of winding-up of a company, any person who has taken part in the formation or promotion of the company or any present liquidation has misapplied or liable for any money or property on guilty of any misfeasance or breach of trust or duty in relation to the company. In such situation on the application of the liquidation or any creditor, the court may compel that person to repay, restore or account for the money or property or to contribute such sum to the asset of the company by way of compensation in respect of the misfeasance or breach of duty as the court thinks fit.

DISQUALIFICATION OF DIRECTORS OF INSOLVENT COMPANIES

Another mechanism that has been heavily debated[28] in regards to directors liability is the issue of disqualification of directors. In Malaysia, it is still

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[28] Walters, A & Davis-White, M, *Directors' disqualification: Law and Practice*, Sweet and Maxwell, London, 1999, Chapter 1, Ong, "*Disqualification of directors: No hiding place for the unfit?* (A.C.C.A : Research Report No 59, 1998).

vague as to whether directors' disqualification is an effective remedy for creditors. This is aggravated by the fact that there are no statutory guidelines to clarify the ground for disqualification unlike the CDDA[29] in England. The Malaysian Companies Act contains a number of provisions for the disqualification of directors and some involve directors of insolvent companies.[30] An undischarged bankrupt cannot be a director, or promoter, or in anyway be involved in the management of a company without leave from the court.[31] A breach of this section is an offence. A person who has been convicted of certain offences cannot be a director, promoter or in any way involved in the management of a company within five years of conviction or release from prison without leave of the court.[32] The specified offences include an offence in connection with the promotion, formation or management of a corporation, any offences involving fraud or dishonesty punishable by imprisonment for a period of three months or more and offences under subsection 132, 132A and 303 of the Companies Act. The disqualification provisions contained in sections 125 and 130 do not cause the person to vacate his office automatically. A person who is caught by any of these sections must resign his directorship and refrain from promoting companies or participating in the management of companies for the prescribed period. A person who does any of these things while disqualified will be guilty of an offence under the relevant section.

It can be said that the disqualification provisions under the Malaysian Companies Act are not punitive, but rather designed to protect the public and to prevent the corporate structure from being used to the financial detriment of investors, shareholders, creditors and persons dealing with the companies. When the court decides whether or not to grant a disqualification order, some of the factors that will be considered are based on case law.[33] These factors include the nature of the offence of which the applicant has been convicted and in the case of a disqualification, his involvement and the applicant's general character. Other factors considered are: the structure of the company which the applicant seeks to manage, or be a director of, and the interests of the general public, the shareholders, creditors and employees of that company.

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[29] Company Directors Disqualification Act 1986. The Insolvency Act 1986 was introduced for the purpose of consolidating the majority of insolvency laws into one statute. However in relation to the disqualification proceeding, the English Parliament decided that a new legislation should be introduced for the specific purpose of consolidating the laws treatment and regulation of this area of law. The consolidating legislation became the Company Directors Disqualification Act 1986.

[30] Section 130A of Companies Act 1965.

[31] Section 125(1) CA 1965.

[32] Ibid, Section 130(1).

[33] See *Quek Leng Chye v. A.G* [1985] 2 MLJ 270, 273.

Finally, the risk to the general public and to the shareholders, creditors and the employees should the applicant be permitted to be a director or to take part in the management of that company will also be assessed. Apart from the Companies Act 1965, Malaysia does not have any other specific legislation which deals with the disqualification of directors. The manner and procedure involved would, therefore, stem from case law and the articles of association of individual companies, which varies from one to the other.[34]

From the above discussion it could be argued that the CDDA is effective in minimizing the abuse of limited liability companies. Disqualification can be a useful device but it is least effective against the more substantial director. Therefore, any proposed legislation in Malaysia as regards disqualification orders should focus, not on driving up the number of disqualification orders, but on achieving disqualification for more serious misconduct and for longer periods. Accordingly, based on the problems mentioned, any proposed Malaysian legislation on this issue should be cautious and formulate a precise and definite classification of specific instances of misconduct which may or may not warrant the court's imposition of a disqualification order. However, notwithstanding the difficulties in specifying what amounts to conduct of an unfit nature, it is possible to lay down guidelines by way of case law *vis-a-vis* examples of the type of business conduct which may or may not be regarded as firm evidence of unfit conduct. The crucial factor that should be considered is the seriousness of the misconduct and not necessarily the misconduct in question. The seriousness of a particular act of misconduct will be measured in accordance with its perceived prejudicial effect on the public interest. The public interest will be measured in general terms but undoubtedly include the interests of, for example, the creditors, shareholders and employees.

RECOVERY AND DISTRIBUTION OF ASSETS FOR CREDITORS ENFORCEMENT ISSUES

One of the problematic issues which concerns insolvency is in relation to enforcement. In England, it is important to stress that under section 214 of

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[34] Unlike in England, Malaysian Companies Act does not contain any provisions listing the criteria and grounds to disqualify the director. When a director is disqualified the procedure which follows is as any form of removal of director subjected to section 128 of the CA. In case of a public company, section 128 provides that the general meeting may by ordinary resolution remove a director before the expiration of his period. The powers of the general meeting of shareholders can only remove a director if empowered to do so by the articles. Most articles of companies in Malaysia have a provision to this effect. Table A, Art 69 of the Fourth Schedule of the Companies Act 1965 empowers the company to remove any director before the expiration of the term of the offence by ordinary resolution. If no such power is conferred by the articles, a special resolution would first be necessary to alter the articles to provide the necessary authority.

the Insolvency Act, only a liquidator has the *locus standi* to initiate a wrongful trading action. The mechanism used to trigger a disqualification for wrongful trading is dependent on the actions of a liquidator who is essentially a private citizen. If a liquidator does not initiate proceedings, then there is no possibility of a director being disqualified for wrongful trading. The section also provides that the liquidator must pursue and resource the action without state financial assistance.

The policy fails to recognize that a liquidator's priorities are commercial. Despite the culpability of a director for misfeasance, a liquidator has nothing to gain or lose by pursuing an action. A liquidator will be reluctant to incur personal liability for costs without obtaining some form of security from creditors that wish to pursue an action under section 214. If the security is not forthcoming, liquidators will only take the risk in the clearest of cases where the proposed defendant has available assets. The reluctance of liquidators to pursue an action may further, be compounded by judicial barriers.[35] In addition, a liquidator has to overcome the normal difficulties of bringing an action, such as the expense and difficulty of gathering evidence, the enforcement of the order, a director's insolvency and the real risk of costs.[36] Although liquidation involves the carrying out of a public policy function, the evaluation of the director's stewardship, it is inherently a 'private process', in the sense that it is financed from the assets of the estate, or by the company's creditors.[37] In many situations, the latter source of funding is not forthcoming. Individual creditors who owed a small amount will not consider it worth their while to contribute as the cost may exceed the gain. The liquidator will therefore be reluctant to proceed without financial backing.

Liquidators, generally, will not pursue a section 214 action because, technically, there is no obligation to do so and the risk of having to pay costs is too great. A major problem with section 214 is arguably the lack of resources to support enforcement, which is attributable, in part, to the inability

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[35] *Re M. C Bacon Ltd* (No 2) [1991] Ch 127 provides an example of the judicial barriers to liquidators. In this case the liquidator pursued an action under section 214. The action failed and the liquidator was ordered to pay costs. When the liquidator sought to recover these costs from the company's assets, the court held that costs were not "expenses properly incurred in the winding up" because an action under section 214 was not an "asset of the company." Consequently any claim for costs by the liquidator ranked with unsecured creditors. Further, in *Re Oasis Merchandising Services Ltd* also held that a section 214 action is not vested in the company. As part of the asset, it only arises on liquidation and is vested in the liquidation for the benefit of the creditor. As a result it cannot be assigned by the liquidator since it is not the company property.

[36] See Hicks, 'Advising on wrongful trading' (1993)14 *Company Lawyer* 16.

[37] See generally G Moss & N. Segal, 'Insolvency Proceedings : Contract and financing. The expenses doctrine in liquidation, administration and receiverships' (1997)1 *CFIRL* 1.

of liquidators to fund section 214 claims. Due to this problem, one of the alternatives appears to be that a recovery action to enforce the directorial duty to creditors should be enforced by the creditors, as a class without recourse to a liquidator. A liquidator could not bring an action on the behalf of one class of creditor, for example unsecured creditors, as this would raise the issue of conflict of interest. It would therefore be far better for a class of creditor to have the right of enforcement.

A class action would enable unsecured creditors to prevent directors from taking a course of action which jeopardizes a company insolvency or instills directors with a sense of responsibility towards a class of creditor's interests in a situation of marginal insolvency. This power could also be said to complement the anticipatory effect of the common law duty. Directors may have to consider a creditors' interest before the moment they ought to have concluded that the company could not avoid going into insolvent liquidation namely before the wrongful trading provisions become applicable. Another advantage of a class action for creditors would be that contributions recovered from directors would go directly to the creditors thereby bypassing any problems relating to the contribution of company assets. Payments out from company assets are subjected to a hierarchy or priorities as mentioned before.[38] The order of payment normally starts with the expenses incurred by the process of liquidation, followed by preferential debts, the debts of creditors that are given priority over unsecured debts. This normally means that certain classes of creditor, especially unsecured creditors, have very little hope of recovering their losses in full, in the insolvency process.

In Malaysia, as in England, a liquidator has the important function of collecting, preserving and realizing the assets of a company with a view to maximizing the dividends to distribute to its creditors and members. A liquidator's function and associated powers also spring from statute.[39] As mentioned earlier, Malaysian law does not have a specific provision on

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[38] Section 292 of the Malaysian Companies Act.

[39] Section 218(1) of the CA 1965 lists the various grounds under which a company may be liquidated. Further, section 181(2)(e) also provides a ground for the winding-up of a company where the court exercises its judicial discretion to end the oppression of members of the company. The power of the board of directors ceases upon the granting of a winding-up order on a company; and these powers are assume by a liquidator who is appointed as the agent of the company. As such the law of agency applies with respect to the actions and decisions taken by the liquidator. This is supplemented by sections 236 and 252 of the CA 1965, together with the Companies (Winding-up) Rules 1972 forming the statutory basis of power of a liquidator. Section 236 lists the provisions pertaining to the powers of a liquidator, while section 237 specifies the provision of exercise and control of a liquidator's powers. Further, section 252 authorizes the court to delegate certain addition powers to be exercised and performed by the liquidator, as an officer of the court but subject to the control of the court.

wrongful trading. However, the Malaysian Companies Act 1965 provides a number of avenues through which the collection of assets by a liquidator may be effected. These include Sections 214 which deals with amounts due from contributors Section 293 and Section 294 which allow a director to avoid certain preferential treatment of creditors Section 295 which empowers a liquidator to claim the excess profits made by 'connected persons' either from sales to or from the company; and finally Section 304 which imposes personal liability upon the officers of the company where it is established that they had engaged in fraudulent trading.

Section 214 stipulates that past and present members, of the company are liable as contributors to contribute to the assets of a company up to an amount sufficient for the payment of debts and liabilities, and the cost of the winding-up process. The claim against past members is subject to a one year limitation period prior to the commencement of winding-up. This rule is also applicable to directors in the winding-up of a limited company, any director, whether past or present, whose liability is unlimited shall in addition to his personal liability (if any) to contribute as an ordinary member, will be liable to make further contributions as if he were a member at the commencement of the winding-up of an unlimited company.[40] This section will also allow creditors to recover debts from a director when a company becomes insolvent.

Sections 293 and 294 deal with provisions in regards to preference. If it can be established that a transaction is tantamount to an undue preference than it is held as a void or voidable transaction.[41] When proved, a liquidator is entitled to recover the void payments.[42] Sections 295 and 304 provide an extensively drafted basis on which a liquidator of an insolvent company may recover funds from its directors to compensate creditors. However, the non-existence of reported cases, in regards to these sections, illustrate the significant difficulty of enforcing the provisions, which has the knock on effect of restricting the possibility of compensation for creditors.

Section 295 authorizes a liquidator to examine any cash transaction for the purchase or sale of any property, business or undertaking entered into by a company with any person who has been a director of the company, or with whom a director was so connected within a period of the two years immediately preceding the date of commencement of winding-up of the company. The principle objective of the section is to enable a liquidator to challenge transactions which appear to have been entered into in breach of the director's fiduciary duty to avoid a conflict of interest when a director contracts with a company.

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[40] Section 214(2) Companies Act 1965.

[41] Section 293(1) Companies Act 1965.

[42] See *Re Yagerphone Ltd* [1935] Ch 392 and *Bibra Lake Holdings Pty Ltd v. Firmadoor Australia Pty Ltd* [1992] 7 ACSR 380.

The absence of any reported case on section 295 in Malaysia is an unfortunate testimony of the difficulties faced by liquidators and reflects the deficiencies of the provision. A liquidator, encounters two immediate problems in enforcing this section. Firstly, the section only applies to a 'cash transaction.'[43] This presents a potential loophole. A director may escape liability because it is not uncommon for consideration to be satisfied via an issue of shares, given that an acquisition or sale may involve assets of significant value namely property, business or an undertaking by the company. It is, therefore, possible for a director to derive entirely legitimate profits from such transactions, particularly when there exists a ready and fluid market for its shares.

The second problem in regards to enforcing the section is evidential. Considerable problems arise in respect to the valuation of a property, business or undertaking of a company at the relevant time of a particular transaction. There are no guidelines as to the method of valuation, except for the inclusion of 'goodwill or profits ... or similar considerations' in ensuring the fair value of such property, business or undertaking was attained when bought or sold. As such, it is possible for a director to escape liability under section 295 by claiming that in his opinion the cash consideration paid or received by a company represented 'fair value' at the time of the said transaction. The onus then shifts to the liquidator to prove, on the balance of probabilities, that the transaction was made at an undervalue, if he wishes to recover the proceeds from either a director or a connected person.

The court may resist exercising its judicial discretion in the application of section 295 when there is a potentially large range of valuations that may be given by experts in a particular area of business in the absence of *mala fides* on the part of the directors concerned.[44] It is proposed that a more objective test should be adopted to determine the valuation of connected transactions made at an undervalue. Reference should be made to normal commercial transactions to assess whether a director has performed in a

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43 A cash transaction was defined by section 295(4) of the MCA as a consideration payable otherwise than by the issue of shares in the company.

44 This is further complicated by the fact that the common law imposes a positive duty upon directors to retain their discretion and not to have this fettered in any manner, in the exercise of their powers of management for the benefit of the company. The courts are loathe to interfere where there has been such an exercise of discretion by directors unless a breach of duty is established: *David Hey v. New Kok Ann Realty Sdn* Bhd [1985] 1 MLJ 167. In this case Hey had obtained certain shares by transfer. The directors refused to register the transfer as it had not been approved by the Foreign Investment Committee (FIC). The Federal Court held that the court should not interfere with the directors' discretion in refusing to register as non-compliance with the Committee's guidelines would adversely affect the company which is a private company.

manner that can be reasonably expected of him in the circumstances. Further, it is also suggested that there should be alternative tests, as used in United Kingdom, to determine the insolvency of a company such as the 'cash flow test' and the 'balance sheet test.'[45]

Section 304 offers a further avenue for liquidators to recover debts from a director if a director is found guilty of the fraudulent trading. The principle aim of section 304 is to impose a statutory obligation on directors of insolvent companies to compensate its creditors where it is established that the former has been engaged in fraudulent trading. Unfortunately there are, as in section 295, problems with enforcing the section.

In common law, the comparable section is section 213 of the Insolvency Act 1986. Civil liability for fraudulent trading, in England,[46] is dealt with in section 213 of the Insolvency Act 1986 whereas criminal liability is contained within section 458 of the Companies Act 1985. Therefore some of the problems raised by section 213 of the Insolvency Act are also relevant to the following discussion.

Some of the difficulties, with the section, arise from trying to determine the meaning of the phrase 'intent to defraud.' It is not entirely clear whether the section is applicable to acts effecting a single creditor, a group of creditors or to all the creditors of the company. It appears, looking at the case law[47] that the phrase 'intent to defraud creditors of the company' has been interpreted as only applicable to the situation where all of the creditors of a company are subjected to an alleged fraud. This would imply that no recovery may be ordered against directors when their actions effect only a single creditor or a group of creditors.

Liability under section 304(1) is only imposed when it can be established that a director was 'knowingly a party' to alleged fraudulent trading. This means that a director who took no interest in a company, or was

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45 The two primary tests of inability to pay debt are the cash flow test and the balance sheet test. In England, the cash flow test is formulated by section 123(1)(e) of the Insolvency Act. Under the cash flow or commercial insolvency test, a company is insolvent when it is unable to pay its debts as they fall due. The cash flow test is relatively easy to apply in practice, for the court looks at what the company is actually doing, if it is not in fact paying its debts as they fall due, it is assumed to be insolvent. The alternative primary test of insolvency is the balance sheet test. Under this test a company is insolvent if its assets are insufficient to meet its liabilities. The idea underlying this test is that it is not sufficient for the company to be able to meet its current obligations if its total liabilities can ultimately be met only by the realization of its assets.

46 For wrongful trading, in the UK, see: Oditah, 'Wrongful Trading' (1990) *LMCLQ* 205, L. Doyle, 'Anomalies in the wrongful trading provisions' (1992)13 *Co Law* 96, Janet Dine, 'Wrongful trading-Quasi Criminal Law', taken from Harry Rajak, *Insolvency Law, Theory and Practice*, Chapter 12.

47 *Re Sarflax Ltd* [1979]Ch 592.

ignorant of the management of a company, or who failed to attend meetings of the board of directors can avoid personal liability for the debts of the company. A positive and active participation is a necessary precondition to incur liability.[48] For a director to be found liable under section 304, a director must be aware that a company is trading fraudulently.[49] The mere fact that a person is a director of a company whether competent or not, or that any other reasonable director ought to have known that a company was trading fraudulently, is not sufficient for the purposes of attaching liability under the section. It is suggested that a more objective standard must be adopted to determine the requisite knowledge and skill of a director in the management of the affairs of a company prior to its winding up. To achieve this the phrase 'knowingly a party' should be deleted from the current section 304. This would also necessitate a rise in the standard of care expected of directors by statutorily overruling the decision in *Re City Equitable Fire Insurance Co.*[50]

In order to bring an action under section 304 a director needs to have already been convicted of the criminal offence. This places an additional burden on a liquidator as the standard of proof is far higher, that of beyond reasonable doubt. Even when this onerous requirement is satisfied, the liability will only be imposed if the 'debt was contracted' at the time when a company was insolvent. This implies that a debt has to be for an ascertained amount and should arise from a positive act on the part of a company.[51] It is proposed that section 304 should be reworded to ensure that such breaches by directors will give rise to civil liabilities, independent of any conviction under section 303(3).

Both sections only authorize a liquidator to initiate proceedings. The existing sections should allow, not only liquidators, but also creditors and contributors of a company to bring an action against directors. This could, however, encourage a multiplicity of expensive legal actions, resulting in denuding the available assets should the costs be treated as a cost of the liquidation process. It would, therefore, be appropriate to design a framework whereby actions against directors are not duplicated. A further point is the cost of the proceedings. In addition to the problems already mentioned, the cost factor is a material consideration that will influence a liquidator's decision as to whether they will take legal action against a director of a company under section 304.

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48 See for example *Re Maidstone Buildings Provisions Ltd* [1971] 3 ALL ER 363 and *Metal Manufacturers Ltd v. Lewis* [1988] 6 ACLC 725.

49 Refer for example to *Re William C. Leitch Bros Ltd* [1932] 2 Ch 71 and *Re Patrick & Lyon Ltd* [1933] Ch 78.

50 [1925] Ch 407.

51 See for example *Rema Industries & Services Pty Ltd v. Coad* [1992]10 ACLC 390.

One of the aims of insolvency law is to ensure that those entrusted with the management of a company are duly punished when the assets of a company are dissipated. It is suggested that section 295 and Section 304 need to be amended and restructured as proposed above, so that directors will take their office seriously and be accountable for their irresponsible behavior when their actions effect the interests of creditors.

CONCLUSION

As discussed in this article, the duties of directors are onerous and often, only when companies go into liquidation can breaches by the directors be uncovered or discovered. The duties of directors are manifold with separate provisions made by statute and common law. In breach of these duties, the directors face not only criminal sanctions but also civil consequences. Although these duties are expressly provided under the statue, the problem surrounding its enforcement issues would still hamper the recovery of asset from insolvent companies. To that extent, the laws in Malaysia under the Act as well as common law have to ensure that persons who seek to be directors must act with a strong sense of integrity and honesty.

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