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CORPORATE INSOLVENCY: SEPARATE LEGAL PERSONALITY AND DIRECTORS' DUTIES TO CREDITORS

by *MOHAMMAD RIZAL SALIM**

Introduction

The primary purpose for the doctrine of separate legal personality is to encourage entrepreneurship, by shifting the risks of business failure away from entrepreneurs to creditors and other risk bearers. Unfortunately this doctrine is subject to abuse by corporate controllers, which prompted the courts and the legislature to provide for exceptions. These exceptions are better known as the lifting or piercing of the corporate veil. How do these exceptions protect creditors? How effective are they? This article seeks to examine laws in relation to the separate legal personality doctrine and the duties of directors which directly affects, or attempts to protect, creditors from unfair and improper conduct by corporate controllers.

The Legal Personality Doctrine

Company as a separate legal personality

It is a fundamental feature of company law that a company is a separate entity, distinct from its shareholders. The starting point for the discussion of this doctrine is the House of Lord's decision more than a hundred years ago in *Salomon v Salomon & Co Ltd.*[1] It follows that since the company is a legal person separate from its' shareholders, the shareholders will not be liable for the company's debts. Consequently, the course of action for the company's creditors is limited only to the company itself, and not its shareholders or even directors.A related doctrine is the doctrine of limited liability.

Limited liability

Limited liability means that the liability of shareholders is limited to the amount unpaid on their shares.[2] Limited liability results in the shifting of the risks of

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* Lecturer in Law, Faculty of Law, Universiti Teknologi MARA, Malaysia, LLM (Melbourne), LLB (Hons) (Malaya), Advocate & Solicitor, High Court of Malaya.
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1 [1897] AC 22.

2 The Companies Act 1965, s 214(1)(d).

entrepreneurship from shareholders to creditors. If the company does well, the gains are passed on to the shareholders. But if the company fails, the creditors will suffer the losses. Because the creditors bear the risk of the company failing, creditors will, quite naturally, attempt to minimise the risk of default. Prudent creditors will always ascertain the creditworthiness of the debtor companies. The more sophisticated creditors such as financial institutions will, in addition to satisfying themselves that the debtor company is creditworthy, require the company to provide security, or require the company's shareholders or directors to provide personal guarantees. They may even go to such lengths as to require the company to provide its financial statements on a periodical basis, overseeing management, or placing their nominees in the board of the company. In addition, any extra risk which lenders bear will be compensated with higher rates of return for them.

Thus, the separate legal personality and limited liability doctrines do not necessarily result in the transfer of risks from shareholders to creditors. Despite this, there exist no acceptable alternatives at the moment.[3]

The separate legal personality and limited liability doctrines have been incorporated into the Malaysian Companies Act 1965.[4]

Lifting of the veil of incorporation

In certain circumstances, the courts may disregard the doctrines of separate legal personality and limited liability. This is known as the lifting or piercing of the veil of incorporation. There are no clear categorisations as to when the court will lift the corporate veil, but cases suggest that it could be done when the company is insolvent and there is fraud, deception or attempts to avoid a legal duty by the shareholders or directors, to the detriment of present or future creditors of the company.

The case of *Salomon v Salomon & Co*[5] provides a good illustration, where the House of Lords said that in the absence of fraud, the court would adhere to the separate legal personality doctrine. Fraud as a ground for lifting the corporate veil is now firmly established. In *Re Darby*,[6] for example, the court found that the promoter had committed fraud sufficient to lift the veil of incorporation.

Apart from fraud, the courts have also lifted the veil of incorporation in cases where the veil was used in an attempt to evade legal obligations. In *Gilford Motor Company v Horne*,[7] an ex-employee incorporated a company to avoid his obligation under a contract with his former employer. In *Jones v Lipman*[8], the seller of a house

3 Although there may be the occasional suggestions for reform, especially in areas where corporate groups are concerned: see P Blumberg, *The Multinational Challenge to Corporate Law* (1993) at 121-147; T Hadden, "The Regulation for Corporate Groups in Australia" (1992) 15 UNSWLJ 61 at 81-85.
4 Section 16(5). See also ss 214(1)(d) and 18(3) of the Act which provide for limited liability of shareholders.
5 Note 1.
6 [1911] 1 KB 95.
7 [1933] Ch 935.
8 [1962] 1 WLR 832.

incorporated a company to evade his obligations under a sale agreement. The decision in both cases were approved by the Supreme Court in *Lim Kar Bee v Duofortis Property (M) Sdn Bhd*[9] where Peh Swee Chin SCJ said that the court will lift the corporate veil to discover an illegal or improper purpose.

Implicit in these cases were attempts by the courts to ignore the separate legal personality doctrine and to lift the corporate veil where the incorporation process was improperly used to benefit its incorporator at the expense of creditors. In other words, incorporation was used to defeat future claims. In *Re Darby*,[10] incorporation was used to defeat possible claims by the company's shareholders against Darby as the real promoter of Quarries. Similarly, in *Gilford Motor Company v Horne*,[11] the ex-employee attempted to evade contractual obligations by using the company to do the act which he was otherwise prevented from doing by contract. In *Jones v Lipman*,[12] the seller of the property transferred the property to a company in his attempt to defeat a claim by the buyer of the property. The claimants in all of these cases were either creditors or future creditors of the incorporators.

There had been occasions where the incorporation process itself was not intended to defeat the claims of creditors, but the courts declined to uphold to the strict application of the separate legal personality doctrine, as by so doing it will prevent the incorporators from satisfying creditors' claims. An example is the case of *Aspatra Sdn Bhd v Bank Bumiputra Malaysia Bhd*[13] where the Malaysian Supreme Court by a majority decided that it is proper to lift the corporate veil as the majority shareholder held almost all shares in several companies and was regarded to be the alter ego of the companies. The court had considered the interests of the creditors, in this case the banks, in ordering that the veil of incorporation be lifted. This was necessary to achieve justice.

Another example is *Hotel Jaya Puri Bhd v National Union of Hotel, Bar and Restaurant Workers*.[14] The court in this case had departed from the separate legal personality doctrine to give effect to the claims of the employees of a company for unlawful dismissal. The court looked at the reality that both a holding and its subsidiary companies as being in one enterprise because the businesses of both the holding and subsidiary companies were interdependent and that there was 'functional integrity and unity of establishment' between them. Therefore the court found it reasonable to ignore the separate legal doctrine principle to give effect to claims by the employees of the subsidiary to enable them to sue the holding company.

9 [1992] 2 MLJ 281.
10 Note 6.
11 Note 7.
12 Note 8.
13 [1988] 1 MLJ 97.
14 [1980] 1 MLJ 109

There are numerous other examples. In *Creasy v Breachwood Motors Ltd*[15], the company was used to avoid a payment owed to a manager fired by the company. In *Re A Company Ltd*[16] the companies were used to conceal and dispose off money obtained through fraud. In *Wallesteiner v Moir*,[17] the court lifted the corporate veil because of the misuse of corporate funds by a shareholder.[18]

The creditors' rights argument in lifting the veil was perhaps one of the reasons for the enactment of the wrongful and fraudulent trading provisions in the Companies Act 1965.[19] When the persons running the company are involved in wrongful or fraudulent trading, the courts will pierce the corporate veil and impose personal liabilities on them to make good the losses due to the creditors, in addition to imposing criminal liabilities.[20]

Obviously, the legislature through the wrongful and fraudulent trading provisions, had deemed it necessary to give effect to creditors' rights where the company is insolvent. Why is it then necessary for the courts to pierce the corporate veil to give effect to creditors' rights when the legislation provides for the same protection? One obvious reason is the limitations of the wrongful and fraudulent trading provisions. These will be discussed later in this article. Another reason is that the wrongful and fraudulent trading provisions require a detailed analysis of each alleged wrongful act.[21] By contrast, the courts need not be satisfied of the wrongful or fraudulent nature of a particular act before it will pierce the corporate veil; the elements to be fulfilled are "more general and more vague".[22] This analysis may be accurate when analysing the approach taken by the courts in certain cases.[23]

Tung's analysis, notwithstanding that he used United States' cases for support, should be equally relevant here in Malaysia. The courts have always been willing to pierce the corporate veil in order to do justice. The attempt to uphold justice, as the cases discussed above had shown, includes justice to creditors, current or future. Cases in which the courts had expressed their willingness to lift the corporate veil to achieve

15 (1993) BCLC 480.

16 [1985] BCLC 333.

17 [1974] 2 All ER 217.

18 For other cases where the court had lifted the corporate veil, see, eg, *Tiu Shi Kian v Red Rose Restaurant Sdn Bhd* [1984] 2 MLJ 313; *Hoffman-La Roche & Co AG v Sieczko* [1968] RPC 460; (incorporation to evade a court order); *Hotel Jaya Puri Bhd v National Union of Hotel, Bar & Restaurant Workers* [1980] 1 MLJ 109; *DHN Food Distributores Ltd v Tower Hamlets London Borough Council* [1976] 3 All ER 462 (in relation to group of companies); *Aspatra Sdn Bhd v Bank Bumiputra Malaysia Bhd* [1988] 1 MLJ 97; *Smith, Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116 (company alter ego its incorporators); *Tan Guan Eng v Ng Kweng Hee* [1992] 1 MLJ 487 (to enforce members' rights); *Re FG (Films) Ltd* [1953] 1 WLR 483; *Re Bugle Press Ltd* [1961] Ch 270 (company a sham).

19 Companies Act 1965, ss 303(3) and 304(1) respectively.

20 Companies Act 1965, ss 304(2) and (5).

21 Described as a 'rifle shot' approach by Frederick Tung, "Fiduciary Duty, Limited Liability, and the Law of Delaware: Limited Liability and Creditors' Rights: The Limits of Risk Shifting to Creditors" 34 Ga L Rev 547 (2000) at 567.

22 Described by Tung as the 'shotgun approach': see Tung, ibid at 568.

23 Tung cites the case of *De Witt Truck Brothers Inc v W Ray Flemming Fruit Co* 540 F 2d 681 (4th Cir 1976), where the dominant shareholder of a company regularly took money belonging to the company for his personal use: see Tung, ibid at 565-566.

justice include *Hotel Jaya Puri v National Union of Hotel, Bar and Restaurant Workers*,[24] *Aspatra Sdn Bhd v Bank Bumiputra Sdn Bhd*,[25] *Tengku Abdullah ibni Sultan Abu Bakar v Mohd Latiff bin Shah Mohd*[26] and *Tan Guan Eng v Ng Kweng Hee*.[27]

The Duties Of Directors

"Bona fide for the benefit of the company"

Directors are under a duty to act "bona fide in the interests of the company as a whole".[28] Following *Salomon v Salomon & Co Ltd*,[29] the natural meaning ascribed to the phrase is the company as a corporate entity, an abstract entity with powers and liabilities; a creation of statute. Following *Percival v Wright*,[30] the duties are owed to the company alone and not to individual shareholders or persons dealing with the company such as creditors. In *Greenhalgh v Arderne Cinemas*,[31] interests of the company were held to mean the corporators as a general body, i.e. the shareholders collectively. Interests of shareholders are generally accepted as the existing shareholders, but may include future shareholders, as shareholders interests means not only interests in the short term but also interests in the long term: *Provident International Corporation v International Leasing Corp*.[32]

These pronouncements, however, do not mean that directors owe a duty to shareholders; the duty is owed to the company, but in acting in the interests of the company, the directors must consider the interests of shareholders. The Jenkins Committee in England said, when commenting on the effect of *Percival v Wright*,[33] that "no fiduciary duty is owed by a director to individual members of his company, but only to the company itself, and *a fortiori* that none is owed to a person who is not a member".[34]

Although directors owe no direct fiduciary duties to shareholders, the Companies Act 1965 provides remedies for shareholders for oppression or unfair conduct.[35]

24 Note 14.
25 Note 13.
26 [1996] 2 MLJ 265; [1996] 2 AMR 2633
27 [1992] 1 MLJ 487.
28 *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656, *per* Lord Lindley MR at 671. See also *Re Smith & Fawcett Ltd* [1942] Ch 304, *per* Lord Greene MR at 306; *Greenhalgh v Ardene Cinemas* [1951] Ch 286, *per* Evershed MR at 291.
29 Note 1.
30 (1902) 2 Ch 421.
31 [1951] Ch 286, *per* Lord Evershed MR at 291. See also *Ngurli v McCann* (1953) 90 CLR 425 at 438.
32 [1969] 1 NSWLR 424 *per* Helsham J at 440.
33 Note 30.
34 *Report on the Committee of Company Law Reform* Cmnd 1749 (1962), para 89.
35 Section 181 of the Companies Act 1965. For equivalent provisions in the UK, see s 459 of the 1985 Companies Act and in Australia, s 260 of the Corporations Law.

Directors' duties to creditors

The phrase "interests of the company" has undergone significant development. In recent years, the phrase was thought to import some considerations of the interests of other stakeholders, including the company's creditor.[36] One of the early cases that expanded the scope of the 'interest of the company' is *Teck Corporation Ltd v Millar*[37] a decision of the Supreme Court of British Columbia, where Berger J suggested that the phrase br expanded to include the interests of employees and the community. While it was said that consideration of these "external" interests were merely permissible and not an obligation on the part of the directors, the Australian High Court decision in *Walker v Wimborne*[38] put a positive obligation on directors to have regard to the interests of creditors.

Commentators argue that having regard to creditors' interests does not necessarily mean that the directors owe a duty to creditors. This is because the notion of directors' duties to creditors is inconsistent with the doctrine of separate legal personality. Furthermore, the relationship between the company and creditors is purely contractual, and there is no basis for finding that directors owe any duties, fiduciary or otherwise, toward the creditors. In addition, even if a duty can be said to exist, there are no remedies that the creditors may obtain.[39]

Courts in the United Kingdom have repeatedly rejected any notion of directors' duties to creditors: see, for example *Re Halt Garage (1964) Ltd*,[40] *Re Horsley & Weight Ltd*,[41] *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*[42] and *Multinational Gas and Petrochemical Co Ltd v Multinational Gas and Petrochemical Services Ltd.*[43]

Walker v Wimborne[44] was however affirmed by later decisions although there were conflicting views on the nature of the duty. On the one hand, there is a line of cases which held that directors owe a duty to creditors. Another line of cases declares that directors' duties are owed to the company, but in exercising their duty, they must take into account the interests of creditors. These two groups of cases will be examined separately.

36 Other interests include the interests of employees, customers, contractors, suppliers, the environment and the community.

37 (1973) 33 DLR (3d) 288.

38 (1976) 137 CLR 1.

39 As Professor Sealy pointed out in one of his many commentaries: "A supposed legal duty which is not matched by a remedy is a nonsense": see LS Sealy, "Directors' Wider Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 MULR 164 at 177.

40 [1982] 3 All ER 1016.

41 [1982] 3 All ER 1045.

42 [1991] 1 AC 187; [1990] 3 All ER 404.

43 [1983] Ch 258; [1983] 2 All ER 563.

44 Note 38.

Directors owe a duty to creditors

Ring v Sutton,[45] *Winkworth v Edward Baron Development Co Ltd*[46] and *Jeffree v National Companies and Securities Commission*[47] are examples where the courts have held that directors owe a duty to creditors.[48] *Ring v Sutton*[49] is a decision of the New South Wales Supreme Court where the court held that the directors of a company breached their duties and disregarded the interests of creditors when they caused the company to lend money at below market rates.[50] *Walker v Wimborne*[51] was cited as an authority that directors' owe a duty to creditors. In *Winkworth v Edward Baron Development Co Ltd*[52] the House of Lords took a view similar to *Ring v Sutton*.[53] Lord Templeman said that "a duty is owed to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors".[54] This was approved in *Jeffree v National Companies and Securities Commission*.[55]

Lord Templeman J's statement is, however, ambiguous. First, he said that directors of a company owe a duty to both the company and its creditors. He preceded this statement with another statement that a company owes a duty to the creditors. How did the duty arise? The relationship between a company and its creditors is no more than a relationship between a debtor and a creditor, which is based on contract. A debtor which is not a company will not normally be imposed of any duty other than that which were imposed upon him under the contract; why would it be different where the debtor is a company? There is no legal basis for imposing any additional duties to the debtor company or its directors. One writer had commented that Lord Templeman J's suggestion that the company owes a duty to its creditors is "a novel suggestion in that it implies some sort of obligation owed by the company to its creditors over and above any contractual obligations incurred by the company in its dealings with its creditors".[56]

Secondly, the court did not specify the nature of the duty – is it simply a duty of good faith or a fiduciary duty? It is unlikely that fiduciary duties will be imposed on directors to creditors – creditors are expected to, and are normally in a position to protect their own interests through bargaining and contract. There is generally no

45 (1979) 5 ACLR. 546.
46 [1987] 1 All ER 114.
47 (1989) 7 ACLC 556.
48 For a different view, see cases cited at nn 61-66.
49 Note 45.
50 This case was curious for two reasons – one, Mason J in *Walker v Wimborne*, note 38, merely said that directors must consider the interests of creditors. This has to be distinguished with a direct duty to creditors. Secondly, in this case, the company was solvent at the time when the loan was made.
51 Note 38.
52 Note 46.
53 Note 45.
54 Note 46 at 118.
55 Note 47. But see L Sealy, "Directors 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 MULR 164, where he opined that this case was 'probably wrong on its reported facts'.
56 See CA Riley "Directors' duties and the interests of creditors" (1989) 10 Company Lawyer 87.

element of trust between directors and creditors and no corresponding vulnerability on the part of the creditors resulting from the trust.[57] Thus it is unlikely that the duties be categorised as fiduciary.

Thirdly, the issue of enforcement for breach of duty. Riley asked the question whether "the duty *ought* to be owed to creditors, and enforceable *by* them".[58] If a breach of such duty is directly enforceable by the creditors, it will 'invite multiplicity of actions, encourage litigation and incur considerable time and expense'.[59] This should be compared with rights of creditors to bring an action under sections 303 and 304 Companies Act 1965 whereby the creditors are given statutory rights to commence proceedings against directors for "wrongful trading" and "fraudulent trading". These provisions will be discussed in Part 2 of this article.

Fourthly, on what basis would the duties be imposed on the directors? Directors owe fiduciary duties to the company because they are the agents of the company, and they have the power to act in a way which could be detrimental to the company. Directors must also act in the interests of the shareholders because it is the shareholders who elect them to office, and the acts of the directors will ultimately affect the shareholders, who are the residual claimants of the assets of the company. If they do their job well and the company prospers, shareholders can expect good returns on their investment through the payment of dividends and the increased value of their shares. On the other hand, if the directors fail in the performance of their duties, the company will also fail, and the shareholders will get no return on their investment. Upon winding up, after the claims of all the creditors had been satisfied, only then may the shareholders claim their share of the assets of the company, or whatever is left of it. This is why it has been said that shareholders are the residual owners of the company. The claims by creditors, on the other hand, are fixed. They have no involvement in the company's affairs, and no power to appoint the directors. Their rights are purely based on contract, and upon winding up they will be entitled to payment in preference to the residual claimants, i.e. the shareholders.[60] Thus, imposing fiduciary or other related duties upon directors to creditors is a theoretical and conceptual leap without valid justification to support the creation of such a duty.

Directors owe a duty to the company but must also take into account the interests of creditors

It has been pronounced, through an overwhelming majority of cases, that directors do not owe any direct duty to creditors. The duties are owed primarily to the

57 The prerequisites for the imposition of fiduciary duties here are derived from the classical statement by Fletcher Moulton LJ in *Re Coomber* [1911] 1 Ch 723 at 728-729. For a local version of this proposition, see *Tengku Abdullah ibni Sultan Abu Bakar v Mohd Latiff bin Shah Mohd* [1996] 2 AMR 2633, *per* Gopal Sri Ram JCA at 2672-2673. See also PD Finn, "Contract and Fiduciary Principle" (1989) 12 UNSWLJ 76; JM Gill, "A Man Cannot Serve Two Masters: The Nature, Existence and Scope of Fiduciary Duties" (1989) Journal of Contract Law 115; BH McPherson J, "Fiduciaries: Who Are They?" (1998) ALJ 288.

58 Riley, n 56.

59 Riley, ibid, at 92.

60 See Andrew D Shaffer, "Corporate Fiduciary – Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About" (2000) 8 Am Bankr Inst L Rev 479.

company. However, in acting for the company, they must have regard to the interests of the creditors. This is the opinion of the courts in several cases which include *Nicholson v Permakraft (NZ) Ltd (in liq)*,[61] *Kinsela v Russell Kinsela Pty Ltd (in liq)*,[62] *Brady v Brady*[63], *West Mercia Safetywear Ltd v Dodd*,[64] *Facia Footwear Ltd (in administration) v Hinchliffe*,[65] and *Yukong Line Ltd of Korea v Rendsburg Investments Corp of Liberia (No 2)*[66].

In *Nicholson v Permakraft (NZ) Ltd (in liq)*,[67] the company ran into liquidity problems, and the directors adopted a restructuring scheme, which was approved by the shareholders. However, the creditors of the company opposed the scheme as being prejudicial to their interests. The company was later placed in liquidation, and the liquidators sought to recover money paid to the shareholders as capital dividends, by commencing an action against the directors. The liquidators argued that the payment of dividends was made in breach of the directors' duties as the company was in a state of near insolvency at that time. In paying the dividends, the directors had neglected the interests of existing and future creditors. All three judges rejected this argument as the company was solvent at the time of restructuring and therefore no issue of directors' duties to creditors would arise. In addition, the directors' had, when implementing the scheme, acted in the best interests of the company. Furthermore, they had acted honestly, and the purpose of the scheme was not to remove the assets from the reach of the creditors. One of the judges, Cooke J, having studied and analyzed the law relating to directors' duties to creditors, offered his view:[68]

> The duties of directors are owed to the company. On the facts of particular cases this may require, *inter alia*, the interests of creditors. For instance, creditors are entitled to consideration, in my opinion, if the company is insolvent, or near insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency...

In *Kinsela v Russell Kinsela Pty Ltd (in liq)*,[69] the Supreme Court of New South Wales approved the statements of Cooke J in *Nicholson v Permakraft*.[70] Street CJ said:[71]

61 [1985] 1 NZLR 242, (1985) 3 ACLC 453.
62 (1986) 10 ACLC 395.
63 (1988) BCLC 20.
64 [1988] BCLC 250.
65 [1998] 1 BCLC 218.
66 [1998] 4 All ER 82, although in this case the company controller was held liable for breach of duty not under the common law, but under s 212 of the Insolvency Act 1986.
67 Note 61.
68 Ibid at 249.
69 Note 62.
70 Note 61.
71 Note 62, at 401 and 404.

> The learned judge in the first instance held, as I have noted, that he was bound by authority to hold that the approval by all of the shareholders validated an action which would otherwise be beyond the powers of the directors provided that there had been a full and frank disclosure to the shareholders of all the circumstances relevant to the proposed transaction ...
>
> The authorities to which his Honour submitted, notwithstanding the generality of their enunciations of principle, were not intended to, and do not, apply in a situation in which the interests of the company as a whole involve the rights of creditors as distinct from the rights of shareholders. In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration ...
>
> It is, to my mind, legally and logically acceptable to recognise that, where directors are involved in a breach of their duty to the company affecting the interests of shareholders, then shareholders can either authorise that breach in prospect or ratify it in retrospect. Where, however, the interests at risk are those of creditors I see no reason in law or in logic to recognise that the shareholders can authorise the breach. Once it is accepted, as in my view it must be, that the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors ... the shareholders do not have the power or authority to absolve the directors from that breach.

Nourse LJ of the English Court of Appeal expressed similar sentiments in *Brady v Brady*:[72]

> In a case where the assets are enormous and the debts minimal it is reasonable to suppose that the interests of the creditors ought not to count for very much. Conversely, where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone.

This approach has gained further acceptance in later decisions: *West Mercia Safetywear Ltd v Dodd*,[73] *Facia Footwear Ltd (in administration) v Hinchcliffe*,[74] and *Yukong Line of Korea v Rendsburg Investment Corp of Liberia (No 2)*.[75]

72 Note 63 at 40.
73 Note 64.
74 Note 65.
75 Note 66.

Thus, it is now quite settled that directors owe a duty to the company, but where the company is insolvent, they must have regard to the interests of creditors. However, this approach is also riddled with difficulties. First, even when the company is insolvent, how are the creditors to enforce their rights when the directors had disregarded their interests as creditors? Pursuant to the rule in *Foss v Harbottle*,[76] since the duty is owed to the company and not to the creditors directly, the damage suffered was the company's, and not the creditors'. Consequently, only the company will be entitled to take action against the errant directors.[77] Even where a liquidator has been appointed, any action taken by the liquidator will be on behalf of the company and not the creditors.

Secondly, the issue of ratification. It is generally accepted that those to whom the duties are owed may release those who owe the duties from legal obligation.[78] Although technically shareholders are not the beneficiaries to whom directors owe their duties, they are recognised to be the residual owners of the company and as such they are empowered to ratify any breach of directors' duty. Two issues arise here. If the directors of an insolvent company had breached their duty to the company by not acting in the interests of the company, can the shareholders ratify this breach of duty? Although no direct authority can be found on this, the answer would probably be negative. As Street CJ said in *Kinsela*,[79] when the company is insolvent, the shareholders no longer have an interest in the company and the creditors become prospectively entitled to displace the power of the shareholders. Therefore, shareholders are no longer entitled to ratify any breach of duty. This poses a further question: where a company is clearly insolvent, can the creditors ratify a director's breach of duty instead? Applying the residual owners theory, the answer is probably negative. Unlike shareholders, creditors are not the residual owners of a company; their rights are still based on contract notwithstanding that the company had become insolvent.

Thirdly, when would the duty arise? Ignoring for the moment the line of cases requiring consideration being given to the interests of creditors despite the company being solvent,[80] the event which would trigger the creation of the duty to creditors would be the insolvency of the company. What is then, the test of insolvency? The courts generally offer no guidance, although Cooke J in *Nicholson v Permakraft*[81] did mention a balance sheet solvency and the ability to pay capital dividend as a form of assessment. Cooke J went on to say that creditors are entitled to consideration not only when the company is insolvent, or near insolvent, or of doubtful solvency, or if a contemplated payment or course of action would jeopardise its solvency. But then

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76 67 ER 189.

77 For a general discussion of this rule, see Mohammad Rizal Salim, "The Shareholders' Derivative Action" [2000] 1 MLJ xliv.

78 PL Davis, *Gower's Principles of Modern Company Law* (Sweet & Maxwell London 6th Ed 1997) 644-645.

79 Note 62.

80 *Ring v Sutton*, n 45 and *Winkworth*, n 46. See also Razeen Sappideen, "Fiduciary Obligations to Corporate Creditors" (1991) JBL 365, where the author examines research done by financial theorists and argues for the need to recognise creditor interests as being at par as shareholders interests in a solvent company.

81 Note 61.

again, how would the directors determine that the company is near insolvent or in a situation of doubtful solvency? Should the courts formulate a test for this? It is extremely important for directors to know exactly (if this is possible) when the company turns from being solvent to near insolvent or doubtful solvency as then they could put their mind to managing the company in such a way so as to protect the interests of creditors rather than that of the shareholders.[82]

In addition, it is to be expected that directors will from time to time make risky business decisions. As long as there is no wrongdoing on the part of the directors, they are entitled to do just that. In fact, the very basis for the doctrine of separate legal personality is to transfer the risk of entrepreneurship to creditors. Risk is very much a part of any business, and directors often take great risks in anticipation of greater profits for the company. Nonetheless, simply by taking risky business decisions, directors may be construed to engage in a course of action which may jeopardise a company's solvency. If this is a test of insolvency, as proposed by Cooke J in *Nicholson v Permakraft*,[83] then every company is in the state of insolvency. Therefore, directors will be obliged to consider the interests of creditors even when the company is solvent. The problem with this is that it is not easy to harmonise the interests of creditors and shareholders. Their interests often conflict. Shareholders seek to maximise the returns to their investment, and may be willing to take great risks in order to achieve greater returns. In taking these business risks, the shareholders will take comfort in knowing that if these investment decisions prove to be wrong, their losses will be limited to what they have promised to pay the company for their shares. The claims of creditors, on the other hand, are fixed under the contract. They will not get anything more than what is due to them even where the company is hugely profitable. However, where the company fails, they may not get paid at all. Thus, creditors would prefer that directors remain prudent in making business decisions, and not take gambles although it may reap large returns to shareholders. Because of the conflict between these two factions, requiring directors to take into account of the interests of both shareholders and creditors at the same time will be impractical.

A similar conflict arose in the United States. The facts in *Credit Lyonnais Bank Nederland, NV v Pathe Communications*[84] were complicated, but essentially, the directors of MGM, a troubled motion picture company, had ceded operating control of the company to nominees of Credit Lyonnais Bank, MGM's substantial creditor. The majority shareholder of MGM sought to make the company sell some assets belonging to the company to repay its debts to Credit Lyonnais and thereafter re-claim control of the company. The nominees refused. In court, the majority shareholder claimed that the nominees had violated their duties to him.[85] Chancellor William Allen dismissed the claim, saying:

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82 See Vanessa Finch, "Directors' duties towards creditors" (1989) 10 Company Lawyer 23.

83 Note 61.

84 Unreported, No 12150, 1991 WL 277613 (Delaware Chancery, 30 December 1991); available at LEXIS-NEXIS.

85 It must be noted that in the United States it is commonly accepted that directors owe a direct duty to shareholders: see e.g. discussion by Andrew D. Shaffer, "Corporate Fiduciary – Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About" 8 Am Bankr Inst L Rev 479 (2000).

> Where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise ... [The corporate controllers] had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximise the corporation's long-term wealth creating capacity.

How the above statement relates to the duties of directors to creditors is not clear at all. Perhaps creditors are part of a corporate enterprise, and thus when the corporation is in the vicinity of insolvency the interests of various stakeholders of the corporation must be considered as well. In any case, the judge did set out, in the footnote of the statement quoted above, a hypothetical problem which sets out a conflict between shareholders and creditors' interest.

Credit Lyonnais[86] attracted a lot of comments and responses[87] primarily because prior to the case, it was an established principle that directors owe no fiduciary duties to creditors.[88] Apart from the much discussed issue of competing claims by shareholders and creditors, a point which had been noted above, commentators also question the meaning of the phrase "vicinity of insolvency". As was pointed out by one commentator, firms are always in the vicinity of insolvency because all it takes to become insolvent is to lose a sufficiently risky bet.[89]

Credit Lyonnais[90] must be read in the Malaysian context with caution because unlike the United States, directors owe a fiduciary duty to the company and not to the shareholders, unless there is a special circumstance which creates such a duty.[91] Because of this, no fiduciary duties will be owed to creditors. The case is however useful to show that the difficulties in relation to directors' duties to creditors are not peculiar to us, but are universal.

Tentative Conclusion

The doctrine of separate legal personality is well established. It appears that the courts are willing to disregard the doctrine where creditors' interests are prejudiced as the result of improper behaviour by corporate controllers. More difficult questions arise on the issue of directors' duties to creditors. Directors are appointed by shareholders to manage the company for the benefit of the shareholders ultimately. Although the

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86 Note 84.

87 See eg, CR Morris, "Directors' Duties in Nearly Insolvent Corporations: A Comment on *Credit Lyonnais*" (1993) 19 The Journal of Corporation Law 61, and the numerous articles cited in the footnote of the article. See also Shaffer, above; Tung, above; Ann Stilson, "Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors" 20 Del J Corp L 1.

88 In *Katz v Oak Industries Inc.* 508 A. 2d 873 (Delaware Chancery 1986), the court said that the relationship between a corporation and its bondholders are governed based on the terms of the contract and the concept of fairness does not apply.

89 TA Smith, "The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty" 98 Mich L Rev 214.

90 Note 84.

91 Eg, *Coleman v Myers* [1977] 2 NZLR 255.

duties are owed directly to the company and not to the shareholders, the interests of the shareholders must be taken into consideration, as it is ultimately for their benefit that the business of the company is being conducted. In other words, the shareholders form the primary corporate constituent of the company, the others being the creditors, employees, and the public at large.

The company's obligation towards the creditors is primarily a contractual obligation. However, even while the company is a going concern, directors must consider the interests of the creditors, as a failure to do so will result in certain repercussions of which the most obvious will be a legal action being taken against the company, and the harm inflicted to the company's reputation and credit rating. While the interests of creditors are relevant, directors will be under no obligation to actively advance creditors interest.[92]

Where the company is insolvent or near insolvent, the creditors will replace the shareholders as the primary corporate constituent.[93] This is because the shareholders will no longer benefit from the company; but it is the creditors who will stand to lose or gain the most, depending on how the business of the company is conducted and its assets utilised.

This (hopefully) explains the seemingly contradictory principles in the cases discussed above. Even in *Winkworth*,[94] Lord Templeman said that the breaches of duty would not matter if the company were able to maintain its solvency, which it failed to do. Perhaps therefore, Lord Templeman's statement should be read in this way: in a solvent company, the duty is owed to the creditors, not directly, but as a part of corporate constituent of the company. Where the directors have disregarded the interests of creditors, and plunges into insolvency, creditors will be entitled to complain. To hold that directors of a solvent company owe no duty to creditors is to give a free licence to directors to act in such a way so as to defeat creditors' rights. A case in point is *Jeffree*,[95] where the entire assets of a company was transferred to a new company formed with the same directors and shareholders, resulting in a creditor being denied of his claim against the first company. The Supreme Court of Western Australia held that this transaction was effected in breach of director's duties.

However, either of these approaches (whether the duties is owed to the company or directly to creditors) poses different sets of difficulties: the enforcement of duties by creditors; ratification of breach of duties and the test for insolvency. The solution to these problems requires more than the piecemeal approach used by the courts to suit the circumstances of their particular case, but through a more comprehensive effort, which can only be provided through legislation.

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92 See R Grantham, "Directors' Duties and Insolvent Companies" (1991) 54 MLR 576.
93 Ibid.
94 Note 46.
95 Note 47.