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INSOLVENCY AND DIRECTORS' DUTIES

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Insolvency and directors' duties in Malaysia: overview

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CORPORATE INSOLVENCY PROCEEDINGS

1. What are the main out-of-court and court-sanctioned insolvency proceedings involving a liquidation of the company's assets?

Overview

There are several insolvency and restructuring processes in Malaysia. All the processes may eventually lead to the liquidation of a company if an attempted rescue of that company fails. Most companies in Malaysia that cannot be rescued or rehabilitated are wound up, liquidated and eventually dissolved under the Companies Act 1965 (Companies Act), supplemented by the Companies (Winding up) Rules 1972, which is the principal statute governing the winding-up of companies and foreign companies in Malaysia. However, before reaching the point when liquidation is inevitable, the debtor may be subject to attempted rescue and rehabilitation under specially enacted legislation catering for the restructuring of certain types of company, including the:

- **Pengurusan Danaharta Nasional Berhad Act 1998 (Danaharta Act).** This Act deals with the restructuring, by Danaharta Corporation or its subsidiaries, of distressed corporate debtors that were indebted under non-performing loan obligations owed to Malaysian financial institutions that were themselves in financial difficulties. Danaharta Corporation first acquired the non-performing loans from the financial institutions concerned, which were then statutorily vested in Danaharta Corporation. Danaharta Corporation then attempted to restructure the debtor's obligations, or to sell its business or assets. The proceeds were shared under a sharing arrangement between Danaharta Corporation and the financial institution.
- **Malaysia Deposit Insurance Corporation Act 2011 (MDICA 2011).** The MDICA 2011 deals with the potential restructuring of:
  - distressed corporate debtors with non-performing loan obligations owed to financial institutions that are members of the deposit insurance scheme administered by the Malaysia Deposit Insurance Corporation under the MDICA 2011; or
  - the member institutions themselves.

See *Question 2*, for further details on the Danaharta Act and the MDICA 2011.

A failed restructuring under either the Danaharta Act or the MDICA 2011 will inevitably lead to the compulsory court-ordered winding-up of the debtor or the institution concerned under the Companies Act (*see below, Compulsory winding-up*).

Under the Companies Act, the other insolvency processes that are available include:

- Voluntary winding-up (*see below, Voluntary winding-up*).
- Appointment of receivers and managers (*see below, Appointment of receivers and managers*).

Compulsory winding-up

In a compulsory winding-up, the court can wind up a company on a number of grounds under the Companies Act. The most common ground is the company's inability to pay its debts, where a creditor initiates the process by filing a winding-up petition with the court. If a winding-up order is made, the court will appoint a liquidator to oversee the liquidation process. Any disposition of property after the commencement of winding-up is void, unless the court orders otherwise.

Voluntary winding-up

A voluntary winding-up can either be a members' or creditors' winding-up. In a members' winding-up, the shareholders can voluntarily wind up their own company if the company is solvent. First, the directors of the company must make a statutory declaration in the prescribed form that the company is solvent and that it will be able to pay its debts in full for the next 12 months following the winding-up. Directors of the company must have reasonable grounds on which to base their declaration. Following the declaration of solvency, an extraordinary general meeting is convened to enable the shareholders to pass a special resolution to wind up the company. The shareholders will appoint a liquidator at this meeting. Once a liquidator is appointed, the directors' powers will cease and any transfer of shares or any alteration in the status of members will be void. Once all these steps have been taken, business activities must cease (except where the liquidator is of the opinion that continuing activities will benefit the winding-up).

If the liquidator subsequently discovers that the company is insolvent, they must convert the members' voluntary winding-up into a creditors' winding-up.

In a creditors' winding-up, an extraordinary general meeting of the company's members must be called, followed by a special creditors' meeting to formalise the liquidation and the choice of liquidator. After this:

- Business activities must cease.
- The directors' powers to control the company cease.
- Any transfer of shares or any alteration in the status of members is void.

A creditors' winding-up is less complicated than a compulsory winding-up. It is also less expensive. Therefore, a creditors' winding-up is preferred over compulsory winding-up if the company has sufficient assets to pay the liquidation fees and expenses.

Appointment of receivers and managers

Receivers and managers can be either:

- **Court-appointed receivers.** These are appointed by the court and will either:

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- carry on the business of the company in the ordinary way; or
- take custody and possession of the assets of the company.

- **Privately appointed receivers.** These are appointed by debenture holders based on the terms of the debenture agreement. Once appointed, a receiver takes possession of the assets of the company, subject to the floating charge that is now crystallised in the debenture.

2. Are there statutory proceedings allowing for a rescue/restructuring of the debtor company's operations and debts?

The following restructuring mechanisms are available to companies:

- A scheme of arrangement under section 176 of the Companies Act 1965 (Companies Act).
- Special administration under the Pengurusan Danaharta Nasional Berhad Act 1998 (Danaharta Act).
- Conservatorship under the Malaysia Deposit Insurance Corporation Act 2011 (MDICA 2011).

Scheme of arrangement

A company can enter into a scheme of arrangement (*Part VII, Companies Act*), which requires the approval of 75% in value and a simple majority in number of each class of creditors. The classification of creditors is done by the debtor company and is usually based on commonality of interests between the creditors. Creditors can challenge their classification, although this is rare (due to the delay in court processes).

After the creditors approve the scheme, the court must sanction it before it can be implemented. Debtors can apply for an order restraining all proceedings against them while they develop a scheme. However, this aspect of the scheme is unpopular with creditors. Repeated extensions of restraining orders can prevent creditors from enforcing their rights. Another unpopular aspect of the scheme with creditors is that the incumbent management is allowed to remain pending the scheme's completion.

Special administration

A company can be under special administration, which involves the appointment of a special administrator (*sections 24 to 26, Danaharta Act*). Under the administration process, the discretion to appoint a special administrator rests with the Danaharta Corporation. The Danaharta Corporation is a statutorily incorporated entity that acquired non-performing loans and the underlying security of those non-performing loans of a company. However, Danaharta has wound down its operations since 2005, and all its residual assets have been transferred to, and are now managed by, Prokhas Sdn Bhd. There have been no appointments of special administrators since 2005 and this statutory mechanism is presently in abeyance.

The appointment of a special administrator must serve the public interest, or one or more of the following conditions must be met (*Danaharta Act*):

- The debtor is unable or unlikely to be able to pay its debts, or is unable, or likely to be unable, to fulfil its obligations to its creditors.
- The survival of the debtor and the whole or any part of its assets as a going concern may be achieved.
- A more advantageous realisation of the debtor's assets may be achieved than on a winding-up.
- The appointment may achieve a more advantageous realisation or a faster settlement of a duty or liability owed by any person to the Danaharta or any subsidiary of the Danaharta, whether future, present, vested or contingent.

With wide powers at their disposal and the requirement that only secured creditors need approve their workout plan, special administrators have succeeded in completing a relatively high number of restructurings.

Conservatorship

A company can also be under conservatorship, where the Malaysia Deposit Insurance Corporation (*section 161(1), MDICA 2011*), which administers a deposit insurance scheme covering all licensed financial institutions, can take control of a non-viable financial institution. The Corporation then acquires and takes control of non-performing loans that are outstanding between the financial institutions, borrowers and security providers. The powers of a conservator and the process involved largely mirror the special administration process (*see above, Special administration*). No conservator has been appointed since the enactment of the MDICA 2011.

3. What are the general requirements for commencing insolvency proceedings?

The general requirements for commencing a voluntary winding-up and a compulsory winding-up are different.

Voluntary winding-up

A company can be wound up voluntarily if any of the following applies (*section 254(1), Companies Act 1965 (Companies Act)*):

- The period fixed for the duration of the company by memorandum or the articles has expired.
- The memorandum or articles provide that the company is to be dissolved and the company (in a general meeting) has passed a resolution for the company to be wound up voluntarily.
- The company passes a special resolution for the company to be wound up.

See *Question 1, Voluntary winding-up* for details on the steps involved in the initiation of a voluntary winding-up.

Compulsory winding-up

Section 218 of the Companies Act provides 14 circumstances in which the court can wind up a company. The two most widely used circumstances are when:

- The company is unable to pay its debts.
- It would be just and equitable to wind up the company owing to a shareholder dispute.

A company is deemed to be unable to pay its debts if any of the following conditions are met:

- The company is indebted in a sum exceeding MYR500.
- The execution or other process required under a judgment, decree or order from any court is not carried out (in whole or in part).
- It is proved to the satisfaction of the court that the company is unable to pay its debts.

Compulsory court-ordered winding-up is initiated by a creditor if the company is unable to pay its debts, while winding-up under the just and equitable ground is typically initiated by at least one member of the company. The process requires the filing of a petition against the company in the High Court.

INSOLVENCY OF CORPORATE GROUPS

4. Are there joint insolvency proceedings available that can apply to a whole group of companies? Do all members of a corporate group have to proceed under the same type of insolvency proceeding?

Malaysian law does not permit a joint proceeding in relation to insolvency proceedings for a group of companies. Separate insolvency proceedings must therefore be filed for separate companies. However, the law permits practical acknowledgement of the related proceedings, which means that an application can be made for the related proceedings to be heard in the same court and before the same judge. In practice, this is rare.

If the members of the group are organised under, or operate in, different locations within the country, the location where the proceedings are commenced depends on the type of proceeding. Winding-up proceedings in the High Court are commenced in the local registry of the High Court in the state of the company's registered office. It is likely that members of the same group of companies will share the same registered address, so separate proceedings can be initiated against different companies within the group, which can then be consolidated or heard together as if they were a single proceeding. However, if the members of the group have their registered addresses in separate states within Malaysia, they must make an application to transfer proceedings to a location where most of the group companies and their creditors are located. In deciding whether to transfer the proceedings, the court will take the following factors into consideration:

- Where the bulk of the company's assets are located.
- Where the majority of the creditors are located.

There is no requirement under Malaysian law for the members of the corporate family to proceed under the same type of proceeding. Each entity is legally entitled to decide on its preferred mode of insolvency proceeding. See *Question 1* regarding the different types of proceedings available.

5. Can the same insolvency office holder(s) administer the assets and the liabilities of the entire corporate group? Is a court hearing required to determine whether administration by the same individual(s) is appropriate and, if yes, does notice have to be given to creditors?

Generally, a single administrator, trustee or receiver cannot be appointed over an entire group of companies.

However, if a number of companies from the same group are subject to the special administration or conservatorship processes (*see Question 2, Special administration* and *Conservatorship*), the Danaharta Corporation or the Malaysia Deposit Insurance Corporation, as the case may be, can appoint the same individual as administrator or conservator of each member of the group. In that case, the same administrator or conservator will administer the assets of the various companies within the group more conveniently, efficiently and coherently than if different administrators or conservators had been appointed over each company within the group. However, as there is no true collective procedure and assets cannot strictly be pooled, the restructuring proposal under the administration or conservatorship must be tailored to each individual company. The pay-out to creditors of the group will invariably be limited to the assets of the debtor company. Creditors do not have a say in the appointment of the administrator or conservator.

Although it is not possible to appoint a single liquidator for all members of a group of companies, the same individual can be appointed as liquidator of each member of the group. Again, a single liquidator cannot administer the winding-up on a pooled basis, and creditors will be paid out from the assets of the company that is indebted to them. Unlike for special administration and conservatorship, creditors have a say in the appointment of the liquidator in compulsory winding-up proceedings. They have a right to be given notice and to be heard before a liquidator is appointed for each company within the group.

6. If the law does not permit a single insolvency office holder, are there provisions allowing different office holders to co-ordinate with each other so that the value of the group's assets can be maximised?

There are no such provisions. However, this is unlikely to be an issue for special administration or conservatorship, because the Danaharta Corporation or the Malaysia Deposit Insurance Corporation will likely appoint the same office holder for each company within the group (*see Question 5*).

In court-ordered winding up proceedings, a court will not generally prevent individual liquidators from co-ordinating with each other with a view to maximising the returns to creditors.

7. Can professional advisers work for the entire corporate group?

Generally, other professionals can work for the entire corporate family.

However, since companies within a corporate group are still essentially independent from one another, a conflict of interest may arise in certain situations. For example, when a dispute arises between two member companies within a group and one legal firm has been representing the entire corporate group, the legal firm must excuse itself from acting for one of the companies, as a conflict of interest will inevitably arise and the maintenance of professional independence will be difficult (*Rules 3 and 5, Legal Profession (Practice and Etiquette) Rules 1978*).

However, it is not unusual for a firm to render daily professional services to a group of companies, and this will not be considered a conflict of interest under normal circumstances.

There are no legal restrictions on an accounting or auditing firm working for the whole corporate group.

8. Are the rules regarding members of a corporate group transferring assets to one another different when one or more members are insolvent?

When the company is solvent, the directors owe a duty to the company. However, this duty shifts to the creditors when the company is insolvent. Therefore, on insolvency any transactions made when the company is insolvent must:

- Not be at an undervalue.
- Not confer a preference to any person.

Malaysian law on the avoidance of transactions is strict and does not require any evidence or consideration of motive or intention. A transaction is absolutely void and a liquidator can take steps to recover the money or asset transferred where both:

- The transaction involves a payment or a transfer of assets by an insolvent company in favour of another company, including a company within the same group.
- The transaction occurs within a period of six months from the date of presentation of a winding-up petition (which

subsequently results in a winding-up order) or within six months of a resolution to voluntarily wind up the company. This covers the six-month period immediately preceding the date of commencement of winding-up, which is deemed by statute to be either the (as the case may be):

- date of the presentation of the winding-up petition, or
- date when the resolution of the company's members to voluntarily wind up the company is passed.

Any transfer of assets after the commencement of the winding-up is void unless the court orders otherwise (*section 223, Companies Act*).

9. How are claims of one member of a corporate group against other members of the group treated in a formal insolvency processes for those members?

Since the member companies within a corporate group are separate entities, a claim by one member company against another for an inter-company debt will be considered in the same way as the claim of any other creditor. Therefore, an inter-company debt creates a valid and enforceable debtor-creditor relationship.

Generally, there is no subordination of inter-company claims to claims of third-party creditors. Therefore, the normal rules apply and will depend on whether the debt is a secured or unsecured debt, and on any agreements relating to the conditions of the debt. When a company is undergoing liquidation, the rights of the creditors rank *pari passu*. If the claim is a secured debt, the security can be realised to pay off the secured debt. Unsecured creditors rank last in the priority of creditors to be paid out of the assets of the company. An unsecured creditor will also rank *pari passu* among other unsecured creditors.

Substantive consolidation

10. Is pooling of assets and liabilities of some or all members of a corporate group allowed, so that a creditor of one member becomes, in essence, a creditor of all members?

Generally, Malaysian law does not allow for the pooling of assets or liabilities of some or all member companies within a corporate group. Malaysian law treats each claim against each group member as separate and distinct. The law requires each company to put its own interests above that of the group as a whole whenever it does a transaction with another group company. However, the directors of one member company can consider the interests of the group as a whole, provided they do not subordinate or sacrifice the interests of their company.

Therefore, creditors fully expect to have each company's assets ring-fenced and made available for realisation for the benefit of all classes of creditors of that company alone, and not for creditors of the group as a whole. One of the reasons for this is that some creditors may have dealt with one company without knowing that it was part of a group.

11. What proceedings are required for the court to order the pooling of assets and liabilities?

Not applicable (*see Question 10*).

12. Is the partial pooling of assets and liabilities allowed? What conditions apply?

Not applicable (*see Question 10*).

13. If the pooling of assets and liabilities is permitted, are there any protections for certain types of creditors?

Not applicable (*see Question 10*).

Secured creditors

14. How are secured creditors treated in relation to a group of companies?

Claims of secured creditors that have a primary claim against one group member and a guarantee for that debt from another member of the group cannot be combined into one claim. Each claim can be validly proved against each company, subject to the rule against double proof, which prohibits a double payment for the same debt in a single insolvency proceeding.

INSOLVENCY PROCEEDINGS FOR INTERNATIONAL CORPORATE GROUPS

15. What extra considerations are necessary if one or more members of the corporate group is incorporated under or governed by the laws of another jurisdiction?

If one or more members of the corporate family is incorporated under, or governed by, the laws of another jurisdiction, that particular entity will be governed by the law of the jurisdiction where it was incorporated and will not generally be subject to Malaysian law unless it has assets in Malaysia.

16. If insolvency/restructuring proceedings are started for corporate group members in different countries, do international treaties or EU legislation apply?

There are no treaties, conventions or legislation that apply (other than Malaysian law) to insolvency or restructuring proceedings commenced outside Malaysia. Malaysia has not adopted the UNICTRAL Model Law on Cross-Border Insolvency 1997. There is very little guidance to assist a foreign insolvency office holder, although Malaysian courts, on the grounds of comity, recognise the appointment of an insolvency office holder by a court of competent jurisdiction over a debtor company that is organised or carried on business in that jurisdiction.

17. Do domestic courts typically attempt to exercise jurisdiction over all the assets of a company filing locally (regardless of where the assets are located) or do they limit their jurisdiction to local assets?

The Malaysian courts limit their jurisdiction to assets within the Malaysian jurisdiction. However, court-appointed liquidators may attempt to seek recognition in a foreign jurisdiction where the company has assets, and then seek the assistance of the foreign court to recover these assets.

18. Do local courts enforce court orders from foreign jurisdictions that attempt to exercise jurisdiction over assets located in your jurisdiction that are owned by a company subject to foreign insolvency proceedings?

The enforceability of a foreign judgment relating to assets located in Malaysia depends on whether the foreign court can determine title to the Malaysian asset under the Malaysian conflict of laws rules.

In the event of a winding-up in Malaysia of a company incorporated in another jurisdiction, Malaysian law requires that assets of the foreign company which are located in Malaysia must first be ring fenced and applied towards Malaysian liabilities to creditors, before the assets can be turned over to a foreign insolvency office holder.

19. Can the courts co-operate with foreign courts to co-ordinate the administration of group assets?

Malaysia has not adopted or informally used the Guidelines Applicable to Court-To-Court Communications in Cross-Border Cases as adopted and promulgated by the American Law Institute and the International Insolvency Institute, or any other similar protocols or guidelines. Although Malaysian law does not prohibit such use, there is no local procedure or protocol to facilitate the formal or informal use of these guidelines, even if a foreign court requests co-operation in insolvency matters.

DIRECTORS' DUTIES

20. Does your jurisdiction encourage or discourage overlapping boards or management teams for separate members of a corporate group?

There are no statutory requirements or prohibitions in relation to overlapping boards or management in a corporate family. However, in practice, each company must have a separate board of directors, and it is therefore common to have an overlap of individuals in management, especially within a group of companies.

21. What legal consequences are there for the directors of a parent company where they are not directors of the subsidiary but do manage the subsidiary's affairs?

Where the directors of a holding company manage the affairs of its subsidiary, these directors are rendered as "de facto" or "shadow" directors of the subsidiary company.

A de facto director is typically a person who has control over the affairs of the company, regardless of its formal appointment. On the other hand, a holding company can be considered as a shadow director when the directors of its subsidiary are nominees of the holding company acting on the directions of the holding company.

A director does not necessarily mean a person that was formally appointed to the office (*section 4, Companies Act 1965*). De facto or shadow directors are deemed to be directors and therefore owe the same duties and responsibilities as directors of a company.

22. What are the main duties and responsibilities of directors and officers to the company, shareholders and third parties? Do they change when the company becomes insolvent?

When a company is solvent, the officers and directors primarily owe duties to the company under both common law and statute. However, in exercising their duties, officers and directors must also have regard to the interest of the company's employees and shareholders.

The directors and officers do not owe a separate duty to shareholders, but the collective interests of the company's shareholders are generally equated with the interests of the company.

When the company is solvent, the directors and officers do not owe a direct statutory or common law duty to the creditors of the company. The directors and officers do not owe a duty to the government authorities.

There is no direct duty owed to the employees of the company. However, directors owe a duty to the employees through their conduct in relation to the company as a whole. This is because the interest of the employees is considered to be part of the interest of the company. For example, the company is empowered to establish and support or aid in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit the employees (among other things) (*paragraph 7, Third Schedule and section 19, Companies Act 1965*).

The duties and responsibilities of the directors and officers change when the company becomes insolvent. There is an evolving common law duty requiring directors to exercise their powers in the interests of creditors once a company is insolvent or is near insolvent, on the ground that it is the creditors that have the residual interest in the remaining assets of the company, and not the shareholders or third parties. This is not a duty that has so far been held to be directly exercisable by creditors. Instead, it is owed to the company, and the liquidator of the company can enforce this duty against one or more directors for the benefit of creditors.

Before insolvency, technically the directors and officers owe a duty to each individual company within a family of companies. They can act in the interest of the family group as a whole (where they are required to act in their best interest). This duty includes the interest of all shareholders within the company family. However, when the company becomes insolvent, the focus of duties owed by the directors shifts to the creditors, although the duty is technically owed to the company. The directors can no longer prefer the interests of the group as a whole, but must consider the position of each company within the group.

Where one or more group companies may be insolvent, the position under Malaysian law is that the directors and officers of one member company owe a duty to the creditors of that particular insolvent company and must prioritise the interest of the creditors of that company over the interests of any other company within the group. This is because each company is a separate legal entity and has a separate set of creditors (*Intraco Ltd v Multi-Pak Singapore Pte Ltd [1995] 1 SLR 313*). Therefore, the duties owed to an insolvent company will differ to those owed to a solvent company, regardless of whether the directors remain the same in both the solvent and insolvent company.

23. How are competing duties addressed where directors and officers of different group company members overlap and there are conflicts of interest between the group members?

Companies within a corporate family are separate legal entities. However, commercial reality dictates that, when dealing with a family of companies, the directors must take into account the welfare of the group as a whole, but are not entitled to sacrifice the interests of one company for the benefit of the group (*Charterbridge Corporation Ltd v Lloyds Bank Ltd [1970] Ch 62*, which was referred to in the Court of Appeal decision of *Pioneer Haven Sdn Bhd v Ho Hup Construction Co Bhd & Anor and other appeals [2012] 3 MLJ 616*).

Directors (especially directors of a holding company) can consider the interests of the group as a whole when making decisions, provided that they do not sacrifice the interests of any company within the group. This means that the transaction must be commercially defensible on a group basis while not being detrimental to the individual company (*Intraco Ltd v Multi-Pak Singapore Pte Ltd [1995] 1 SLR 313*, which was referred to in cases such as *Double Acres Sdn Bhd v Tiarasetia Sdn Bhd [2000] 7 CLJ 550* and *Abdul Mohd Khalid Hj Ali & Ors v Dato' Hj Mustapha Kamal & Anor [2003] 5 CLJ 85*).

24. What specific types of conduct are in breach of the duties and responsibilities of directors and officers?

Failure to take reasonable steps to minimise losses to creditors

When the company is solvent, a director will not be liable for losses sustained by the company if they acted in good faith, for proper purposes and in the interests of the company.

However, when a company is insolvent, the interests of the creditors become the dominant factor in what constitutes the "benefit of the company as a whole" (*West Mercia Safetywear Ltd v Dodd [1988] BCLC 250*), and directors owe duties to ensure that their actions do not prejudice creditors or increase the debt of the company. The directors are also discouraged from carrying on the company's business and contracting debts when there is no expectation of paying the debts as and when they fall due.

Misappropriation of corporate assets

Misappropriation of corporate assets is a breach of duty, as directors are prohibited from (*section 132(2), Companies Act 1965* (Companies Act)):

- Engaging in any improper use of company's property.
- Taking advantage of their position or any corporate opportunity that arises.
- Competing with the company.

It is also an offence for officers of companies during liquidation to fraudulently remove any part of the company's property to the value of MYR50 or more within 12 months before the commencement of the winding-up, or at any time thereafter (*section 300(1)(c)(ii), Companies Act*).

Undervaluation of corporate assets to the detriment of creditors

Directors who enter into a transaction that undervalues corporate assets commit a breach of fiduciary duty, as the undervaluation of assets will dilute the assets that are available to repay the creditors.

During insolvency, the directors owe the creditors a duty and any conduct that is prejudicial to the creditors' interests is a breach of this duty. A liquidator is allowed to recover any cash transaction for the purchase or sale of any property, business or undertaking previously entered into by a company with any person who was a director of a company, or with whom a director was connected, within a period of two years if (*section 295, Companies Act*):

- The purchase was overvalued at the time of purchase.
- The sale was undervalued at the time of sale.

Failure to inform creditors of insolvency

Failure to inform creditors that the company is insolvent is not a breach of duty. However continuing to trade in the knowledge that the company is insolvent is a breach of a director's duty, and a potential offence under the Companies Act.

Preferring payment to one creditor

Any undue preference payment to a particular creditor is void against the liquidator (*section 293, Companies Act* and *section 53, Bankruptcy Act 1957*). This is to preserve the *pari passu* principle, under which the creditors in a winding-up share rateably in the assets that are available for distribution (*Sime Diamond Leasing (M) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (in Liquidation) [1998] 4 MLJ 569*). Therefore, a director preferring payment to one creditor over another creditor when insufficient funds are available to pay both will amount to an undue preference, which will be void against the liquidator.

Continuing to trade with little prospect of being able to pay debts

The directors commit a breach of their duties if they continue trading either (*Companies Act*):

- Knowing that the company has little or no prospect to pay its debts when they fall due (*section 303(3)*).
- With the intention to defraud the creditors of the company (*section 304(1)*).

The first offence above is easier to prove than the second, as the test for the first offence is objective and does not require proof of fraud or dishonesty.

Other duties

When the company is insolvent, the directors are also under a duty to (among other things) (*Companies Act*):

- Keep proper accounts of the company (*section 303(1)*).
- Not destroy, mutilate, alter or falsify any books or documents of the company (*section 302*).

25. What civil and criminal liability exists for directors and officers if they breach their duties and responsibilities?

Liability

Officers and directors face both civil and criminal liability (imprisonment and criminal fines). The amount/term of the fine/imprisonment varies according to the breach.

Before insolvency

Before insolvency, the directors/officers can be exposed to possible civil claims by the company if they breach their duties and responsibilities. Directors can be liable to pay damages for breach of their duties of care and skill, and to compensate the company for loss caused by an improper exercise of their powers.

If the duties of a director conflict with their personal interest, the director can be liable to pay equitable damages. A director who received any property of the company will be liable to restore the property.

After insolvency

After insolvency, the officers and directors are still exposed to possible civil claims brought by the liquidator on behalf of the company if they breach their duties and responsibilities (among other things).

Once insolvency arises, and particularly after winding-up, directors can be exposed to criminal actions under the Companies Act, including for:

- Wrongful trading and fraudulent trading (*sections 303 and 304*).
- Committing one or more criminal acts that are specified in section 300.

26. Is potential personal civil or criminal liability a factor in officers and directors deciding if and when to put the company into a formal insolvency/reorganisation procedure?

The threat of directors being found personally liable for insolvent or fraudulent trading is one of the main factors for directors to put the company into a formal insolvency or reorganisation procedure. This is because directors who are aware of the company's financial difficulties (that is, that the company is unable to pay its debts), and still trade during that period, may be found personally liable for insolvent trading under section 303(3) (read with section 304(2)), and fraudulent trading under section 304, of the Companies Act 1965, which can result in potential civil and criminal liability. It is therefore safer to put the company under a formal insolvency procedure to avoid any personal liability. However, prosecutions under these statutory provisions, and the imposition of unlimited personal civil liability, are rare in Malaysia.

27. Is insurance available to protect directors and officers from claims arising while operating a financially distressed company?

Directors' and officers' liability insurance in relation to third-party claims is available at reasonable premiums. A company is not precluded from obtaining insurance to protect its officers and directors from any personal liabilities to third parties that may arise while they are exercising their duties. However, Malaysian law does not allow a company to exempt or indemnify a director from liability to the company itself for negligence, default, breach of duty or breach of trust.

In theory, the risk of personal liability for continuing to trade while insolvent should be a factor as to whether the company should continue to trade. However, in practice, this is only likely to be a significant factor with regards to public companies that are listed on a local stock exchange. This is due to a lack of awareness of the restrictions and, and consequences of, trading while insolvent among directors of many private, small to medium companies. Directors of small to medium private companies are unlikely to consider directors' and officers' liability insurance as being necessary, or even to appreciate the utility of insurance cover in situations of marginal or doubtful solvency. Therefore, the availability of insurance cover is unlikely to be a factor in deciding if and when to put a company into a formal insolvency (reorganisation) proceeding in Malaysia.

28. Can directors and officers resign from their positions if the company becomes financially distressed and what difference will this make to their potential liability?

Officers and directors can resign from their positions once the company becomes financially distressed, as there is no provision preventing them from doing so. However, the statutory minimum number of directors is two, which means that the entire board cannot resign en bloc. Directors who resign on or before the onset of financial distress will escape liability for anything occurring in relation to the company's affairs thereafter, but their conduct of the company's affairs before their resignation will still be subject to scrutiny by any liquidator appointed subsequently.

29. How common is litigation against directors and officers for violation of their duties after commencement of insolvency/reorganisation proceedings? Is the litigation typically successful?

Actions for violation of duties of directors after the commencement of insolvency are not frequent, but have been brought in Malaysia. Invariably, actions are brought by liquidators against directors whose conduct of the company's business led to insolvency or exacerbated it.

Creditors do not have standing per se to bring civil actions against directors for damages, but can make an application under section 305 of the Companies Act 1965 to have a court examine the conduct of a director and determine if there was a breach of duty or misfeasance. If found liable, a director may be ordered to restore money, compensate the company or contribute to the company's assets for misapplication of assets, misfeasance or breach of duty committed before the winding-up.

The author is unable to comment on whether legal actions against officers and directors are typically successful, as they are generally fact-specific and the likelihood of success varies on a case-by-case basis.

30. What defences against civil and/or criminal sanctions are available to directors and officers?

Good faith

A plea that a director acted at all times in good faith is available to directors and officers under common law and statute. However, good faith is not a defence per se, but is a necessary and essential element for establishing one or more of the defences below.

The director must prove that they acted bona fide (in good faith) and in the best interest of the company (*sections 132(1) to 132(1B), Companies Act 1965* (Companies Act)). Good faith is a factor in considering any liability on part of the directors and officers.

Due diligence

The defence of due diligence (for example, in relation to obtaining a valuation of the company's assets) is available under common law and statute. The director must prove that they exercised their duties with reasonable care, skill and diligence, and with the knowledge, skill and experience reasonably expected of them, having regard to their responsibilities and any additional knowledge, skill and experience (*sections 132(1A) to 132(1B), Companies Act*).

Reliance on outside consultant or professionals

A director, in exercising their duties, can rely on external consultants or professionals (such as accountants, legal advisers or

financial advisers) provided that the reliance was based on reasonable grounds, namely in good faith and after making an independent assessment of the information or advice, and opinions, reports or statements, having regard to the director's knowledge of the company and the complexity of the structure and operation of the company (*sections 132(1C) and 132(1D), Companies Act*). Where a director or officer acts on the advice of professionals whom they reasonably believe to be reliable, that can be a defence to any personal liability of the director or officer.

Reasonable business judgement with intent to preserve "ongoing value" of enterprise

There is no specific provision on the exercise of a reasonable judgement with the intent to preserve the "ongoing value" of the enterprise. However, a director is entitled to make a business judgement (defined as "any decision on whether or not to take action in respect of a matter relevant to the business of the company") (*section 132(6), Companies Act*). A director who makes a business judgement must (*section 132(1B), Companies Act*):

- Make the business judgement in good faith for a proper purpose.
- Not have a material personal interest in the subject matter of the business judgement.
- Be informed about the subject matter of the business judgement to the extent the director reasonably believes to be appropriate under the circumstances and reasonably believes that the business judgement is in the best interests of the company.

31. If it appears that "going concern values" will result in a higher return to creditors than a liquidation of the assets, can directors and officers be protected if they decide to continue operations to protect the values for the benefit of all creditors?

There are no provisions prohibiting officers and directors from continuing operations with the hope of preserving going concern values, but they may not be protected in such a situation. In any event, officers and directors are still subject to the statutory and common law duties owed to the creditors and the company.

Even if the directors and officers choose to continue operations with the hope of preserving going concern values, if the company is subsequently liquidated, they may be liable for contracting debts with knowledge that there is no reasonable prospect that the company will be able to pay the debt (*sections 303(3) and 304, Companies Act 1965*).

The directors and officers may also be liable, even if they act in good faith, if business activities are carried in such a way that it results in an increase of debt owed to the creditors. Good faith is merely a consideration in determining whether the directors and officers were in breach of their duty, and is not a defence per se.

32. If a company becomes insolvent, is a director or officer of the insolvent company legally restricted from acting as a director or officer in another company, or from obtaining credit as a promoter of another company?

An officer or director of an insolvent company is not automatically disqualified from managing another company. However, the Registrar or Official Receiver can apply to the court for an order requesting that this officer or director cannot, without the leave of court, take part in the management of a company (*section 130A, Companies Act 1965* (Companies Act)). If the order is granted, disqualification will take effect from the date of the order and will last for a maximum period of five years.

When considering whether to disqualify a director, apart from being a director of an insolvent company, the court must be satisfied that their conduct as director makes them unfit to be concerned in the management of a company (*section 130A(1)(b), Companies Act*).

33. If a director or officer becomes personally insolvent, is he legally restricted from continuing to act as a director or officer of his current company or another company?

An undischarged bankrupt cannot continue to be a director of any company without the leave of court. Any undischarged bankrupt who acts as a director of a company is guilty of an offence and can be liable to either or both (*section 125, Companies Act 1965*):

- Imprisonment for up to five years.
- A fine of up to MYR100,000.

ONLINE RESOURCES

Attorney General's Chambers of Malaysia

W www.agc.gov.my

Description. Official website of the Attorney General's Chambers of Malaysia with legislation in the national language, Malay. Official translations of legislation in English can also be found on this website.

Companies Commission of Malaysia

W www.ssm.com.my

Description. Official website of the Companies Commission of Malaysia, which is the principal regulator of companies in Malaysia and is responsible for the administration and oversight of all companies in Malaysia.

Malaysian Department of Insolvency

W www.insolvensi.gov.my

Description. Official website of the Insolvency Department, Malaysia, which is responsible for all aspects of the winding-up and liquidation of companies in Malaysia under the Companies Act 1965. The Official Receiver of Malaysia acts as the default liquidator in any liquidation where a private liquidator is not appointed, and is ultimately responsible for supervising all private liquidators.

Office of the Chief Registrar, Federal Court of Malaysia

W www.kehakiman.gov.my

Description. Official website of the Office of the Chief Registrar, Federal Court of Malaysia, with decisions in the national language, Malay. Decisions in English can also be found on this website.

Practical Law **Contributor profile**

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Professional qualifications. Barrister and Solicitor, New Zealand, 1986; Advocate and Solicitor of the High Court of Malaya, 1987

Areas of practice. Commercial law; corporate law; banking; insolvency.

Non-professional qualifications. LLB (Hons), University of Canterbury, New Zealand; LLM (Hons), University of Cambridge, United Kingdom

Recent transactions

- The First Malaysian case at the Court of Appeal under the new statutory derivative action provision in section 181A of the Companies Act 1965 (*Celcom Malaysia Berhad v Mohd Shuaib Ishak [2011] 3 MLJ 636*).
- The case involving the takeover of a public listed company, EGM for removal of directors (*Extreme System S/B v Ho Hup Construction Company [2010] MLJU 232; [2010] 1 LNS 338 and 478 and 481*).
- Advised a number of boards of public-listed companies on directors' duties.
- Numerous other unreported cases involving allegations of breaches of directors' duties.

Languages. English, Malay

Professional associations/memberships

- Founding and current Council Member of the Insolvency Association of Malaysia.
- Member of the International Insolvency Institute, New York.
- Former Member of the Advisory Board to the Institute of Asian Pacific Business Law at the William S Richardson School of Law, University of Hawaii, US.

Publications. Article on the law of holding and subsidiary companies in *(1986) 3 University of Canterbury Law Review (NZ) 1 which is cited in John Farrar, Company Law (4th Edition), 2002, chapter 33*; *"Whether an Appearance amounts to a 'Step in the Proceedings' under section 6 of the Arbitration Act 1952" (2002), International Arbitration Law Review.*