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About

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INSIGHT Journal focuses on social science and humanities research. The main aim of INSIGHT Journal is to provide an intellectual forum for the publication and dissemination of original work that contributes to the understanding of the main and related disciplines of the following areas: Accounting, Business Management, Law, Information Management, Administrative Science and Policy Studies, Language Studies, Islamic Studies and Education.

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FOREWORD BY DEPUTY RECTOR OF RESEARCH, INDUSTRIAL LINKAGES & ALUMNI

Since 2018, the INSIGHT JOURNAL (IJ) from Universiti Teknologi MARA Cawangan Johor has come up with several biennial publications. Volume 1 and 2 debuted in 2018, followed by Volume 3 this year as well as Volume 4 with 19 published papers due to the great response from authors both in and out of UiTM. Through Insight Journal, lecturers have the ability to publish their research articles and opportunity to share their academic findings. Insight Journal is indexed in MyJurnal MCC and is now an international refereed journal with many international reviewers from prestigious universities appointed as its editorial review board members.

This volume 5 as well as volume 6 (which will be published in 2020) are special issues for the 6th International Accounting and Business Conference (IABC) 2019 held at Indonesia Banking School, Jakarta. The conference was jointly organized by the Universiti Teknologi MARA Cawangan Johor and the Indonesia Banking School Jakarta. Hence, the volumes focus mainly on the accounting and business research papers compiled from this conference, which was considered a huge success as over 66 full papers were presented.

Lastly, I would like to thank the Rector of UiTM Johor, Associate Professor Dr. Ahmad Naqiyuddin Bakar for his distinctive support, IJ Managing Editor for this issue Dr. Noriah Ismail, IJ Assistant Managing Editor, Fazdillah Md Kassim well as all the reviewers and editors who have contributed in the publication of this special issue.

Thank you.

ASSOCIATE PROF. DR. SAUNAH ZAINON
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Distribution of Profits under the Companies Act 2016: Satisfying the Insolvency Test

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Abstract

Under the law, distribution of profits or dividends may only be paid to members of a company if there are profits available for that purpose. The Companies Act 2016 requires that the company can only make the distribution to the shareholders out of profit if the company is solvent. Previously, in the Companies Act 1965, the company can pay dividends to its shareholders out of its profits and there is no requirement that the company must fulfill the solvency test. The aim of this paper is to look at the new requirement of solvency test and in what circumstances the company can pay out its dividends. It also examines the effects of non-compliance with the solvency requirements and the implications to the company and directors (if any) under the Act.

Keywords: Dividends, profits, insolvency test, non-compliance, implications.

1. Introduction

The term 'capital' referred to loans of money and later expanded to include other assets. These funds were used to engage in the company's trade. In modern company law, capital deals with share capital contributed by shareholders and debt capital advanced by creditors. Share capital confers rights in the company to the shareholders, while debt capital concerns a set of rights against a company arising from a contractual relationship between a debtor and a creditor. Share capital funds are made up either wholly paid or partly paid shares which represent the legal measure and the actual amount subscribed by shareholders.

Generally, a company is not allowed to pay dividends out of its capital because the amount contributed by shareholders signifies the company's capability to make repayment. This point was accentuated by the decision in *Re Exchange Banking Flitcroft's Case* (1882) 21 Ch D 519 at page 553 when Jessel MR explained:

The creditor has no debtor but the impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to that company on the faith of representation that the capital shall be applied only for the purpose of the business, he has therefore a right to say that the

corporation shall keep its capital and not return it to the shareholders, though it may be a right which he cannot enforce otherwise than on a winding up.
The common law rule on distribution rule has been incorporated into the statutory provision. This can be seen where section 131 of the Companies Act 2016 states the company may only make a distribution to its shareholders out of profits available if the company is solvent.

2. Definition of Dividends

The Companies Act 2016 has added a new requirement in section 131 in that the company has to be solvent prior to the distribution of profit. The authorisation for declaration of dividend may be made by the directors under section 131 at such time and in such amount, they consider appropriate if the directors are satisfied that that company will be solvent immediately after the distribution is made. The definition of a solvent company for the purpose of distribution of profit is given in section 132(3) where the company is able to pay its debts as and when the debts become due within twelve months immediately after the distribution is made, then the company is deemed to be solvent. The solvency test in the section adopts the cash flow test which focuses on the ability of the company to meet the current demands irrespective of whether the company is possessed of assets, which, if realised, would enable it to discharge its liabilities in full.

Heath J in the New Zealand' s case *Re DML Resources (in liq)* [2004] 3 NZLR 490 at 492 explained the rationale for adopting the statutory solvency test before a company enters into transactions that involve distribution of funds or property to shareholders. He stated that:

"The Act requires the board of directors of a company to determine whether it is solvent before returning wealth to its shareholders. As shareholders stand behind creditors in the priorities in which they are paid on insolvency, it is inappropriate for a shareholder to receives benefits, ahead of creditors, at a time when the company is insolvent. The need for a company to be solvent before distributions are made to shareholders is underscored by provisions in the Act by which a company may seek recovery of amounts distributed from shareholders and directors: see sections 56(1), (2) and (4) of the Act"

In *Marra Developments Ltd* v *BW Rofe Pty Ltd* [1977] ACLR 185; the court concluded that at the time when the dividend is declared there must be profit available. There is no requirement that the profits must be available at the date for satisfaction of the dividend. Hence, the company could in theory declared dividends if its account shown profits between the end of financial year and declaration of dividend. The company may in the event it suffers losses after the date of declaration borrow in order to satisfy the dividend though over times it may not be prudent decisions to make.

In *Hilton International Ltd* v *Hilton* [1989] 1 NZLR 442; the court stresses that in addition to dividends may only be aid out of profit, the company could not make any declaration if it is trading insolvency or if the declaration would jeopardise the company's solvency. Directors may be in breach of duty and are liable to compensate the company of its losses.

Section 365 under the Companies Act 1965 provided that the company can only pay dividends to its shareholders out of its profits or pursuant to section 60. Section 60 of the

Act dealt with the payment of dividends pursuant to the application of the share premium account of a company provided that the payment such dividends are satisfied by the issues of shares.

3. Remedial Consequences of Improper Dividends

It is important to identify what the remedies are because without satisfactory legal redress, the law will not be effective in meeting the aims of the statute. There are several remedies under the statute and common law which give rights to the company, shareholders and creditors in the vent distributions are made not in accordance with the law. The provisions in the Companies Act 2016 gives more remedial rights than those in the Companies Act 1965.

3.1 Civil Remedies

Section 133(1) of the Companies Act 2016 also allows the company to recover the amount of distribution paid to the shareholders which exceeds the value of any proper distribution that could have been made. The same section allows the shareholders to keep the distribution if they received the distribution in good faith and has no knowledge that the company has failed the insolvency test in section 132.

The company can recover the amount which exceeds the value of any proper distribution that could have been made from its director or manager who willfully pays dividend in contravention with section 132 which he knows from his knowledge is not profitable. The burden is on the company to show that the director has knowledge that the company is not making profit, and this is subjective element.

Under the Companies Act 1965, section 365(2) imposed liability on every director or manager who willfully pays or permits to be paid or authorizes the payment of any improper or unlawful distribution to compensate creditors or liquidators for the amount of debts due to them. The provision in the Companies Act 2016 allows only the company to recover the amount of distribution paid while in the 1965 Act the creditors or liquidator have right to recover under the Act the amount owed by the company to them.

3.2 Criminal Penalty

Section 132(5) of the Companies Act 2016 directors or officers of the company who willfully pays or permits to be paid or authorizes the payment of any improper or unlawful distribution shall on conviction, be liable to imprisonment for a term not exceeding five years or a fine not exceeding three million ringgit or to both.

The penalty for imprisonment in the 2016 Act has been reduced from ten years to five years while the amount of fine in the former is increased from two hundred and fifty thousand to three million Ringgit Malaysia. The increase in the amount of fine on directors or managers indicates the law seriousness of the offence and should act as deterrent to others.

Section 365(2) stated that every director or manager who willfully pays or permits to be paid any dividends out of what he knows is not profits, except pursuant to section 60-

(a) Shall without prejudice to any other liability be guilty of an offence against this Act;
(b) Shall be liable to the creditors of the company for the amount of the debts due by the company to them respectively to the extent by which the dividends so paid have exceeded the profits and that amount may be recovered by the creditors or liquidator suing on behalf of the creditors.

The penalty is imprisonment for ten years or two hundred and fifty thousand ringgit or both. The term willfully in the section shows intention or knowledge on part of directors that the distribution made is not from profits.

3.3 Disqualification of Directors

Directors may also be subjected to disqualification under section 199 of the Companies Act 2016 if they have within the last five years, been directors of two or more companies which went into liquidation resulting from the company being insolvent due to their conduct as directors, or due to contravention of duties as directors or due to habitual contravention of the Act.

3.4 Common Law Liability

3.4.1 Duty to Act Bona Fide

Directors owe loyalty and good faith to the company under common law has been embodied in section 213(1) of the Companies Act 2016. Lord Greene MR in *Re Smith & Fawcett Ltd* [1942] 1 All ER 542 held that: they must exercise their discretion bona fide in what they consider not what the court may consider to be in the interests of the company and not for any collateral purposes". This duty is wide enough to cover the situation where the directors after declaring dividends found the company to be insolvent. It is a settled law that directors are required to take into consideration the interests of creditors when insolvency lurks because they are now the residual claimants of the company's assets. Directors who have been found in breach of their duty could be made liable to pay the losses suffered by the company. This can be seen in the case of *Hilton International Ltd* v *Hilton* [1989] 1 NZLR 442.

3.4.2 Duty of Care and Diligence and Skills

Directors may also be subjected to breach of this duty if their action in declaring dividends resulting the company to become insolvent. Section 213 (2) of the Companies Act 2016 provides that in discharging their duties, directors are expected to act based on the knowledge, skill and experience of a reasonable director. However, the court is also required to take into consideration the knowledge, skill and experiment of the director in question. Directors who have breached this duty are liable to make good the loss. The Companies Act 2016 has under section 213(3) imposes on those who contravene the section to be liable to imprisonment for a term not exceeding five years or to a fine not exceeding three million ringgit or both. The section is also applicable to those who contrives section 213(1).

3.5 Liabilities under the Insolvent Trading and Fraudulent Trading Provisions

There is a possibility that the directors could be made liable for fraudulent trading provision in section 540 of the Companies Act 2016. A declaration of valid dividends by directors constitutes a debt of the company which needs to be paid out to shareholders. Thus, if the directors make declaration while not satisfying the solvency requirement, the directors could be held responsible under fraudulent trading provision if the company ends up in liquidation.

Section 540 provides that "If in the course of winding up of a company or in any proceedings against a company it appears that any business of the company has been carried on with intent to defraud the creditors of the company or creditors of any other person or for fraudulent purpose, the Court on application of liquidator or any creditor or contributory of the company, may, if the Court thinks proper so to do, declare that any person who was knowingly a party to the carrying on of the business in that manner shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court directs"

The wordings of the section are wide enough to cover the declaration of dividends when the company is not solvent. In *LMW Electronics Pte Ltd* v *Ang Chuag Juay & Ors* [2010] 1 MLJ 185 at page 199, the court concluded that the phrase "carrying on the business" to include a myriad of activities and transactions undertaken by the company which did not necessarily involve trading.

In *Kawin Industrial Sdn Bhd (in liquidation)* v *Tay Tiong Soong* {2009} 1 MLJ 723 at 732-733, the court explained that finding an intention to defraud creditors means an intention to deprive creditors of an economic advantage or inflict upon them some economic loss. The decision in the case is consistent with the decision in *R* v *Grantham* [1984] QB 675 at 683-684 which stated, "fraudulent trading can be made our even if it is not possible to establish that anyone has suffered a loss".

When the company made distribution to the shareholders when it is not solvent, the company is in fact has been incurring debts. Under the law, the company may be subjected into the liability under the fraudulent trading provision in section …. or under the insolvent trading position in section.

For civil liability, section 540 provides that "…shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court directs". Thus, directors could be made personally liable for an unlimited amount as the Court deems fit. The punitive aspect in the section is expected since the section originated from the old UK fraudulent trading section which was based on criminal liability. The main purpose of imposing a duty on directors at that time was to curb incidents where those who had been entrusted with public funds misused them, hence the punishment.

4. Defences

The new section introduces a defence to directors against consequences of paying improper dividends. The section imposes a positive duty on the director to take steps to prevent distribution if the company ceases to be insolvent prior to distribution. There is no such duty imposed by the Companies Act 1965. Directors, therefore, need to be familiar with the financial position of the company. The directors must maintain supervision and monitor the company's status and if necessary, review plans and decisions they have made. The standard of duty in the section indicates the objective element and therefore in determining whether there are grounds to believe that the company ceases to be solvent, courts are to have regards to the knowledge, skills and experience of a reasonable person as well as the individual director's concern. The director then should show that he has taken all the reasonable steps that the experienced and skilled directors would have taken. In doing so, it would be a defence to directors from the liability in section 132(5).

Section 132(3) of the Companies Act 2016 states that in the event that after a distribution is authorised and before it is made, the directors cease to be satisfied on reasonable grounds that the company will be solvent immediately after the distribution is made, the directors shall take all necessary steps to prevent the distribution being made.
Previously, the company may declare dividends if at the time of declaration there the company is making profit. Hence, companies can legally pay dividends if their accounts indicate profit and the company borrow in order to pay dividends. The solvency requirement in the Companies Act 2016 may prevent the company from making commercial imprudent to pay dividend.

The requirement in the section that directors to take all necessary steps to prevent distribution can act as a defense to directors. In other words, directors who can show that they have taken all necessary steps may avoid the consequences of paying improper dividends described above. The wordings of the section seem to indicate that the test of whether the directors have taken all necessary steps is objective rather than subjective.

The section which imposes a positive duty on the directors to take steps to prevent distribution from being made is almost similar to the wrongful trading provision in the UK Insolvency Act 1986. In the UK, section 214 once the liquidator is able to show at which point before the commencement of the winding that the director knew or ought to have concluded that there were no reasonable prospects of avoiding insolvent liquidation, the burden shifts on the directors to show that he "has taken every step he ought to have taken". The directors must convince the court that the steps taken were with the aim of minimising loss to creditors.

If the directors are held to be liable under section 540 for fraudulent trading, they could be subjected to both criminal and civil liabilities. This is because section 540 consists of both criminal and civil liabilities. The consequences of breaching the section is that directors could be subjected to imprisonment for a term not exceeding ten years or to a fine not exceeding one million ringgit or both.

5. Conclusion

The beneficial effect of the proposition that distribution could not be made out of the capital and the company can only declare dividends out of profit in the Companies Act 1965 could be understood in the light of assumptions in the nineteenth century. The assumption was that a registered company would be like a deed of settlement company with a large membership.

The Companies Act 2016 has introduced a new test, a solvency test before a distribution of profits can be made to shareholders. The requirement is in line with the Companies legislation in New Zealand and Australia which requires that a statutory solvency test must be satisfied when the company enters into transactions that involve distribution of funds to shareholders. The rationale for adopting this concept can be seen in the case of *Re DML Resources (in liq)* [2004] 3 NZLR 490, which is related to the shareholders' position as residual claimants in winding up.

A shift towards solvency test of the company is said to be able to reflect the current position of the company because it is a relevant concept in protecting the interests of the creditors' interests. The law which prohibits distribution being made to shareholders if the company could not maintain its solvency thereafter is to prevent the misallocation of wealth from the company to shareholders since such act would not benefit the company.

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