DREW & NAPIER

CASE UPDATE

Director's Duties: Shareholders Interest a Proxy of Company's Best Interests? Not Always, Depending on its Solvency

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LEGAL UPDATE

In this Update

In Foo Kian Beng v OP3 International Pte Ltd (In liquidation) [2024] SGCA 10, the Singapore Court of Appeal dismissed the Appellant's appeal and held up the findings by the Judge of the General Division of the High Court of Singapore that a director has a duty to consider the interests of creditors as part of his duty to act in the best interests of the company at a time when the company was in a financially parlous state, and that the Appellant had breached that duty by authorising the payment of disputed transactions to himself.

This update analyses Singapore's landmark decision to provide guidance and clarity on the nature, scope and content of a director's duty to consider the interests of creditors as part of its duty to act in the best interests of the company ("**Creditor Duty**"). The Singapore Court of Appeal expanded on the UK Supreme Court's landmark judgment in BTI 2014 LLC v Sequana SA and others [2022] UKSC 25 ("***Sequana***") which affirmed that the director's duty to act in the best interests of the company may, in certain circumstances, enjoin a director to have regard to the interests of creditors.

INTRODUCTION

In Foo Kian Beng v OP3 International Pte Ltd (In liquidation) [2024] SGCA 10, the Singapore Court of Appeal dismissed the Appellant's appeal and held up the findings by the Judge of the General Division of the High Court of Singapore that a director has a duty to consider the interests of creditors as part of his duty to act in the best interests of the company at a time when the company was in a financially parlous state, and that the Appellant had breached that duty by authorising the payment of disputed transactions to himself.

The Singapore Court of Appeal issued the landmark decision to provide guidance and clarity on the nature, scope and content of a director's duty to consider the interests of creditors as part of its duty to act in the best interests of the company ("**Creditor Duty**"). The Singapore Court of Appeal expanded on the UK Supreme Court's landmark judgment in BTI 2014 LLC v Sequana SA and others [2022] UKSC 25 ("***Sequana***") which affirmed that the director's duty to act in the best interests of the company may, in certain circumstances, enjoin a director to have regard to the interests of creditors.

BACKGROUND

The Singapore Court of Appeal's decision stems from the payment of US$2.8 million in dividends by interior design, decorating and construction services company OP3 International, to its sole director and shareholder Foo Kian Beng, between 2015 and 2017.

OP3 made the payments at a time when it was solvent on a balance sheet and cashflow basis, but facing the risk of becoming insolvent in the future due to contingent liabilities stemming from a lawsuit brought against it by Singapore-based Smile Inc Dental Surgeons.

Smile Inc brought the suit in May 2015 seeking compensation over defective fitting work the company had done, which caused it to incur ancillary costs of repair and to shut down a clinic for an extended period on two occasions.

In October 2017, the court found OP3 liable to Smile Inc for over US$534,000. The company was wound up at Smile Inc's petition in April 2020, after failing to satisfy the judgment.

OP3's liquidators subsequently brought a claim against Foo claiming he breached his duties as a director by making the dividend payments.

In September 2022, Judge Hoo Sheau Peng in the Singapore High Court dismissed Foo's arguments that no value should be ascribed to the contingent liability and that he was not obliged to consider the interests of creditors unless OP3 was insolvent or on the verge of insolvency, which it wasn't at the time the dividend payments were made.

The judge engaged in a broad and practical assessment of the financial health of the company to determine whether the Creditor Duty had arisen and the extent to which a director was obliged to consider the interest of creditors. The judge held that the duty to creditors was invoked when the company found itself in a financially parlous state, even though it was in a less dire situation than being on the verge of insolvency. The judge noted that the underlying duty to creditors stemmed from safeguarding a company's assets from wrongful dissipation, which was not solely reserved for times when the company was on the verge of insolvency.

Factoring in the contingent liability, Judge Hoo Sheau Peng held that OP3 would have been balance sheet insolvent at around 31 December 2016, when it had net assets of US$157,683. The judge reasoned Foo was in breach of his fiduciary duty to act bona fide in the best interests of creditors because the US$500,000 dividend was paid on 27 December that year.

Foo appealed against the judge's findings.

TWO-PRONGED FRAMEWORK

The Singapore Court of Appeal observed there was no uniform language describing when the Creditor Duty is first engaged in Singaporean case law: some precedents suggested directors were obliged to consider creditors' interest when the company was insolvent or perilously close to being insolvent, while others suggested they are obliged to do so merely when the debtors is in a parlous financial position.

The appeal judges said the court should ascertain whether the Creditor Duty has arisen and consider a distinct issue of whether the Creditor Duty was breached, and these two issues should be dealt with sequentially.

In determining whether the Creditor Duty is engaged, a court objectively examines a company's solvency at the time the material transactions were entered into, taking into consideration the surrounding circumstances of the case, including the claims, debts, liabilities and obligations of a company. For this assessment, the Singapore Court of Appeal categorised the company's financial state in three stages:

(1) Category 1

In the first financial state – when a company is solvent and able to discharge its debts. A director typically doesn't need to do anything more than act in the best interests of shareholders to comply with his fiduciary duty and the creditor duty doesn't arise, the court said. But it pointed out that if a director sought to defraud creditors, there would be a breach.

(2) Category 2

In the intermediate zone, the judges said, the court should scrutinise the subjective bona fides of a director with reference to the potential benefits and risks that the relevant transaction might bring the company. They added that the court should be slow to second-guess the "honest, good faith commercial decisions" made by a director to give a company the best possible chance of "revitalising its fortunes". The appeal judges warned that transactions exclusively benefitting shareholders or directors in this scenario would attract heightened scrutiny: the greater the exclusive benefits, the more closely the court should scrutinise the director's decisions.

(3) Category 3

In the last scenario, where a corporate insolvency proceeding is inevitable, the Court of Appeal said there was a clear shift in the company's economic interests because its assets will be insufficient to satisfy creditors' claims. The Creditor Duty operates to prohibit directors from authorising corporate transactions that exclusively benefit them or shareholders in such circumstances, it noted.

Having objectively ascertained the financial state of the company at the material time, the court should then ascertain whether the director had acted in breach of the Creditor Duty. In this regard, however, the court examines whether the director subjectively believed he had acted in the best interests of the company. The appeal judges said "the financial state of the company provides a useful analytical yardstick against which the subjective bona fides of the director may be tested".

The appeal judges said that once a breach of the Creditor Duty has been ascertained, then a court should consider whether it is appropriate to relieve a director of liability under Section 391 of the Companies Act, where they could have, in good faith, misjudged a company's financial state and failed to adequately consider the interests of creditors. "We stress, however, that such cases are likely to be few and far between," they clarified.

COURT OF APPEAL'S DECISION

Turning to the case at hand, the Singapore Court of Appeal agreed with the lower court that OP3 was in the intermediate scenario and said it rightfully scrutinised the Appellant's actions because the transactions only benefited him. The Singapore Court of Appeal also agreed that the contingent liability from the Smile Inc lawsuit was reasonably likely to materialise and had to be taken into account in assessing the company's solvency.

OP3's financial statements painted "a picture of a rapidly deteriorating operating environment", the judges said, agreeing that the Appellant's Creditor Duty was engaged when he made the transactions.

The appeal judges also found that legal advice the Appellant had sought on Smile Inc's lawsuit had been "extremely cursory, given orally, and in respect of which no written notes of those conversations exist". The mere fact the Appellant had sought legal advice did not mean he would be found to have acted bona fide, the appeal judges added.

Finding that the Appellant failed to consider the interests of creditors and breached his duty by authorising the payments, the Singapore Court of Appeal refused to grant the Appellant relief because he did not act honestly and reasonably, and had enriched himself at the company's expense, while knowing Smile Inc's lawsuit had merit and that the business was on a steep decline.

RATIONALE FOR THE CREDITOR DUTY

The Singapore Court of Appeal noted that Singaporean case law had "spoken with one voice" on the underlying rationale for the Creditor Duty – namely, the need to constrain directors from externalising the risks of continued trading of a financially distressed company on to creditors.

The Singapore Court of Appeal endorsed Lord Reed's observations in Sequana that "being on the brink of insolvency does not necessarily require an immediate cessation of trade and the realisation of the company's assets".

While the going concern test and the balance sheet test provided a useful indication of a company's financial health, "a strict and technical application of these tests should be eschewed", the appeal judges explained.

The appeal judges also agreed with Lady Arden in Sequana that the two tests must be applied with "the degree of flexibility appropriate to the rationale and context of the creditor duty" and that "the court should be alive to the reality that prompt payment may not always be insisted on by creditors".

Rather, the Singapore Court of Appeal recognised that insolvency was not an uncommon phenomenon in the life of viable companies and directors may, in good faith, perceive there is a reasonable prospect the company can trade itself out of insolvency for the benefit of both creditors and shareholders. The appeal judges said that there needed to be a "broader assessment of the surrounding circumstances", which would include consideration of all claims, debts, liabilities and obligations of a company.

The Singapore Court of Appeal advocated an approach of practicality on this issue. The appeal judges said that in as much as the court is examining the business judgment of a director, it will be slow to interfere with commercial decisions made honestly but which, on hindsight, were financially detrimental to a company. Directors undertake corporate decisions based on information then available to them and it is not the role of the court to censure directors who, in good faith, have made commercial decisions which turn out to be incorrect.

OTHER DUTIES OWED BY DIRECTORS

The Singapore Court of Appeal cautioned that compliance with the Creditor Duty does not immunise a director from breaches of other directors' duties which may be engaged on the same set of facts. As an action for breach of the Creditor Duty focuses on the subjective intentions of a director in committing a company to a certain course of action, it is theoretically possible, though perhaps uncommon, for a director to have honestly believed that he had acted in the best interests of the company and be found to have complied with the Creditor Duty even though his actions are found to fall below the objective standard of care and diligence expected of a director.

The appeal judges also emphasised that it is not the case that the interests of creditors only become relevant when the Creditor Duty is engaged or that those interests are otherwise immaterial. The underlying duty is a duty to act in the best interests of the company, and this enjoins directors to have regard to the interests of different stakeholders, including creditors, at all times. Therefore, it remains possible for a director to breach his duty to act in the best interests of the company at a time the company is solvent by undertaking acts that unjustifiably prejudice the interests of creditors.

CONCLUSION

In an action for breach of the Creditor Duty, the relevant question is whether the director exercised his discretion in good faith in what he considered (and not what the court considers) to be in the best interests of the company, as understood with reference to the financial state of the company prevailing at the material time. Although the duty is a subjective one in that sense, the court will assess a director’s claim objectively, by asking whether the view the director claims to have formed was one that is credible or was reasonably open to him, given the information available at the time.

This landmark decision provides a timely reminder that in the current situation where companies are facing an environment of instability and financial uncertainty as a result of high interest rates and supply-chain disruptions, it is important for directors, regardless of executive or independent, be appraised on the financial statement of a company at all times, and to be prepared to justify (and document) their commercial decisions based on the relevant financial state of affairs. To mitigate against the risk of potential breaches of the Creditor Duty, it would also be helpful to consider the suitability of the suite of restructuring tools (from moratorium, scheme of arrangement, judicial management and even liquidation).

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