

CHAPTER 1

NATURE OF A COMPANY AND INCORPORATION PROCESS

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INTRODUCTION

1.001 Company is an organization used as a vehicle to conduct business. It usually starts when several persons who agree to pool their resources and to carry on a business by using a company, get together and register or incorporate the company. It is a form of business organization which is created through an incorporation process. The incorporation process is often carried out by persons who want to use a company as a business vehicle; they are the promoters of a company. Once the incorporation process is completed, a company comes into existence as an artificial legal person having its own rights and obligations i.e. a separate legal entity or having separate legal personality. Although there must be persons who initiate the incorporation process, i.e. the promoters, once a company is incorporated, it exists independently of these persons and independently of persons who become its members subsequently. A company's existence is not affected by any changes in its membership. Although the members may withdraw from the company, the company continues to exist until it is dissolved by a winding-up process.

FORMS OF BUSINESS STRUCTURES IN MALAYSIA

Company limited by shares

1.010 A company limited by shares will have the following characteristics:

- Legal personality. This means that a company is a legal person and has the capacity to contract and incur legal obligations.
- Limited liability. This means that where the company has incurred any debts and obligations, it is the company's funds that must be used to fulfill any financial obligations. In general, the members will not be required to pay off any of the company's debts if the company's funds are insufficient. Members' liability is limited to the amount of shares that they have taken up but not paid for.
- Transferability of shares. In a company limited by shares, the shares that a member owns can be transferred to another person.
- Two organs or decision making bodies. One is the board of directors and the other is the general meeting of its members. There is centralized management by the board of directors.
- Perpetual succession. A company will continue to exist as a legal person until it ceased to exist through a process known as winding-up. The company continues to exist even if there is a change in membership or even if all its members ceased to exist.

A company may also be incorporated as a company limited by guarantee. Such companies are set up for charity, education, religious purposes, research, art and scientific purposes. These companies are not set up for profit purposes.

As at December 2013, there were 1,059,698 registered local companies and 4,564 foreign companies in Malaysia. There were a total of 1,889 companies limited by guarantee as at 31 December 2013.

1.011 Company is a popular business vehicle because of its separate legal entity and the limited liability of the members of a company. Separate legal personality enables the company to continue its business without having to be closed down when there are changes in its membership. It is quite common to find businessmen establishing companies to be used for the purpose of limiting their personal liability for obligations or liabilities incurred in the future by the company in carrying on that business. This is possible because of the separate legal personality of the company. The transferability of shares also enables a person who has invested in the company (i.e. a member) and who has been given shares to represent his investment in a company, to easily sell the shares. This makes investment in companies more attractive than a partnership (discussed below). The governance structure is made up of the general meeting of members and the board of directors; and the two organs of a company have powers to make decisions for the company. The powers exercisable by these two organs are stipulated under the *Companies Act 1965* (CA 1965). Each organ, generally cannot make decisions which is not within its powers. The powers exercisable by each of these organs can be delegated. In most large companies, the power of management is often delegated to employees of the company. Centralized management enables the investors not to have to be involved in managing the business which makes companies an attractive investment vehicle.

1.012 There are however some disadvantages of carrying on business using a company. The rules and regulation governing companies are more than other types of business form. This means that the cost of compliance, in terms of financial costs, time and resources will be higher compared to other forms of business vehicles. For example, a company has reporting obligations regarding its financial records and status and there is also an obligation to have its financial statements audited. A company is more exposed to public scrutiny as there are documents that must be filed with the regulatory authorities and these documents are available to the public. The information about businesses conducted through a company cannot be kept private due to the reporting obligation. Some business owners may not be comfortable with such disclosure and reporting obligation particularly if the information could reveal or expose their financial status to the public.

Sole proprietorship

1.013 The term refers to a business carried on by a single person in his own name. There is no separation between the business and personal assets or obligations of the person conducting the business. The sole proprietor signs all the contracts relating to the business, owns its assets and is personally liable for all its debts. Management rests on that one person and his liability is unlimited. One of the advantages of this form of business is that there are fewer formalities in terms of its formation and registration.

As the income generated by the business is the income of the proprietor, the proprietor is the taxpayer and the business' losses or profits can be offset against the proprietor's other income. Although a sole proprietorship does not require registration to be established, all types of business must be registered with the Registry of Business under the *Registration of Business Act 1956* (RBA 1956).

General partnership

1.014 A partnership is an association of two or more people carrying on business in common with a view to profit. A partnership comes into existence by the conduct of these persons in carrying on a common business. Unlike a company, there is no registration requirement for the partnership to be established. However, a business as a partnership must be registered with the Registry of Business under the RBA 1956.

The *Partnership Act 1961* (PA 1961) governs the relationship between partners and partners, and partners and third parties. A partnership is also not a separate legal entity and the partners do not have limited liability unlike members in a company. When there are any changes in the identity of the partners, the original partnership is dissolved although in practice, it is common for a partnership agreement to provide that the partnership continues when there is a change of partners. Despite the existence of such a term in the partnership agreement, under the law, the old partnership ceases to exist automatically and a new partnership is established by the new partners continuing the business. A transfer of assets and obligations from the outgoing partners to the new partners is required.

As at December 2013, the number of business registered with the Registrar of Business under the RBA 1956 were 5,301,378 comprising sole proprietorships and partnerships. There were 329,895 new businesses registered in 2013 alone, of which 281,102 were sole proprietorships and 48,793 were partnerships.

Limited liability partnership

1.015 The limited liability partnership (LLP) was introduced as a business vehicle in Malaysia in 2012 with the enactment of the *Limited Liability Partnership Act 2012*. As of 31 December 2013, there were 1,440 LLPs registered with the Suruhanjaya Syarikat Malaysia i.e., the Companies Commission of Malaysia (SSM). The LLP is similar to a general partnership in that the participants are partners with more flexible management structure of a general partnership. The LLP must comprise of two type of partners; general partners and limited partners. Limited liability is only for limited partners who are not involved in the management of the firm. However, the LLP is similar to a company since the LLP has a separate legal existence from the partners. The LLP has authority to enter into obligations and incur debts and the partners will not be liable for the LLP's debts unless these were the result of a partner's wrongful act or omission or acting without authority.

<i>Characteristics</i>	<i>Sole proprietor</i>	<i>Partnership</i>	<i>Company (limited by shares)</i>
1. Legal personality	None	None	An artificial legal person
2. Procedure for formation	None	None	Incorporation process and registration with the Registrar of Companies.
3. Membership	One individual	Two persons and not more than 20 persons. Persons can be individual as well as a company.	A minimum of two persons with no maximum. Persons can be individual as well as a company.
4. Transferability of interest	Subject to sole proprietor's consent.	Subject to consent of partners.	Through share transfer forms and subject to company articles.
5. Limited liability	Sole proprietor is liable for all the business debts.	Partners are liable for all the firms' obligations which are incurred by any partner acting within his powers. In a general partnership, where the capital is insufficient to pay off their debts, all the partners will be liable for the shortfall. In a LLP, a partner will be liable only if he acted without authority or for any wrongful act or omission	Members' liability is limited to the amount of shares that they have taken but not paid for. Creditors cannot sue the members for the company's debts.

<i>Characteristics</i>	<i>Sole proprietor</i>	<i>Partnership</i>	<i>Company (limited by shares)</i>
6. Management	Managed by sole proprietor.	In a general partnership, every partner has a right to participate in the management of the firm. In a LLP, only general partners can be involved in managing the business.	Management is vested on the board of directors assisted by a company secretary.
7. Duration	Subject to sole proprietor's consent	A partnership can be terminated by the provisions under the PA 1961 or the LLP Act. A partnership is dissolved by any changes in membership structure of a partnership.	Enjoys perpetual succession. Liquidation process is subject to the CA 1965 and Companies (Winding-Up) Rules 1972. The life-span of a company is not affected by any changes in its shareholding or membership structure.
8. Taxation	Taxed individually	Partners are taxed individually.	Subject to corporate tax.
9. Reporting and disclosure	None	None	Required to lodge annual audited accounts, prescribed return forms and annual returns.

SOURCES OF COMPANY LAW

1.020 Company law refers to the set of rules that regulate the life cycle of a company, commencing from its formation until its termination. It provides for process for the birth of a company *via* a registration or incorporation process and its eventual demise *via* a winding-up procedure. It sets out rules affecting the internal relation of corporate participants during the life of a company as well as upon winding-up. It clarifies the relationship between the members of the company amongst themselves and with the company and its directors and officers, stipulating these corporate participants' obligations and responsibilities and providing remedies for maladministration. It deals with decision-making powers of the members and/or the directors and officers and provides a framework for capital raising.

Company law also concerns some rules governing the interaction between the company and outsiders, for example, creditors or customers who deal with the company on a commercial basis. Since a company can raise its capital through borrowings, company law rules discuss some aspect of creditors' protection. Company law also discusses the basis of a company's liability by ascertaining when the company would be liable to third parties based on the conduct of persons acting on behalf of the company. However, company law does not exhaustively deal with all the rules that affect how a company operates its business. Other laws such as labour and employment law, environmental law, consumer protection, contract law and criminal law may be relevant. While these laws are applicable to a company, this does not make them part of what we generally consider to be "company law".

1.021 The sources of company law in Malaysia are:

- The *CA 1965* and Companies Regulations 1966
- Case law.

Other sources of law:

- Companies Regulations, *Securities Commission Act 1993* (SCA 1993)
- *Capital Markets and Services Act 2007* (CMSA 2007)
- Code on Take-overs and Mergers 1998
- Malaysian Code on Corporate Governance (Revised 2007)
- *Offshore Companies Act 1990* (OCA 1990)
- Bursa Malaysia Listing Requirements (BMLR) and
- The accounting standards.

The Companies Act 1965 and Companies Regulations 1966

1.022 The main statute regulating companies in Malaysia is the CA 1965 and the Companies Regulations 1966. The CA 1965 is applicable to all types of the company and is the primary legislation dealing with the formation and incorporation rules and procedures, the management of the company which includes statutory provisions covering directors' duties, members' rights and remedies, statutory provisions dealing with share issuance, increasing and reducing share capital, debt capital, reporting and disclosure obligations and audit requirements, and administration of companies in financial difficulties including a

winding-up or liquidation of a company. Apart from the statutory provisions, the CA 1965 also includes nine Schedules. These include a table of the fees to be paid to the Registrar, a Schedule on the contents of memorandum and articles of association, a list of the contents of prospectuses and statements in lieu of prospectuses, and a Schedule of the contents of annual returns and accounts. Additional rules relating to companies' administration are set out in the Companies Regulations 1966. The Regulations prescribe general provisions relating to forms and other documents and contain various Schedules related to company matters.

The Malaysian Companies Act was enacted in 1965 and was modeled on the UK *Companies Act 1948* and the Australian *Uniform Companies Act 1961*. Prior to 1965, the applicable company legislation was the various laws applied to the Straits Settlements, the Federated Malay States and the Unfederated Malay States which had its respective companies' legislation. These were the respective administrative areas of the Malay States or Malaya before these states obtained its independence from Britain in 1957 and before the establishment of Malaysia in 1963, comprising Sabah and Sarawak.

Corporate law reform exercise

1.023 The CA 1965 has not remained in its original form since its enactment. Several amendments to some provisions have been made throughout the years. These have been of a piecemeal nature addressing specific topical issues.

In 1999, following the Asian Financial Crisis (1997/98), the Malaysian High Level Finance Committee on Corporate Governance published its recommendations suggesting reforms and review of a wide range of issues relating to corporate governance. The report highlighted several defects in the governance practices of listed companies. The recommendations covered legislative reform proposals as well as changes to the Listing Requirements. Changes to the Listing Requirements incorporating the recommendations were implemented in 2001. Legislative reform however only occurred in 2007 when SSM proposed amendments to the Companies Act relating to, amongst others directors' duties, substantial property transactions and minority shareholders' protection.

Despite the wide ranging issues covered by the High Level Finance Committee, this reform did not address the need to have a comprehensive review of company law. A comprehensive law reform programme finally came to fruition in 2004. The SSM started a review of the Malaysian company law by establishing the Corporate Law Reform Programme. The reform programme was conducted by an independent body, i.e. the Corporate Law Reform Committee (CLRC) established on 17 December 2003 pursuant to SSM's powers under s 17 and s 19 of the *Companies Commission Act 2001*. The CLRC comprised members of the main Steering Committee. To assist the Steering Committee in its reform work, the Steering Committee had established five working groups. These were:

- Working Group A on company formation, private companies and alternatives forms of business vehicles
- Working Group B on capital raising and capital maintenance
- Working Group C on corporate governance and shareholders' rights

- Working Group D on corporate securities and insolvency
- Working Group E on enforcement and sanctions

These Working Committees and the Steering Committee were assisted in their work by a secretariat. The main objectives of the corporate law reform programme are:

- the creation of a legal and regulatory structure that will facilitate business; and
- the promotion of accountability and protection of corporate directors and members taking into account the interests of other stakeholders, in line with international standards.

During 2004–2008, the CLRC conducted several public consultations based on the consultation papers issued by the CLRC. This method is considered to be a novelty in terms of law reform exercise in Malaysia where stakeholders' views were publicly and actively sought throughout the law reform exercise by the CLRC. The feedbacks were taken into consideration by the CLRC and were also published on SSM's website to enable a wider sharing and discussion of important areas of concern. In the reform exercise, the CLRC also took into account the amendment to the Companies Act in 2007 arising out of the recommendations of the High Level Finance Committee work. While supporting the recommendations of the High Level Finance Committee, the CLRC made some recommendations improving the earlier amendments. The Final Report containing the final recommendations was published in 2008.

As the CLRC's work covered core-company law issues, another committee was set up to consider aligning the accounting standards and various accounting issues and financial reporting with the new company law. This work was entrusted to the Accounting Issues Consultative Committee in February 2010.

Subsequently, in June 2010, the government issued its policy statement regarding the recommendations made by the CLRC. On July 2013, an exposure draft of the Companies Bill 2013 was issued for public comments and consultation. The Bill is still pending introduction in Parliament.

Between 2000 and 2012, there were several other reform proposals that covered a wider range of issues concerning the capital market and economic reform that would also have implications for company law practices. In addition to the 2007 amendment of the Companies Act, several amendments were also made to the securities law which are relevant for company law particularly relating to capital raising and directors' accountability. The Capital Market Masterplan (2001) suggested 152 recommendations; these were aimed at strengthening fundraising activities, promote the growth of the investment management industry, enhance market and intermediation effectiveness, provide a strong and facilitate regulatory regime and establish Malaysia as an international Islamic capital market centre. In 2011, the Capital Market Masterplan 2 was published to chart the strategies to further transform and strengthen the capital market for the next 10 years. There were also various corporate governance reforms that aim at enhancing board structure and composition and directors' role, functions, rights and responsibilities. These can be found in the Malaysian Code of Corporate Governance 2000 which was subsequently reviewed in 2007 and more recently in 2012. There is also the Corporate Governance Blueprint (2011) which sets

out a five-year strategic direction and action plans to for the creation of a better corporate governance eco-system.

Case law

1.024 As a common law jurisdiction, case law is an important source of Malaysian company law. Although the CA 1965 contains rules regulating companies, it is not a complete or comprehensive source of law. One critical feature of common law is that the judiciary takes the role of interpreting the statute and in doing so, make law. Their decision of interpreting the CA 1965 is binding statements as to what is the legal position in relation to specific statutory provisions of the CA 1965. On some issues not expressly covered by the CA 1965, the judicial decision provides additional rules governing companies. As a common law jurisdiction and due to the historical origin of company law in Malaysia as well as the *Civil Law Act 1956*, UK case law continues to be part of the sources of company law. Case law development in Malaysia is also greatly influenced by development in Australia and other common law jurisdictions with similar statutory provisions.

Due to the historical origin of the CA 1965, decisions from the UK courts and Australian courts have been either binding or highly influential in interpreting the corresponding Malaysian provision. The history of the common law in Malaysia can be traced to the introduction of English law in Penang, in 1807 by the first Royal Charter of Justice. A second Royal Charter of Justice was granted in 1826, which introduced codified English law to Penang, Malacca and Singapore on 26 November 1826. These three states were known as the Straits Settlements and the legislative Council of the Straits Settlement passed the Civil Law Ordinance 1878 (Straits Settlements Ordinance No 4 of 1878) which introduced a considerable body of English commercial law into Malaya. Section 6 of the Ordinance provided that in all questions or issues arising in specific areas of commercial law as well as in respect of mercantile law, generally the law to be administered would be the same as that administered in England in the corresponding period. This provision was retained when the 1878 Ordinance was replaced by the Civil Law Ordinance 1909. The position was preserved under the Civil Law Enactment 1937 of the Federated Malay States, which was subsequently extended to the Unfederated Malay States in 1951 which had no specific provisions for the reception of English commercial law. In 1956, a single Civil Law Ordinance was introduced in the Federation of Malaya, which replaced both the Straits Settlements Ordinance and the Federated Malay States Enactment. In 1972, the Civil Law Ordinance 1956 was revised and extended to Sabah and Sarawak by the provision of the *Civil Law Act 1956* (Revised 1972). Section 3(1) of the Civil Law Ordinance provides that English common law, rules of equity and statutes of general application may apply in Malaysia, subject to such qualifications as local circumstances render necessary.

By virtue of s 3 and s 5 of the *Civil Law Act 1956*, the common law of England (case law) was imported into Malaysia, subject to the existence of local statutes to the contrary. Specifically, s 5 of the *Civil Law Act* provides that:

"In all questions or issues which arise or have to be decided in the States of Peninsular Malaysia other than Malacca and Penang, with respect to the law of partnerships, corporations, banks and banking, principals and agents, carriers by air, land and sea, marine insurance, average, life and fire insurance and with respect to mercantile law

generally, the law to be administered shall be the same as would be administered in England in the like case at the date of the coming into force of this Act, if such question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by an written law.”

The position in England would be referred to in situations where there is an absence of legislation in Malaysia. Nonetheless, there have been a series of law reform exercise through the common law world in the past decade which may make the body of the common law substantially different between one jurisdiction to another.

Capital Markets and Services Act 2007

1.025 A public company must comply with CMSA 2007. The CMSA 2007 was introduced for the purpose of replacing and consolidating various legislation which were then used to regulate the capital market; these were the *Securities Industry Act 1983* (SIA 1983) and *Futures Industry Act 1993* (FIA). The CMSA 2007 consolidates the SIA 1983, FIA 1993 and Part IV of the SCA 1993 which deals with fund raising activities is enforced by the main capital market regulator, i.e., the Securities Commission (SC). The CMSA 2007 contains provisions dealing with capital raising activities by public companies, provisions dealing with market misconduct offences and enforcement mechanism including investor protection provisions. The main focus is regulating the conduct of market participants involving dealings in the securities of a public company. While the CMSA 2007 is mainly related to conduct of market participants, there are provisions dealing with duties of directors and disclosure obligation of company’s officers.

Securities Commission Act 1993

1.026 The CMSA 2007 is administered by the SC which was established under the SCA 1993. The SC was established as a response to the global share market crash in October 1987 and was intended to revitalize the capital market. As the single regulatory body for the capital market, it had the responsibility to promote the development of the capital market, to streamline the regulation of the securities market and to facilitate the processing and approval of corporate transactions. The SC, which absorbed the functions of the Capital Issue Committee (CIC), the Panel on Take-overs and Mergers (TOP) and some of the previous functions of the Registrar of Companies (ROC), began operating on 1 March 1993 and is accountable to the Minister of Finance. The SC’s regulatory and supervisory purview also includes the supervision of market institutions such as exchanges, clearing houses and central depositories, the issue of securities, take-overs and mergers, unit trust schemes, the designation of futures market and the registration of market participants. In addition to the CMSA 2007 and SCA 1993, capital market participants are required to comply with guidelines issued by SC in relation to corporate transactions.

Approved accounting standards

1.027 The approved accounting standards refer to the accounting standards issued by the Malaysian Institute of Accountants, which are largely based on the International Accounting Standards (IAS) issued by the International Accounting Standards Committee

(IASC). The Companies Act requires that a company must keep and maintain financial records relating to the company’s affairs, to prepare financial reports including financial statements, have those reports audited, lodge copies of them with the ROC and send copies to members. These financial records and reports must comply with the *Financial Reporting Act 1997* which sets out and defines the approved accounting standards in Malaysia in relation to the company’s reporting obligation.

Bursa Malaysia Listing Requirements

1.028 The BMLR are applicable to companies who have all or some of their shares (or securities) quoted on the stock exchange. The Malaysian stock exchange is Bursa Malaysia which was formerly known as the Kuala Lumpur Stock Exchange (KLSE). In January 2004, the KLSE was converted from a company limited by guarantee into a public company limited by shares. This demutualisation exercise resulted in the stock exchange shares being listed on the stock exchange. The securities exchange is operated by Bursa Securities. Apart from the SC, the stock exchange, Bursa Malaysia, is also given recognition as a regulator where it has the duty to ensure, so far as may be reasonably practicable, an orderly and fair market in the securities or futures contracts that are traded through its facilities.¹ This is achieved by the stock exchange being given powers to take appropriate action as may be provided under the Listing Requirements for the purpose of monitoring or securing compliance with such rules.²

For the shares to be quoted or listed on stock exchange, in addition to the CMSA 2007, the SCA 1993, and the CA1965, the public company must comply with the BMLR. The Listing Requirements enable Bursa Malaysia to facilitate the admission of only suitable qualified entities. Once listed, the Listing Requirements provide guidelines to ensure that the entities conduct themselves in a proper manner that will give due regard to investor protection and at the same time, enable them to achieve their corporate objectives.

The BMLR cover a variety of matters, such as:

- disclosure requirements and the continuing obligations of listed companies;
- requirements that a company must meet before it enters into certain types of transactions or issues new securities;
- requirements to enhance corporate governance and transparency;
- requirements to strengthen investor protection and to promote investor confidence in the securities market;
- requirements for financial reporting; and
- requirements for the protection of minority shareholders.

¹ Sections 11(2) and 354, CMSA 2007.

² The SC also exercises supervisory oversight over its activities and has authority to take action to enforce compliance with the Listing Requirements: s 354 and s 355, CMSA 2007. The Listing Requirements has also been said to have statutory force and has been referred to as subsidiary legislation. See *Tan Sri Dato’ Hj Lamin bin Hj Mohd Yunus v Bursa Malaysia Securities Bhd* [2012] 7 MLJ 85; *Seek Keng Leong v Bursa Malaysia Securities Bhd & Another Case* [2012] 6 CLJ 191 at p 195.

Malaysian Code on Corporate Governance

1.029 The Malaysian Code of Corporate Governance (MCCG) was first developed by the Working Group on Best Practices in Corporate Governance in 1999 and subsequently approved by the High Level Finance Committee on Corporate Governance. The 2000 MCCG Code sets out the principles and best practices on structures and process that companies may use in their operation to achieve an optimal governance framework. The code has been revised in 2007 and more recently in 2012. The amendments were aimed at strengthening the roles and responsibilities of the board directors and audit committee, and ensuring that they discharge their duties effectively.

The MCCG is enforced through a company or explain approach and is applied to public listed companies. Paragraph 15.26 of Chapter 15 of the BMLR requires that *all listed companies* must disclose in their annual reports a narrative statement of how they have applied the principles and recommendations in the Malaysian Code on Corporate Governance. They are also required to explain reasons if they do not follow the recommendation in the Code. Thus, public listed companies are given the freedom to decide what is the most suitable corporate governance practice for themselves and whether or not to adopt the contents of the code with explanation to be given for non-adoption.

The 2012 Code contains eight principles, followed by 26 recommendations providing how the principles could be implemented. The recommendation acts as a set of guidelines or practices intended to assist companies in designing their approach to ensuring the corporate governance principles are followed.

Code on Take-overs and Mergers

1.030 Takeovers in Malaysia are primarily regulated under Division 2 of Part VI of the CMSA 2007, i.e., s 217 to s 225 of the Act, and the Malaysian Code on Takeovers and Mergers 2010. The Code on Takeovers and Mergers was introduced in 1998 and was modeled on the UK *City Code on Take-overs and Mergers*. The Code has been revised in 2004 and 2007. A new code on Takeover and Mergers was introduced in 2010 replacing the 1998 Code. The 2010 Code came into effect on 15 December 2010. The Code is supplemented by the SC's Practice Notes and Guidelines on Contents of Application relating to Take-overs and Mergers which also came into force on 15 December 2010. These amendments were aimed at strengthening investor protection mechanisms and inculcating higher standards of governance in takeover and merger activities.

The Code addresses the need for enhanced transparency and protection of minority shareholders in take-overs and mergers. The Code requires offer documents, board of directors' circulars and independent advice circulars to include all relevant information that would enable shareholders and their professional advisers to make an informed assessment on a take-over offer. The code is applicable when the target company is either a public company (whether or not it is listed on Bursa Malaysia), a company that is incorporated outside Malaysia but listed on Bursa Malaysia, or a real estate investment trust that is listed on Bursa Malaysia. The Code must also be complied when a takeover offer is effected by way of a scheme of arrangement, compromise, amalgamation or selective capital reduction.

Offshore Companies Act 1990

1.031 An offshore company or foreign company must be incorporated or registered respectively under the OCA 1990 in order to carry on offshore business activities in or from Labuan and to enjoy the preferential tax treatment provided under the *Labuan Offshore Business Activity Tax Act 1990*. The OCA 1990 provides for the incorporation, registration and administration of offshore companies and foreign offshore companies and matters connected with that.

In summary, the objective of the OCA 1990 is to create a structure with minimal statutory requirements in which companies may operate. It allows for financial assistance to facilitate the purchase of the company shares, the option of whether or not to conduct annual general meetings within or outside Labuan, and the passing of resolutions by telex, fax and such other electronic means can be reproduced in print form without the physical presence of the members. However, there are also restrictions on participation by Malaysian residents either as shareholders or via any trading or business activity with the offshore company.

INCORPORATING A COMPANY — RULES AND PROCESSES

1.040 The incorporation process involves:

- Name reservation.
- The submission or lodgment of the memorandum of association.
- The submission and lodgment of the articles of association (if any).
- Payment of the prescribed fees to the ROC.

There are companies that are registered but not immediately used to carry on a business, instead these companies are incorporated for the purpose of being “sold” to persons who may want to acquire already incorporated companies. These are known as “shelf companies”. The company is “sold” to the acquirer, the value of the company (which is nominal and includes costs and expenses of the incorporation process) is paid to the promoter and the shareholding will be changed so that the person acquiring the company becomes the new shareholder.

Name reservation

1.041 Prior to submission of the relevant document, the person who intends to use the company as a business vehicle, i.e., the promoter, must choose and reserve a name for the company. This is done by lodging with the ROC the prescribed form (Form 13A), a request for availability of name, accompanied by the prescribed fee. If the name is available for registration, the name that is submitted is reserved for three months.³ Within these three months, the memorandum and articles of association, and statutory declarations by the secretary and promoter of the proposed company, together with the prescribed fees must be lodged with the ROC.⁴

³ Section 22(6), CA 1965.

⁴ Section 16, CA 1965.

Although the promoter is free to choose whatever name he thinks appropriate for the company that is going to be incorporated, there are guidelines as to the suitability of the chosen name.⁵ A company shall not be registered by a name that in the opinion of the ROC is undesirable or is a name that the Minister has directed the ROC not to accept.⁶ A name that is “undesirable” includes any name or names which would offend public policy or might give offence to any particular section of the community, or any particular religion or a friendly State.⁷ The ROC is given the discretion to decide whether the name can be used based on these guidelines and has the power to order a change of name where necessary. A company may also voluntarily change its name after incorporation by passing a special resolution of the members.⁸

Limited public companies must include the word “Berhad” or the abbreviation “Bhd” in their name.⁹ Private companies must include “Sendirian Berhad” or the abbreviation “Sdn Bhd” in their name.¹⁰

Legal issues relating to company's name — Passing off and opportunistic registration

1.042 It is not uncommon that a name used or reserved to be used by a company is similar to that of an existing business. This could give rise to an act of passing off, particularly where this creates confusion that the businesses are connected or that the business conducted by “Company A” belongs to another company. Sometimes, an “opportunistic registration” may occur where a promoter reserves or uses a name that has not been used by an existing business in the country but has been used in a different jurisdiction. Another example is where a person is aware of a pending merger of two companies and incorporates a new company using the name or a variation of the name of the proposed merged entity or new company. The promoter may have incorporated the company using the name or a variation of the brand name without any intention to use the company to trade but plans to make a financial gain by the sale of that name by forcing the “original brand owner” to buy the name.

1.043 Where there is allegation of passing off, the remedy available is under the torts of passing off where the aggrieved party goes to court and apply for relief in the form of damages and/or injunction for change of name. It is the promoter's responsibilities to ensure that there is no infringement of the law of passing off, or any contravention of copyright or trademark concerning the name that has been chosen by the company. There have been several decisions where the court decided that these conduct could amount to passing off particularly when there is goodwill in the name. *Glaxo PLC v Glaxowellcome Ltd* [1996] FSR 388 is an example. The defendant had registered “Glaxowellcome” as

⁵ Section 22(1), CA 1965.

⁶ *Ibid.*

⁷ *South Pacific Airlines of New Zealand Ltd v Registrar of Companies* [1964] NZLR 1; *Abacus Finance Ltd v Registrar of Companies* [1985] 2 NZLR 607 and *Drilex System Pte Ltd v Registrar of Companies & Anor* [1991] 1 MLJ 473.

⁸ Section 23(1), CA 1965.

⁹ Section 22(3), CA 1965.

¹⁰ Section 22(4), CA 1965.

a company name when he realised that a merger was planned between Glaxo PLC and Wellcome PLC. The defendant attempted to negotiate with the company for the sale of the name and later wrote to the plaintiff demanding £10,000 for the company's name. The court held that this was passing off and granted a *quia timet* injunction on the grounds of passing off.¹¹

1.044 The legal proceedings does not involve the ROC although ROC can be made a party so as to make it bound by the court's order for the change of name to be made. The company may by itself apply for a change of name by passing a special resolution.¹² On its own accord, the ROC has the discretion not to allow registration of a company where the name is confusingly similar to an existing business, company or cooperatives.¹³ The ROC also has the authority under the CA 1965 to order a change of name.¹⁴ This would likely be exercised in passing off or opportunistic registration cases either on the ROC own accord or where the aggrieved party whose business name has been “misappropriated” applies that the ROC orders the other company to change its name. The ROC has the discretion to decide in relation to name registration and making an order for name changes and the decision may be subject to an application for judicial review. An order for a change of name can be made where there is a level of unavoidable confusion amongst the public, whether or not the similarity in names is designed to mislead the public, and the applicant has suffered some financial loss.¹⁵ There is likelihood of confusion where the companies are dealing in the same commodities or involved in the same line of business or business of the same nature so that persons doing business with them can be mistaken as to the identities of the respective businesses.¹⁶

Incorporating process

1.045 In order to complete the incorporation process, certain documents need to be lodged.¹⁷ These are the memorandum of association which must be submitted and lodged with the ROC. The other document is the articles of association which every company must have but need not be lodged upon incorporation, unless the company is a company limited by guarantee. Where a company does not lodge its articles of association, the CA 1965 states that the company is deemed to have adopted the model articles of association, i.e., Table A, CA 1965.

¹¹ *Quia timet* (“because he fears”) injunctions is granted before damage has taken place. See *Sharp Dohme Corp and Bristol-Myers Squibb Pharmaceuticals Limited v Teva Pharma BV* [2013] EWHC 1958 (Pat), in which a *quia timet* injunction was granted to stop threatened and intended patent infringement.

¹² Section 23(3), CA 1965.

¹³ Section 22(9), CA 1965; See *Tan Gek Neo Jessie v Minister for Finance* [1991] 2 MLJ 301; *Angkasa Jurutera Perunding Sdn Bhd v Pendaftar Syarikat (Ketua Pegawai Eksekutif, Suruhanjaya Syarikat Malaysia) & Anor* [2004] 2 AMR 547.

¹⁴ Section 22(9), CA 1965.

¹⁵ *Drilex Systems Pte Ltd v Registrar of Companies & Anor* [1993] 2 SLR 345; In *RH Macy & Co Inc v Trade Accents*, [1992] 1 SLR 581, it was held that the power to order a change of name should only be used where the aggrieved party has some goodwill to protect.

¹⁶ *D G KOM Sendirian Berhad v Pendaftar Syarikat & Digi Com Berhad* [2010] MLJU 153 (HC).

¹⁷ Section 16, CA 1965.

CHAPTER 7

LOAN CAPITAL AND DEBENTURE

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INTRODUCTION

7.001 Debt capital or loan capital is another important source of capital for a company. Debt or loan capital refers to the capital that a company raised by borrowings or loans obtained from financial institutions or from a private lender or any person who is willing to lend money to the company to be used in the company's business. A company may also raise capital by issuing debt securities in the form of debentures. This occurs when a company makes an offer or invites others to lend money to the company and the company then issues debentures which represents the creditors' investment in the company.

The limitations imposed on a private company's ability to issue shares are equally applicable to the issue of debentures. Therefore, unlike a public company, a private company cannot raise capital by making a public offer of its debentures. If the company is a public company, it may raise debt capital by making a public offer of its debentures, i.e., by issuing debentures to the public.

The creditors who have given loans to the company and in whose favour debentures have been issued are usually long term capital providers where the company's obligation to repay the full amount of the loan (principal and interests) is spread over a long period. Loan capital can also be sourced from trade financing where the supplier of goods or services gives these on credit to the company to be paid for at a future date. These trade financiers are not long term capital providers as the obligation to pay is usually when the goods and services are supplied when demand is made. While they are an important source of credit, they are not capital providers in the same category as those providing long term capital by way of loan to the company and are not debenture holders because debentures have not been issued to them.

To enable the company to carry on its business, part of the functions of the board is to determine how much capital should be raised from equity and how much from debt. The board will usually consider the following in its decision whether or not to raise debt capital:

- Debt capital is a favoured way of raising capital if the company does not want to dilute control or voting power of existing shareholders. In general, creditors and debenture holders do not have voting rights although in some situations, their consent maybe required before a corporate transaction maybe implemented, for example, in a reduction of capital or to alter the objects clause. One of the situations when creditors' votes are required is during a creditors' voluntary winding up.
- There are also tax advantages of raising capital through borrowings as the payment of the loan can be tax deductible.
- However, unlike shareholders who are paid dividends when there is available profits, creditors must be paid irrespective of the availability of profits. Payment of the loan may be taken out of capital whereas dividends can only be paid out of available profits and not capital. The debt may also be redeemed at any time by the company without having to comply with any particular procedure involving shareholders' approval under the *Companies Act 1965* (CA 1965). In contrast, when shares are issued to shareholders, these may not be redeemed or bought back except in accordance with procedures under the CA 1965. The company must be able to gauge whether it will be able to pay the principal and interests on the loan throughout the duration of the loan. This often depends on the capital market and the pricing of securities (debt and

equity). For example, where the interest rate is high, a company may want to raise capital by issuing new shares. When the company's debt level is too high, this might affect the available funds to be paid to shareholders as dividends. A higher ratio of debt capital to equity capital may also increase the company's risk of bankruptcy.

THE COMPANY'S POWER TO BORROW

7.010 The power of a company to borrow to raise capital may be found in the articles of association. Section 19 of CA 1965 provides that the powers of a company include those set out in the Third Schedule to the Act, unless expressly excluded or modified by the memorandum or articles. The Third Schedule in turn provides that a company has power, among other things, to borrow or raise or secure the payment of money in such manner as the company may think fit. Special powers are given to companies which are not available to individual natural persons and these are:

- the power to issue debentures;
- the power to give security by charging its uncalled capital; and
- the power to grant a floating charge over the company's property.

DEBENTURES

What are debentures?

7.020 Under the common law, the definition of debenture is "any document which evidences a debt", and it excludes negotiable instruments.¹ The term was also defined by *Chitty J* in *Levy v Abecorris Slate and Slab Co* (1887) 37 Ch D 260, as a document which either creates a debt or acknowledges it and any document which fulfils either one of these conditions can be regarded as a debenture. The Malaysian High Court in *Bensa Sdn Bhd v Malayan Banking Bhd* [1993] 1 MLJ 119, was of the view that the 19th century definition of "debentures" by *Chitty J* ought to be given a more liberal interpretation, in the context of modern day needs. The court decided that the definition should include any obligation, covenant, undertaking, guarantee to pay or acknowledgement of a debt. Thus, in *Bensa's* case, it was held that a memorandum of deposit relating to money placed in a fixed deposit was a form of debenture.

However, while the common law definition is quite wide, not all forms of undertakings to repay a loan or document acknowledging a debt is a debenture. This is because the statutory scheme under the CA 1965 and the *Capital Markets and Services Act 2007* (CMSA 2007) provide for a more specific legal definition of a debenture. Section 4(1), CA 1965 defines debentures as including any debenture stock, bonds, notes and other securities of a corporation, whether constituting a charge on the assets of the corporation or not. The definition in s 4(1) of CA 1965 excludes among others, bank deposit slips, bills of exchange and promissory notes.

¹ *Handvel Pty Ltd v Comptroller of Stamps (Vic)* (1985) 157 CLR 177.

The definition of “debenture” is further clarified by s 2, CMSA 2007.² It has the same definition of debenture under s 4(1), CA 1965 but provides an excluded list of categories of instruments which are *not classified* as debenture:

- (a) any instrument acknowledging or creating indebtedness for, or for money borrowed to defray the consideration payable under, a contract for sale or supply of goods, property or services or any contract of hire in the ordinary course of business;
- (b) a cheque, banker’s draft or any other bill of exchange or a letter of credit;
- (c) a banknote, guarantee or an insurance policy;
- (d) a statement, passbook or other document showing any balance in a current, deposit or savings account;
- (e) any agreement for a loan where the lender and borrower are signatories to the agreement and where the lending of money is in the ordinary course of business of the lender, and any promissory note issued under the terms of such an agreement; or
- (f) any instrument or product or class of instruments or products as the Minister may, on the recommendation of the Commission, prescribe by order published in the *Gazette*.

7.021 Debentures can take the following forms:

- A **redeemable debenture** is one that can be redeemed by the company at the company’s option or upon a specified date.
- A **perpetual debenture** is one that cannot be redeemed except after a long stipulated period or upon a contingency arising or the happening of an event for example only upon winding-up of a company or after 99 years.
- A **bearer debenture** is a debenture that requires the company to pay the loan to the person holding or in possession of the debenture, i.e., the bearer.

A company may reissue any debentures which it has redeemed provided this is not prohibited, expressly or impliedly, in the constitution of the issuing company or any contract entered into by the company. The redeemed debenture cannot be reissued where the company has expressed an intention to cancel the redeemed debenture. This is evidenced by the company passing a resolution to that effect or by some other act.

A company may reissue the redeemed debenture by reissuing the same debenture or issuing any other debenture in its place. In some situations, the company’s ability to issue debenture may be limited to a certain amount or number of debentures. If the company reissues the redeemed debentures, this is not deemed to be a new issue of debentures for the purpose of limiting the amount or number of debentures that may be issued by the company. The debenture holder of the reissued debenture has the same priorities as if the debenture had never been redeemed.

7.022 The concept of raising capital by issuance of debenture and its status as a document which either creates a debt or acknowledges it is provided for under s 38(1)(b), CA 1965, whereby a company or proposed company which intends to invite the public to deposit money with or lend the company money must register a prospectus in relation to the invitation with the Registrar of Companies (ROC) and the prospectus must contain an

² “Debenture” includes debenture stock, bonds, notes and any other evidence of indebtedness of a corporation for borrowed monies, whether or not constituting a charge on the assets of the corporation.

undertaking by the corporation that it will within two months after the acceptance of any money as a deposit or loan from any person in response to the invitation issue to that person a document which acknowledges or evidences or constitutes an acknowledgement of the indebtedness of the corporation in respect of that deposit or loan.

However, a debenture can only be described as a *mortgage debenture* or a *certificate of mortgage debenture stock* only if it is secured by a first mortgage over land, and if it is secured by the charge over the land the value must not exceed 60% of the value of the corporation’s interest in the land.³

In addition, for the purpose of a public issue of debentures, s 38(11) of CA 1965 states that a document issued by a borrowing corporation certifying that a person named therein in respect of any deposit with or loan to the corporation the registered holder of a specified number or value of:

- (a) unsecured notes or unsecured deposit notes;
- (b) mortgage debentures or debenture stock; or
- (c) debentures or debentures stock;

issued by the corporation upon or subject to the terms and conditions contained in a trust deed referred to or identified in the certificate, is deemed to be a document evidencing the indebtedness of that corporation in respect of that deposit or loan.

OFFER AND ISSUE OF DEBENTURES

General requirements and process

7.030 The power to issue debentures is conferred on the directors who will pass a board resolution to issue debentures. The board sometimes delegates this borrowing power and the power to issue debentures to the managing director or the chief executive officer (CEO). The validity of the contract to borrow and the issue of debenture will depend on the authority conferred and exercised by the managing director or the CEO.

When a company issues a debenture, the person to whom it is issued is called a debenture-holder. The debenture represents the investor’s (debenture holder) claim against the company and contains terms regarding the debenture holder’s rights including the repayment of any prescribed interest payment. The debenture will also include the debenture holder’s rights in respect of any security created under the debenture (such as a charge over the company’s assets). The company issuing the debenture is therefore a debtor of the debenture holder and a secured creditor to the extent of the security created by the company under the debenture in favour of the debenture holder.

The regulatory framework for the issue of debentures can be found under the CA 1965 and CMSA 2007. The regulatory framework requires that:

³ Section 38(4) and the Fifth Schedule, CA 1965.

- Every company that issues debentures which are not transferable by delivery (an example is bearer debentures) must keep and maintain a register of debenture holders. This must be kept at the company's registered office or at some other place in Malaysia.
- In addition to the CA 1965, an issue of debentures by a public company must comply with the provisions in CMSA 2007. The CMSA 2007 provides additional requirements as to the form and content of the register of debenture holders.⁴ These debentures can be listed for quotation on Bursa Malaysia and the debenture holders can sell their debentures on the secondary market conducted by Bursa Malaysia.
- An issue of debenture by a public company i.e., when a company offers or invites the public to subscribe or purchase debentures, must be accompanied by a trust deed for the debentures and there must be a trustee for the debenture-holders.⁵
- A company that offers or invites the public to subscribe or purchase debentures must obtain the approval of the Securities Commission (SC), unless exempted by CMSA 2007.⁶

Trustee for debenture holders

Public company's obligations

7.031 When a public company offers or invites the public to subscribe or purchase debentures, it must appoint a trustee for the debenture holder. The debentures cannot be allotted until the trustee has been appointed.

The trustee must be approved by the SC to act as trustee and must be either:

- a company registered as a trust company under the *Trust Companies Act 1949*; or
- a corporation that is a public company under the CA 1965 or under the laws of any other country.

The SC also has the power to revoke the approval given to a trustee if he has failed to comply with any term or condition imposed in relation to his appointment or where he has contravened any provision of the CMSA 2007.

A person is disqualified from being appointed or to act as trustee for debenture holders without the approval of the SC if the person—

- is a shareholder who beneficially holds shares in the borrower;
- is beneficially entitled to monies owed by the borrower to it;
- has entered into a guarantee in respect of the amount secured or payable under the debenture; or
- is a related corporation of—
 - the persons referred to in paragraphs (a) to (c); or
 - the borrower.

⁴ See s 283 and Schedule 8, CMSA 2007.

⁵ Sections 74 and 76, CA 1965; ss 258 and 259, CMSA 2007.

⁶ See Schedules 8 and 9 of CMSA 2007 for a list of exemptions.

7.032 The company must ensure that there is a trustee at all times in relation to the debentures. The company has an obligation to replace a retiring trustee.⁷ Sometimes a trust deed will specify the duration of a trustee's appointment. However, where no provision exists regarding the appointment of a successor to a retiring trustee, the company must appoint a successor within one month after becoming aware of the intention of the trustee to retire. However, an existing trustee shall continue to act as a trustee until a new trustee is appointed and has taken office as trustee.

7.033 The company also has an obligation to replace the existing trustee if the trustee no longer qualifies. The company must take all reasonable steps to replace a trustee as soon as is practicable after becoming aware that—

- the trustee has ceased to exist;
- the trustee has not been validly appointed;
- the trustee is not eligible to be appointed or to act as trustee under s 260;
- the trustee has failed or has refused to act as trustee in accordance with the provisions or covenants of the trust deed or the provisions of this Act;
- a receiver is appointed over the whole or a substantial part of the assets or undertaking of the existing trustee and has not ceased to act under that appointment, or a petition is presented for the winding-up of the existing trustee (other than for the purpose of and followed by a reconstruction, unless during or following such reconstruction the existing trustee becomes or is declared to be insolvent); or
- the trustee is under investigation for conduct that contravenes the *Trust Companies Act 1949*, the *Trustee Act 1949*, the CA 1965 or securities law.

Court's powers regarding trustee

7.034 The CMSA 2007 also provides for court's involvement in the appointment or replacement of a trustee. Although the obligation is on the company to ensure that there is a trustee for the debentures at all times, any debenture holder or the SC (and the company itself) may apply to court for the court to appoint, as trustee, a person who is eligible to be appointed or to act as trustee if—

- the existing trustee has not been validly appointed; or
- the trustee has ceased to exist.

This provision will enable debenture holders to take appropriate measures to ensure their interests are protected.

The court also has the power to terminate the appointment of an existing trustee and appoint his replacement where an application is made by the company, a debenture holder or the SC—

- the existing trustee is not eligible to be appointed or to act as trustee under s 260;
- the existing trustee fails or refuses to act in accordance with the provisions or covenants of the trust deed or the provisions of the CMSA 2007;

⁷ Section 262, failure to do so is an offence: see s 262(3).

- (iii) a receiver is appointed over the whole or a substantial part of the assets or undertaking of the existing trustee and has not ceased to act under that appointment, or a petition is presented for the winding-up of the existing trustee (other than for the purpose of and followed by a reconstruction, unless during or following such reconstruction the existing trustee becomes or is declared to be insolvent); or
- (iv) the trustee is under investigation for conduct that contravenes the *Trust Companies Act 1949*, the *Trustee Act 1949*, the CA 1965 or the securities law.

Contents of trust deed

7.035 The trust deed must specify what are the rights of debenture holders and the rights and duties of the corporation and the trustee. The trustee's main function is to administer the trust in accordance with the provisions of the trust deed. The primary duty of the trustee is to ensure that the debt is repaid (principal and all accruing interest amounts) as it falls due. The trustee also has the obligation to enforce all other obligations stated in the trust deed on behalf of the debenture holders. The CMSA 2007 also imposes certain statutory duties on a trustee which includes:

- The obligation to exercise reasonable diligence in exercising their duties towards the corporation (s 273, CMSA 2007).
- Comply with other requirements of the CMSA 2007 and this includes the duty to call a meeting of debenture holders under s 277.

COMPANY CHARGES

7.050 When a company borrows money, the creditor may require that some form of security is given in relation to the loan. A security in this sense means that the company gives special rights over its property to a creditor. The most common form of security is a charge over the company's property or capital such as a charge over land, or other forms of property such as money owed by third parties to the company. This secures the loan so that in the event of default on the payment of the loan, the property can be used (usually sold off) to settle the amount owed by the company to the creditor. The advantage of a security is that the property will be used first to pay off the debts that the company owes to the creditor in whose favour the security has been created. The loan is called a secured loan and the creditor is a secured creditor.

When there is no security given for the loan, the creditor is an unsecured creditor. They are normally short-term providers of capital such as supplier of goods and services.

The term "charge" is defined in s 4 of CA 1965 as including a mortgage and any agreement to give or execute a charge or mortgage whether upon demand or otherwise. In view of this broad definition, a charge may be legal or equitable and includes any form of security for repayment of a debt, thereby encompassing mortgages, charges and other securities such as pledges and liens. A company may create several charges on several different properties and can even create several charges over the same property. When a property is used as a security for several creditors, this will depend on the value of the property and whether the value of the property will be sufficient to pay off all the debts which is secured by the charged property. It is important for creditors to appreciate the significance of accepting a

charge over a company's property in a situation where there are several charges in favour of different creditors over the same property. Generally, the total amount of loans secured by all the charges ought not to exceed the total value of the property. However, in terms of entitlement to the proceeds from the disposal of the secured property for settlement of debts, the secured creditor whose charge was created first in time generally has the first priority followed by the subsequent charges. However, this is also subject to the charge being properly and effectively registered as discussed in 7.122 below and in the instance of a floating charge, on which is the first in time to crystallise as discussed at 7.061.

The following discussion is important for the purpose of determining priority of the payment of the company's debts.

Floating charges and fixed charges — Definition and distinction

7.051 In *Re Yorkshire Woolcombers Association* [1903] 2 Ch 284⁸, a *floating charge* is defined as:

- a charge over a class of assets present and future;
- the class of assets is one that, in the ordinary course of business, constantly changes;
- the company is at liberty to dispose of the subject matter of the charge in the ordinary course of its business. The company may sell, charge or otherwise deal with the assets subject to the charge until the floating charge "crystallises".⁹

In contrast, a fixed charge is a charge where the assets subject to the charge is identified from the time the charge is created. It is attached to a specific asset which does not change. A property or asset which does not need to be disposed of by the company as part of its ordinary business can be the subject matter of a fixed charge. The company cannot deal with the assets subject to the fixed charge without the consent of the creditor in whose favor the charge has been created.¹⁰ Examples of fixed charge are charges over land, factory or machineries. A charge over the fixed deposit of a company in a bank is also treated as a fixed charge.¹¹ A charge over stock, shares and bonds of a company is also a fixed charge.¹² However, share certificates kept in a designated safe, which requires any movement of share certificates in and out of the designated safe to be recorded but where the company was free to deal with them was held to create a floating charge. The shares were deposited

⁸ *Re Panama, New Zealand and Australian Royal Mail Co* (1870) LR 5 Ch App 318; *Government Stock and Other Security Investment Co v Manila Railway Co* [1897] AC 81:

"A floating security is an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying condition in which it happens to be from time to time. It is of the essence of such a charge that it remains dormant until the undertaking charged ceases to be a going concern, or until the person in whose favour the charge is created intervenes. His right to intervene may of course be suspended by agreement. But if there is no agreement for suspension he may exercise his right whenever he pleases after default ..."

⁹ These characteristics of a floating charge were affirmed in *Illingworth v Houldsworth* [1904] AC 355 (House of Lords).

¹⁰ *Re Yorkshire Woolcombers Association* [1903] 2 Ch 284; *Illingworth v Houldsworth* [1904] AC 355.

¹¹ *Bensa Sdn Bhd v Malayan Banking Bhd & Anor* [1993] 1 MLJ 119.

¹² *Affin Bank Bhd v Malayan Banking Bhd* [2009] 2 MLJ 74 (COA); *Tee Siew Kai (as the liquidator for Kumpulan Kerjaya Bhd (the receiver and manager appointed)) (in liquidation) v Affin Bank (formerly known as BSN Commercial Bank (M) Bhd) & Anor* [2011] 4 MLJ 491.

as continuing security for the banking facilities granted by the respondents and was to include the shares deposited or to be deposited and any substituted shares.¹³

7.052 In order to determine whether the charge is a fixed charge or a floating charge, consideration must be given to the characteristics and nature of the charge. The term used to describe the charge is helpful but is not a conclusive evidence of the type of charge. The most important characteristics is whether the asset subject to the charge is under the control of the charge/creditor and whether the asset is of a type that is constantly changing and needs to be disposed of in the company's ordinary course of business. In *Re Cosslett (Contractors) Ltd* [1998] Ch 495, it was stated that:

"The essence of a floating charge is that it is a charge, not on any particular assets, but on a fluctuating body of assets which remain under the management and control of the chargor, and which the chargor has the right to withdraw from the security despite the existence of the charge. The essence of a fixed charge is that the charge is on a particular asset or class of assets which the chargor cannot deal with free from the charge without the consent of the charge. The question is not whether the chargor has complete freedom to carry on his business as he chooses, but whether the chargee is in control of the charged assets."

The charge is a floating charge where the assets are under the control of the company even though the charge document described the charge as a fixed charge and the charge document used a different term.¹⁴ It is clear that a charge over land or factory or building is a fixed charge because these assets are clearly identified and not part of a class of assets. However, a "fixed charge" created over the company's entire assets and undertaking is actually a floating charge.¹⁵ This is because where the reference is made to the company's entire assets, it will most likely be a combination of specific assets which do not change and also other assets which the company can use or dispose of in its ordinary course of business. In this instance, the charge is treated as a floating charge because only a floating charge will allow these secured assets to be used by the company in its ordinary course of business during the term of the charge. Nonetheless, if the specific asset is the only property or asset owned by the company, for example, a building or a ship, a fixed charge may be created over it.¹⁶ A charge purportedly a fixed charge, was created over all the company's assets excluding the company's lands and trading stock of goods held for resale. The court nevertheless held this to be a floating charge as it would have included office equipment, tools and book debts.¹⁷

In some instances, a composite charge is created which will be over the same assets covered by both a fixed charge and a floating charge. This will be termed as "a fixed charge over specific assets and a floating charge over the other assets not covered by the fixed charge". In general, a company may create a floating charge over its entire assets and undertaking and create another floating charge over a class of assets and gives priority to the second floating charge. Two separate floating charges can be created over the same assets and

¹³ *Re EG Tan & Co (Pte); Wong Tui San & Ors v Chase Manhattan Bank NA* [1991] 3 MLJ 301.

¹⁴ *National Westminster Bank Plc v Spectrum Plus Ltd & Ors* [2005] 4 All ER 209.

¹⁵ *Re Lin Securities (Pte)* [1988] 2 MLJ 137; *Zeno Ltd v Prefabricated Construction Co (Malaya) Ltd & Anor* [1967] 2 MLJ 104.

¹⁶ *Re Panama, New Zealand and Australian Royal Mail Co* (1870) LR 5 Ch App 318.

¹⁷ *Re G E Turnbridge Ltf* [1995] 1 BCLC 34.

undertaking in favour of two persons but priority cannot be given to a subsequent floating charge over the same assets as covered by an earlier floating charge without the earlier floating chargee's consent.¹⁸

A company is also allowed to create a subsequent fixed charge over assets subject to an earlier floating charge with priority given to the fixed charge. However, this right in many instances may be restricted by the presence of a *negative pledge* clause in the debenture or charge documents of the earlier floating charge. A negative pledge is a clause which prohibits the company granting the security from creating any other security interests over the same property, which might compete with (or rank *pari passu* with) the security of the first secured creditor under the debenture or charge document; the negative pledge will normally prohibit creation of other subsequent charges unless with the consent of the first secured creditor. In general, it is highly unlikely that the first secured creditor would consent to the creation of any other subsequent charge ranking ahead of its security. This would adversely affect the position of the first charge because the subsequent charge would then have the first right to utilise the secured property in an event of default.

7.053 A floating charge enables the company to raise financing over its entire assets including the goods it manufactures or its trading stock or stock-in-trade. These types of assets are made for sale and are a valuable source of income to the company. By allowing the company to create a charge over its trading stock, the company is able to raise capital by using this class of assets without affecting the company's ability to trade i.e., sell the goods. The company can have an uninterrupted cycle where the company sells its existing stocks and replaces it with new manufactured stock. These types of assets cannot be the subject of a fixed charge as it will have the effect of restricting the company's ability to trade because then the company is required to obtain the creditor's consent before it can sell each of the goods it manufactures. However, the right of sale inherent in a floating charge terminates on crystallisation.¹⁹

7.054 A floating charge is a charge over a class of assets, present and future. The asset need not be in existence at the time the floating charge was created. This means that new assets which are in the class or of the same type is only impressed with the charge when it is acquired by the company or only after it has been manufactured, if the company manufactures the assets. However, a fixed charge may also be over assets that may be acquired by the company in the future.

¹⁸ *Re Benjamin Cope & Sons Ltd* [1914] 1 Ch 800.

¹⁹ *Jones & Ors v National Westminster Bank Plc* [2001] EWCA Civ 1541; [2002] 1 BCLC 55.

CASE EXAMPLE***Affin Bank Bhd v Malayan Banking Bhd* [2009] 2 MLJ 74 (COA)**

Wembley Industries Holdings Bhd (Wembley) received banking facilities given by PhileoAllied Bank (which has since merged with Malayan Banking Bhd). Wembley created a debenture dated 10 July 1995 (debenture 1) containing fixed and floating charges over all its assets, properties and undertakings, both present and future. Debenture 1 was duly registered under s 108, *Companies Act 1965*. Wembley then charged all shares it then owned or acquired in the future to PhileoAllied under a fixed charge. There was a restrictive clause stating that Wembley shall not, during the subsistence of the debenture, without the consent in writing of the PhileoAllied Bank, create any encumbrance over the charged assets. Form 34, filed pursuant to s 108, also states, *inter alia*, that the creation of subsequent charges is restricted or prohibited.

Wembley subsequently created three other fixed charges in favour of three other financial institutions over the same assets which were then novated to PhileoAllied. All these debentures ranked *pari passu*.

Wembley later acquired title to 8 million shares which were charged to BSN Commercial Bank (now Affin Bank) by way of two memoranda of deposit, one for 5.6 million shares, and another for the balance of 2.4 million shares.

Affin Bank came to know that PhileoAllied Bank has a prior first fixed charge over the 8 million shares as soon as they were acquired by Wembley. Affin Bank then sold the 8 million shares without giving any notice to or informing PhileoAllied Bank of the proceeds of sale.

PhileoAllied/ Malayan Banking applied for a declaration that that the four debentures had created a fixed specific charge over the 8 million shares and the charge over the shares had priority over the charge in favour of Affin Bank. The High Court made the order in favour of the plaintiff. The defendant appealed to the Court of Appeal.

Held:

The charge in favour of PhileoAllied is a fixed charge. This was a charge over shares even though the shares are not those presently owned and were to be acquired in future. These shares were specific asset. The Court of Appeal followed *Re Yorkshire Woolcombers Association; Houldsworth v Yorkshire Woolcombers Association* [1903] LJR 635 at p 640 and *Illingworth v Houldsworth & Anor* [1904] AC 355 (HL).

Is charge over book debts a fixed or floating charge?

7.055 Book debts are debts or money owed to the company. As this is money payable to the company, it can be part of the company's assets and used as a form of security to secure its own debts. When a company creates a charge over its book debts, whether the charge is a floating charge or a fixed charge will depend on whether the assets subject to the charge is under the control of the chargee/creditor and the company (chargor) is able to use its book debts without the consent of the charge holder. To be a fixed charge over book debts, the debenture document must prevent the company from realizing the debts or from utilizing it. This has been laid down in *Re Spectrum Plus Ltd, National Westminster Bank Plc v Spectrum Plus Ltd & Ors* [2005] 4 All ER 209. It was held that in determining the status of a charge over book debts, what is important is whether the proceeds were at the company's disposal, to be used freely by the company. *Re Spectrum Plus* is an important case as it changes a longstanding banking practice whereby any money paid into a bank account, becomes the company's property under banking law.

In *Re Spectrum Plus Ltd, National Westminster Bank Plc v Spectrum Plus Ltd & Ors* [2005] 4 All ER 209, the court emphasised the importance of the borrower's freedom to control the use of the assets in determining whether the security qualifies as a floating charge. The essential characteristic that distinguishes a floating charge from a fixed charge is that the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event. In the meantime, the chargor is left free to use the charged asset and to remove it from the security. *Re Spectrum Plus Ltd* states that where the agreement requires the company to collect the debts and put it into a blocked account with the chargee bank but allows the company to withdraw the amount subject to a limit, this is a floating charge. Further, the fact that the company is allowed to authorize another person as agent to collect the amount on its behalf does not mean that there is no fixed charge over the book debts. In Malaysia, *Re Spectrum Plus* has been approved in *Affin Bank Bhd v Malayan Banking Bhd* [2009] 2 MLJ 74.

CASE EXAMPLE***Re Spectrum Plus Ltd, National Westminster Bank Plc v Spectrum Plus Ltd & Ors* [2005] 4 All ER 209**

In this case, the company, Spectrum Plus had opened a current account with National Westminster Bank and obtained an overdraft facility. Spectrum then executed a debenture to secure its indebtedness to the bank which included specific charge of "all book debts and other debts... now and from time to time due or owing to Spectrum." The debenture document contains the statement that where the book debts are concerned, Spectrum shall pay into its account with the bank all moneys which it may receive in respect of such debts and shall not "without the prior consent in writing of the bank sell, factor, discount or otherwise charge or assign the same in favour of any other person or purport to do so." As is common for an overdraft facility, Spectrum was free to draw on the account for its business purposes provided the limit was not exceeded. Spectrum later went into voluntary liquidation. The bank applied for a declaration that the debenture had created a fixed charge over Spectrum's book debts. This was challenged by other preferential creditors who would have been entitled to the book debts if it were a floating charge. The case went all the way to the House of Lords on appeal by the preferential creditors.

Held:

At the Court of Appeal, this was held to be a fixed charge because it was a common banking law and practice that money paid into a bank account becomes the property of the bank although the bank may give the account holder a contractual right to withdraw the money.

The House of Lords disagreed with this finding and held that this was a floating charge. Although the collected debts from the company's debtors must be placed in a designated account with the chargee bank, the chargor could deal with the funds in the account without the consent of the bank. It was held that since the company may freely draw on the account for its business purposes within the overdraft limit, it was capable in law of being a fixed charge.

7.056 *Re Spectrum Plus* overruled *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142.²⁰ In *Siebe Gorman*, the company, RH McDonalds Ltd, gave Barclays Bank a "fixed charge" over its book debts. The company was required to pay all money it received into a bank account and the funds cannot be used without the bank's consent. McDonalds had assigned some bills of exchange as payment for some debts to Siebe Gorman. The court held that to determine whether the book debts is covered by a fixed

²⁰ In this case, the charge over McDonalds' book debts was a fixed charge.

charge or a floating charge, the debenture document must prevent the company from using the funds in the ordinary course of its business without the consent of the charge. The court held that since the company is required to pay the money into a designated bank account, this indicated that the company had no control over the funds. Hence, the charge was a fixed charge. *Siebe Gorman* was overruled on its facts because the House of Lords in *Re Spectrum Plus* held that the obligation to pay money into the account with the bank is insufficient to indicate control by bank over the utilization of the funds. *Re Spectrum Plus Ltd, National Westminster Bank Plc v Spectrum Plus Ltd & Ors* [2005] 4 All ER 209 focused on who has control over the book debts to determine whether it is a fixed or floating charge. It was held that *Siebe Gorman* was wrongly decided on its facts.

7.057 *Re Spectrum Plus* is also authority for the rule that a company cannot create a fixed charge over the uncollected book debts and a floating charge over their proceeds. This is because the security interest over the uncollected debts and the proceeds operates as a single continuous security interest, not as separate security interests.²¹ It overruled *Re New Bullas Trading Ltd* [1994] 1 BCLC 485 on this point. In *Re New Bullas Trading Ltd* [1994] 1 BCLC 485, a company created a fixed charge over the uncollected book debts but once the debts are collected and paid into the account, a floating charge is created over this proceeds. The Court of Appeal allowed the creation of such a security interest and held that there was a fixed charge over the uncollected book debts. *Re New Bullas Trading Ltd* was overruled in relation to a company's ability to create such a security interest by the Privy Council in *Re Brumark* [2001] 2 AC 710²² and by the House of Lords in *Re Spectrum Plus*.²³ The House of Lords in *Re Spectrum Plus* did not agree with this finding. However, *Re Spectrum Plus* did not lay down the rule that a fixed charge cannot be created over book debts.²⁴

Is a retention of title clause/Romalpa clause a fixed or floating charge?

7.058 A common clause in some commercial contracts for the supply of goods is a retention of title clause, i.e., a *Romalpa* clause. This is a clause that reserves title of the goods in the supplier or seller until full payment is made.²⁵ When there is a valid retention of title clause in a transaction between the company and a third party, this clause creates a charge in favour of the third party. The issue is whether the retention of title clause creates a fixed charge or a floating charge. This depends on the document creating the retention of title fulfilling the elements of a floating charge.²⁶

²¹ *Agnew v Commissioner of Inland Revenue (Re Brumark Investments Ltd)* [2001] 2 AC 710; See L Sealy and S Worthington, *Cases and Materials in Company Law* (2008, Oxford University Press) at pp 485-488.

²² *Agnew v Commissioner of Inland Revenue (Re Brumark Investments Ltd)* [2001] 2 AC 710, on appeal from New Zealand.

²³ *Re Spectrum Plus Ltd, National Westminster Bank Plc v Spectrum Plus Ltd & Ors* [2005] 4 All ER 209 (House of Lords).

²⁴ See *Re Harmony Care Homes Ltd* [2009] EWHC 1961.

²⁵ Section 25, *Sale of Goods Act 1957*; *Aluminium Industrie Vaasen BV v Romalpa Aluminium Ltd* [1978] 1 WLR 676 (COA).

²⁶ *Re Bond Worth Ltd* [1980] Ch 228.

Another example of a contract where a person retains title of products supplied is in relation to a hire-purchase agreement where the goods still belong to the "supplier" until full payment is made under the hire-purchase agreement.

Crystallisation of floating charge

7.059 The ability of the company to deal with or dispose the assets subject to the floating charge ceases when the floating charge crystallises. The effect of crystallisation is that the floating charge is transformed into a fixed charge so that the assets subject to the charge can no longer be used by the company in its ordinary course of business. However, this does not mean that the floating charge which has crystallized is of the same status as a charge which was originally created as a fixed charge. In terms of priority, a charge which was originally created as a fixed charge will rank in priority to a charge that becomes a fixed charge due to crystallisation.

7.060 Crystallisation may occur in the following manner:

- (a) Winding-up of a company. A winding-up of a company will result in *all* floating charges crystallising. The time of crystallisation is when the winding-up commences. Section 219 of CA 1965 provides that where the winding-up is by order of the court:
 - The winding-up commenced at the time of the presentation of the petition for the winding-up.
 - If there is a resolution passed by the company for voluntary winding-up, the winding-up of the company commenced at the time of the passing of the resolution.
 Section 255, CA 1965 provides that where there is a voluntary winding-up, the winding-up commences either at the time of passing of the ordinary resolution for voluntary winding-up or when the statutory declaration under s 255(1), CA 1965 is lodged with the ROC when a provisional liquidator is appointed.
- (b) Cessation of the company's business. All floating charges will crystallize when the company has not been wound up yet but has ceased trading.²⁷
- (c) Appointment of a liquidator or a receiver.²⁸ A receiver may be appointed to realise the charged assets. This means that the assets will be sold off so that the proceeds may be used to pay off the debt owed to the creditor.
- (d) In accordance with any crystallisation events as specified in the instrument creating the charge. The debenture agreement may provide that the floating charge will crystallize if a third party attempts to execute a judgment against the company or if a company debt increases beyond a certain ratio compared to its equity. It is quite common for the debenture document to require notice to be given if the crystallization event occurs.²⁹ The debenture agreement may also contain an "automatic crystallisation" clause that operates to crystallise the floating charge if the company attempts to create another floating charge or a fixed charge over the assets. In *Silverstone Marketing Sdn Bhd v Hock Ban Hin Trading Sdn Bhd & Ors* [1998] 2 MLJ 695,³⁰ a floating charge can be

²⁷ *Re Woodroffes (Musical Instruments) Ltd* [1985] 2 All ER 908.

²⁸ *UMBC Bhd v Official Receiver of Soon Hup Seng* [1986] 1 MLJ 75.

²⁹ *Re Woodroffes (Musical Instruments) Limited* [1986] Ch 366.

³⁰ *Re Brightlife Ltd* [1987] 2 WLR 197.

crystallized automatically when the crystallization event occurs, without the creditor having to give notice to the company. The charge document however must clearly state that the floating charge will automatically crystallise.

A sample of a crystallisation clause

"The Bank may at any time by notice in writing to the Borrower forthwith convert the said floating charge over the property and assets into a Fixed Charge as regards any or all of the properties or assets specified in the said notice which it shall in its absolute discretion consider to be in jeopardy or in danger of being seized or sold under any form of distress or execution levied or threatened, and may appoint a receiver thereof, and the Borrower hereby undertakes to do and execute all acts and things to effect the above said conversion in respect of the properties and assets specified in the said notice."

A sample of an automatic crystallisation clause

"If the Borrower charges, pledges, or otherwise encumbers in favour of any third party, whether by way of a fixed or floating security, any of the assets hereby charged, or attempts to do so without the prior written consent of the Bank, or if there be any petition presented or any resolution passed or any other step taken for the winding-up of the Borrower, or if any person attempts to levy any distress, execution, sequestration or other attempts or other process against any of the assets hereby charged, or if any floating charge whether created before or after the date hereof, shall crystallise over any of the assets hereby charged, the floating charges hereunder shall automatically without notice operate as fixed charges instantly such event occurs."

7.061 When a crystallization event occurs under a specific floating charge, it will only crystallise that floating charge. Other floating charges will not be affected. However, in most cases other creditors will also give notice to crystallize their floating charge. This will have an impact on which of the creditors will be paid first. When there are several floating charges and not all of them have been crystallized, a floating charge that has crystallized will be paid first before a floating charge which has not crystallized.³¹ In *Re Woodroffes (Musical Instruments) Limited* [1986] Ch 366, the company created two floating charges in favour of two persons at different times. The second chargee sent a notice to the company to crystallize the floating charge. The court held that the notice by the second chargee did not have the effect of crystallizing the first charge as well as the second charge.

Invalid floating charge

7.062 Since a floating charge can be created over a company's entire assets and undertaking, it can be used by persons who are in control of the company to "transfer" assets by creating charge over debts to get priority over other unsecured creditors. To prevent this, if a company grants a floating charge and the company is then wound up in insolvency within six months, the floating charge is void, unless the company received certain benefits or the chargee can prove that the company was solvent immediately after creating the charge. Under s 294, a floating charge created within six months before the commencement of a winding up is invalid except to the extent of money paid to the company at the time of or subsequent to the creation of the charge and in consideration of it. The charge however could be saved if the creditor is able to prove that the company was solvent immediately after its creation.

³¹ *Re Woodroffes (Musical Instruments) Limited* [1986] Ch 366.

Voidable transaction due to "undue preference"

7.063 If a company is wound up by reason of insolvency, a charge created by it may be invalidated if it is found by the court to be part of an "undue preference transaction". The provision is designed to protect the general body of unsecured creditors where the assets of the company will not be dissipated to enrich or benefit one or more unsecured creditors at the expense of other unsecured creditors. It aims at preserving the sanctity of the *pari passu* principle by which creditors in the winding-up share rateably in the assets available for distribution.³² Section 293 of CA 1965 provides that any transaction made relating to the property of a company which had it been made or done by or against an individual would in his *bankruptcy under the law of bankruptcy* be void or voidable shall in the event of the company being wound up be void or voidable.³³ This means that s 293(1), CA 1965 makes the *Bankruptcy Act 1967* applicable to companies. The law relating to fraudulent preferences under the *Bankruptcy Act 1967*, is set out under ss 53 and 54. For the transaction to be an undue preference transaction, the following requirement must be fulfilled:

- that the transaction in question took place within six months prior to the commencement of the winding-up;
- that it satisfied the description of one of the types of transaction mentioned in s 53(1) of *Bankruptcy Act 1967*;
- that it took place at the time when the company was insolvent;
- that the person in whose favour the transaction was effected stood in the relation of creditor to the company; and
- the effect of the transaction was to confer on that person preference, priority or advantage over the other creditors in the winding-up.³⁴

³² *Tee Siew Kai (as the liquidator for Kumpulan Kerjaya Bhd (the receiver and manager appointed)) (in liquidation) v Affin Bank (formerly known as BSN Commercial Bank (M) Bhd) & Anor* [2011] 4 MLJ 491.

³³ *Lian Keow Sdn Bhd (In Liquidation) & Anor v Overseas Credit Finance (M) Sdn Bhd & Ors* [1988] 2 MLJ 449.

³⁴ *Sime Diamond Leasing (M) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liquidation)* [1997] 1 MLJ 499, these principles were approved on appeal to the Federal Court although the decision of the lower court was overruled by the Federal Court: *Sime Diamond Leasing (M) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liquidation)* [1998] 4 MLJ 569.

CHAPTER 12

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INTRODUCTION

12.001 The duty of care, skill and diligence under Malaysian company law has gone through some significant changes in 2007. The amendment to the *Companies Act 1965* (CA 1965) in 2007 replaced the former s 132(1)¹ with s 132(1A).

SECTION 132 AS TO THE DUTY AND LIABILITY OF OFFICERS

- 132(1A) A director of a company shall exercise reasonable care, skill and diligence with —
- the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and
 - any additional knowledge, skill and experience which the director in fact has.

Prior to 2007, the statutory provision dealing with duty of care under the CA 1965 did not specify what is the statutory *standard of care*. This was explained through case law. The standard of care for directors in Malaysia followed the standard of care laid down in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407, widely criticised as being unsuitable in modern business environment. (see 12.015). Sadly, the case law development in Malaysia on directors' duty of care, skill and diligence has not been in tandem with the development in other common law jurisdictions.² However, due to the statutory codification of the standard of care, skill and diligence, the rule regarding directors' standard of care, skill and diligence in *Re City Equitable Fire Insurance Co Ltd* has been replaced by s 132(1A), CA 1965 while *Re City Equitable Fire Insurance Co Ltd* specified a subjective standard of care. Section 132(1A) introduces an objective and subjective standard. The Draft Companies Bill 2013 retains the wording of the present s 132(1A).

In addition to these two sources of the duty of care, skill and diligence, it is quite common to find the duty of care arising out of contract. This will usually be stipulated in a contract between a company and its officers. A term of the contract might be that the executive director or officer must exercise the care, diligence and skill expected of a person who occupies the position in question.

The statutory duty of care is enforced by the Registrar of Companies. While there is no specific penalty of fine or imprisonment for contravention of s 132(1A), a breach may lead to a disqualification order. This means that it is possible for the court to order a director who has breached the statutory duty of care not to be involved in managing companies for a specified period of time. This type of remedy is not available for a breach of the common law duty of care. A breach of the common law duty of care will usually result in the payment of compensation or damages to the company.

¹ "A director shall at all times act honestly and use reasonable diligence in the discharge of his duties."

² Aiman Nariman Mohd Sulaiman, "Revising the Director's Duty of Care, Skill and Diligence in Malaysia" in Vol 17(2) (2004) Aust Journal of Corporate Law 196–217. For judicial decisions that still apply or refer to the standard laid down in *Re City Equitable Fire Insurance*, see *Abdul Mohd Khalid v Dato Haji Mustapha Kamal* [2003] 5 CLJ 85 citing *Double Acres Sdn Bhd v Tiarasetia Sdn Bhd* [2000] 7 CLJ 550, where *Re City Equitable Fire Insurance* was still cited as the source of the standard for the duty of care skill and diligence; *Chin Foh Berhad & Anor v Kwan Yun Hong @ Kuan Onn Hing & Ors* [2012] MLJU 462; *Ho Hup Construction Company Bhd v Bukit Jalil Development Sdn Bhd & Ors (No 2)* [2012] 1 CLJ 649.

COMPONENTS OF THE DUTY OF CARE, SKILL AND DILIGENCE

12.010 Discussion about the duty of care, skill and diligence revolves around the conduct of directors in managing the company's affairs and in making decisions in the performance of their role to manage or supervise management of a company. The components of the duty of care, skill and diligence can thus be categorized as:

- The duty to exercise reasonable care;
- The duty to demonstrate skill;
- The duty to be diligent; and
- The duty when delegating and relying on others.

Duty to exercise standard of care

12.011 Section 132(1A) lays down a dual standard of care which is a combination of an objective standard and a subjective standard.

- A director is expected to demonstrate a minimum objective standard of care and skill of a reasonable director which requires him to keep himself informed of the company's affairs and financial position. The minimum objective standard of care and skill is based on what may be expected of a director having the same responsibilities. At this juncture, the general knowledge, skill and experience of other directors having the same responsibilities will be used as a measure to ascertain whether a director has fulfilled the minimum objective standards.
- However, where a director has special skill, the law requires him to be assessed by the care, skill and experience of persons having those skill. Thus, the minimum standard is an objective standard while the subjective standard will be used to determine the higher standard of care and skill. The law operates to inform directors that their special skill or experience will be relied on where they actually possess these skill and experience.

In discussing the dual standard of care found in the UK *Companies Act 2006*, the court stated in *Lexi Holdings Plc (in admin) v Luqman & Ors* [2008] 2 BCLC 725³ that:

"The objective test sets the basic standard. It is no excuse for a director to say that, in fact she did not have the general knowledge, skill and experience reasonably to be expected of a person carrying out her appointed functions. The subjective test potentially raises the standard by reference to any greater knowledge, skill or experience which the particular director has."

12.012 It must be noted that the principle stated above does not mean that a director who has knowledge, experience and qualifications will *always* be judged in relation to his duties to his company based on the higher standard.⁴ An evaluation of the higher standard of care to be imposed needs to be related to whether his special skill are those that is relevant to the matter that the board is considering or that can be expected of a director who is entrusted with the responsibilities or position assigned to that director in that company.

³ Per Briggs J at para 37.

⁴ See V Finch, "Company Directors: Who Cares about Skill and Care?" (1992) Modern Law Review 179, at p 203.

What does the minimum standard of care requires director to do?

12.013 In *Daniels v AWA Ltd* (1995) 13 ACLC 614; 16 ACSR 607, the Australian New South Wales Court of Appeal laid down the modern formulation of duty of care and the minimum standard of care, skill and diligence expected of all directors.

CASE EXAMPLE

Daniels v AWA Ltd (1995) 13 ACLC 614; 16 ACSR 607

The company, AWA Ltd, suffered loss due to foreign exchange transactions conducted by one of its employees. The employee managed to make substantial profits but started making losses thereafter. After there were losses, the employee concealed them from the supervisors and arranged for borrowings on behalf of the company from other banks and these were unauthorized by the company. Although the employee had authority to conduct the transactions, there were no controls as to the amount that could be transacted or reporting of the numerous dealings.

AWA Ltd's auditors did not detect these unauthorized borrowings but did inform the senior management of the inadequate internal controls. These were not acted upon by the senior management. The auditor had knowledge that the senior management has not addressed his concerns but did not inform the board of this. The auditor subsequently informed the chairman and the CEO of the inadequacies in the company's internal control and monitoring system but did not specifically mention his concern about the foreign exchange operations. The board became aware of the losses from the foreign exchange operations in 1987.

AWA Ltd sued the auditors who counterclaimed that there was contributory negligence by the company. The company then sued its directors for contribution.

The auditors argued that there was contributory negligence on the part of the company because the directors had breached their duty of care.

Held:

The auditors were negligent but the company had contributed to the negligence due to the breach of duty of AWA Ltd's directors. The court held that the minimum standards of care, skill and diligence expected of all directors are that:

1. A director must acquire a basic understanding of the business of the company and must be familiar with the fundamentals of the company's business.
2. Directors are under a continuing obligation to make inquiries and keep themselves informed about the activities of the company and its business operations.
3. Detailed inspection of day-to-day activities is not required but what is required is a general monitoring of the company's business affairs. Accordingly, a director should attend board meetings regularly.
4. While directors are not required to audit the company's books, they should maintain familiarity with the financial status of the company by a regular review of financial statements.
5. Directors who are appointed because of their special skill or responsibilities must also pay attention to other aspects of the company's business that might reasonably be expected to attract inquiry.
6. Directors cannot shut their eyes to corporate misconduct and then claim that they did not see the misconduct and did not have a duty to look.

The non-executive directors were not held liable because they had requested information about the foreign exchange transactions from the senior management and the auditor when the auditor informed the board about their concerns.

Similarly, decisions from the UK have also specified a more objective minimum standard of care. In *Re D'Jan of London Limited* [1994] and *Re Barings Plc and Ors* [1999] BCLC 433, the courts have laid down the following principles:

- Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.
- Directors are entitled, subject to the articles of association of the company, to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent. However, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.
- Whether or not the duty above has been discharged depends on the facts of each case, including the director's role in the management of the company.

12.014 In large companies particularly for public and public listed companies, the composition of the board must comprise non-executive directors. In the 1992 decision of *AWA Ltd v Daniels* (1992) 7 ACSR 759, the court distinguished between the duty owed by an executive director and a non-executive director. It was stated that:

"the non-executive directors are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board meetings, and at meetings of any committee of the board upon which the director happens to be placed."⁵

However, on appeal in *Daniels v AWA Ltd* (1995) 13 ACLC 614; 16 ACSR 607, the court did not accept this distinction. It was held that although all directors (executive and non-executive) owe the same duty, the *standard* of care and skill differs between an executive and a non-executive director because of the time commitment and scope of responsibilities.⁶

Rejection of the standard of care laid down in *Re City Equitable Fire Insurance*

12.015 The traditional approach to the duty of care, skill, diligence and delegation of authority was laid down in *Re City Equitable Fire Insurance Co Ltd* as follows:

- A director need not exhibit, in the performance of his duties, a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.
- A director is not required to give continuous attention to the affairs of the company and his duty arises intermittently while performing his functions at board meetings.
- A director is entitled to delegate his duties. In the absence of grounds of suspicion, the director is justified in trusting the official (to whom his duties were delegated) to perform such duties honestly.

⁵ *AWA Ltd v Daniels* (1992) 7 ACSR 759.

⁶ In a Malaysian decision, *Sime Darby Bhd & Ors v Dato' Seri Ahmad Zubair @ Ahmad Zubir bin Hj Murshid & Ors and Tun Musa Hitam & Ors (third parties)* [2012] MLJU 189, the court made a statement, obiter, about the distinctive duties between an executive and a non-executive directors, "The duties of a Non-Executive Director are not co-extensive with the duties of an Executive Director *vis-a-vis* the Company on whose Board they sit". It is submitted that this view is not in line with development relating to duty of care, skill and diligence.

A shortcoming of the approach in *Re City Equitable Fire Insurance* is that it does not encourage directors to gather (more) knowledge about the company's business and affairs or to acquire more skill. The later cases and s 132(1A) resolved the problem arising out of *Re City Equitable Fire Insurance* where a director who has no skill or experience will be able to rely on these inadequacies to escape liability. Traditionally there was no requirement that a director equipped himself with knowledge about the company's operations or financial status. However, this is no longer the applicable law in Malaysia because of s 132(1A).

In addition, *Re City Equitable Fire Insurance* enables passive directors to escape liability by arguing that he was not involved in the management of a company. Older cases such as *Re Cardiff Savings Bank; Marquis of Buite* [1892] 2 Ch 100, held that where a director who was appointed when he was a minor and had never been involved in managing the company was not liable for breach of duty of care, skill and diligence. This is no longer the law. A director who is passive, uninformed and uninvolved is liable for breach of duty of care, skill and diligence.⁷ A director is in breach of his duty of care, skill and diligence where he allows other directors to dominate him resulting in a total abrogation of his responsibilities.⁸

12.016 In the following cases, the Singapore courts have rejected the traditional approach in favour of the modern standard of care. These cases were decided based on the Singapore's equivalent of the former s 132(1), CA 1965.

CASE EXAMPLE

Lim Weng Kee v PP [2002] 4 SLR 327

The defendant was the managing director of a pawnshop business. A customer had pawned her jewellery. The customer had built up close relations with the directors, often giving them gifts and falsely represented that she was very wealthy with connections to the Brunei royal family. In actual fact, the jewellery items did not belong to her and were taken from a diamond merchant. As a result of outstanding payments on the loan, the managing director had contacted the customer who informed the directors of her intention to redeem the jewellery. She gave several post-dated cheques and requested that these are to be deposited at a future date and that any refunds can be returned to her later. She then requested that the jewellery be returned to her. Although this was not accepted initially by the managing director, due to requests by other board members, he had accepted the cheque and released the goods which had been pawned without first waiting for the cheques to clear. The cheques were dishonoured.

Held:

The court held that a person in the position of the accused had not acted with due skill and care. By having the experience of being a pawnshop managing partner, he ought to have known that pawned goods should not be released before actual payment had been received. The accused was therefore convicted.

⁷ See *Lim Weng Kee v PP* [2002] 4 SLR 327, rejecting *ASC v Gallagher* (1993) 10 ACSR 43. See also AS Sievers, "Farewell to the Sleeping Director—The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill and Diligence—Further developments" (1993) 21 ABLR 111.

⁸ *Re Westmid Packing Services Ltd; Secretary of State for Trade & Industry v Griffiths (No 3)* [1998] BCC 836 at 842B–843D; *Re Barings Plc* [1999] 1 BCLC 433 at pp 486–489; *Lexi Holdings Plc v Luqman (No 2)* [2008] 2 BCLC 725 per Briggs J and [2009] BCC 716 per Sir Andrew Morritt C.

The standard of "reasonable diligence" under s 157(1) of *Companies Act (Cap 50)* ("CA") is objective. The issue therefore was whether the appellant exercised such degree of care and skill as would amount to the reasonable care which an ordinary person might be expected to take in the circumstances on his own behalf. This objective test applies to both civil breaches of the duty to use reasonable diligence under s 157(3)(a); as well as criminal breaches of that duty under s 157(3)(b).

The court stated that the test of whether a director had acted with due skill and care would not be lowered to accommodate inadequacies in an individual's knowledge and experience, but the standard would be raised if the individual held himself out as having knowledge or experience. The court rejected *Re City Equitable Fire Insurance Co Ltd*.

The test to be applied for civil breaches of directors' duties under s 157(3)(a) of CA

"[23] Under the traditional approach exemplified by these lines of cases, the standard of 'reasonable diligence' is essentially objective but it contains an important subjective qualification: it is measured against what an 'ordinary' director, *sharing the same level of knowledge and experience as the defendant*, would or would not have done on the facts of the case. This makes it possible for a defendant to escape liability by appealing to his own lack of knowledge or experience.

[24] However, times have changed. Professor Paul Davis pointed out in *Gower's Principles of Modern Company Law* (6th Ed) at p 640, 'those cases seem to have framed the directors' duties of skill and care with non-executive rather than executive directors in mind and, moreover, on the basis of a view that the non-executive director had no serious role to play within the company but was simply a piece of window-dressing aimed at promoting the company's image'.

[25] In *Daniels v Anderson* (1995) 16 ACSR 607 at 666–667, the Supreme Court of New South Wales indicated that it is no longer appropriate to judge a director's conduct by the traditional approach applied in cases such as *Lagunas Nitrate Co v Lagunas Syndicate* (supra):

'The duties of a director are eloquently explained in the judgment of Pollock J, giving the opinion of the Supreme Court of New Jersey, in *Francis v United Jersey Bank* 432 A 2d 814 (1981) ... In our opinion, this has become what the law requires of directors. At 812–3 Pollock J said: "... Because directors are bound to exercise ordinary care, they cannot set up as a defense lack of the knowledge needed to exercise the requisite degree of care. If one feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act ... A director is not an ornament, but an essential component of corporate governance. Consequently, a director cannot protect himself behind a paper shield bearing the motto 'dummy director'." [Emphasis is added.]

[26] This passage was quoted with approval in the Chancery Division in *Re Barings plc* [1999] 1 BCLC 433 at 488. The policy under this modern approach is clear: a person who accepts the office of director undertakes the responsibility that he understands the nature of the duty required of that office. That duty will vary depending on the circumstances, the size and the business of the particular company and the experience or skills that the director *held himself out* to possess in support of appointment to the office.

[27] A similar view was held by Hoffman J in *Re D'Jan of London* [1994] 1 BCLC 561 (Chancery Division) where he decided that the duty of care owed by a director at common law is the conduct of a reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience which that director has. As pointed out by Professor Davis in *Gower's Principles of Modern Company Law* (6th Ed) at p 642, the crucial difference with the traditional approach is that limb (b) adds a subjective standard which can operate only to increase, and not decrease the level of care and diligence required by the director.

[28] In my opinion, the modern approach exemplified in *Daniels v Anderson* and *Re D'Jan of London* (supra) also represents the position here. The law hence stands as thus: the civil standard of care and diligence expected of a director is objective, namely, whether he has exercised the same degree of care and diligence as a reasonable director found in his position. This standard is not fixed but a continuum depending on various factors such as the individual's role in the company, the type of decision being made, the size and the business of the company. However, it is important to note that, unlike the traditional approach, this standard will not be lowered to accommodate any inadequacies in the individual's knowledge or experience. The standard will however be raised if he held himself out to possess or in fact possesses some special knowledge or experience.

[29] This position is not just in line with recent developments in England and Australia but supported by two other reasons on principle: firstly, the traditional approach made it too easy for directors to escape responsibility for breaches of duty by relying on their personal lack of experience or knowledge. Surely the law cannot act as an excuse for directors to continue in their ignorant state. That is however exactly the effect of the traditional approach. This detracts from the protection to shareholders intended by s 157. Secondly, most of the older cases predated the modern objective test of negligence propounded by the House of Lords in *Donoghue v Stevenson* [1932] AC 562 and should be read in the light of subsequent developments. Hence, the traditional position in *Lagunas Nitrate Co v Lagunas Syndicate* (supra) should no longer be followed."

CASE EXAMPLE

Jurong Readymix Concrete Pte Ltd v Kaki Bukit Industrial Park Pte Ltd (Chng Heng Tiu, third party) [2000] 4 SLR 723

Jurong entered into a contract with Boonan Pte Ltd to supply concrete for a development project. Boonan was the contractor for the project which belonged to Kaki Bukit Industrial Park. Kaki Bukit agreed to guarantee the supply of concrete made by Jurong to Boonan. However, Boonan failed to pay for the concrete and Jurong took legal action in relation to the guarantee. Kaki Bukit then sued one of its directors, Chng Heng Tiu, to obtain indemnity for the company's costs and expenses on the grounds that Chng had acted without authority when he signed the guarantee and that he was acting in breach of his fiduciary duties as a director of Kaki Bukit when he did that.

Held:

The court held that the director was liable for breach of duty of care because he neither obtained legal advice on the giving of the guarantee nor did he peruse the guarantee document. If he had done so, he would have found out that the supply contract did not require a guarantee. Although Chng had not issued such guarantees before, he did not refer the matter to his fellow directors or seek legal advice, and had executed the guarantee based on the assumption that Kaki Bukit could pay Jurong out of deductions from payments due to Boonan.

Acquiring an understanding of company's business and financial position

12.017 The minimum objective standard requires a director to keep himself continuously informed of the company's business, affairs and financial position.⁹ This duty is of a continuing nature and rejects the view in *Re City Equitable Fire Insurance* that the duty of a director is intermittent in nature to be exercised at board meetings.

Due to the minimum objective standard of care, where the directors fail to prepare the company's financial reports and this affected the directors' ability to understand the company's financial position, such failure will be significant in determining liability.¹⁰ The CA 1965 contains a financial reporting framework where the responsibility for the company's financial statements rests with the directors.

Failure to find out about the company's affairs could also lead to liability especially if this causes the company to become insolvent. Thus, there was breach of duty of care where the non-executive directors had *failed to request* that the company's accounts be submitted to them at least on a regular basis which would have enabled them to notice the increasing amount of unlodged cash deposits in the bank statements and would have been able to inquire as to why this occurred¹¹. An executive director who failed to inspect monthly bank statement which showed an increasing amount of "unlodged cash deposits" i.e., cash from sales which were not yet credited into the company's account and relied on an officer of the company was liable as the reliance did not relieve him from the duty to exercise supervisory control, monitor management and ensure the company's policies and procedures for handling the assets of the company was properly complied with.¹² In *Sheahan v Verco* [2001] SASC 91, the court held that it was not reasonable for a director to fail to make any enquiries in relation to the company's solvency.

⁹ *Re D'Jan of London Limite* [1994] BCLC 561 and *Re Barings Plc and Ors* [1999] 1 BCLC 433; *Re Barings Plc and Ors (No 5)* [2000] 1 BCLC 523.

¹⁰ *The Secretary of State for Trade and Industry v Birstow & Ors* [2004] EWHC 1730 (Ch). See Hanak A, "The Interaction Of The Company Director's Duty Of Care And The Director's Obligations Relating To Insolvent Trading And Financial Reporting" (2007) 25 C&SLJ 180.

¹¹ *Planassurance PAC formerly known as Patrick Lee PAC v Gaelic Inns Pte Ltd* [2007] 4 SLR 513.

¹² *Ibid.* See Aiman Nariman Mohd Sulaiman, "Directors' Reliance And Responsibility To Supervise And Auditors' Duty Of Care: *Planassurance PAC Formerly Known As Patrick Lee PAC v Gaelic Inns Pte Ltd*" [2009] 4 MLJ xlv.

CASE EXAMPLE**Sheahan v Verco [2001] SASC 91**

The annual reports and financial statements of the company for 1990 and 1991 were never considered by the directors as there was only one board meeting held between 1990 and December 1991 when the company was put under a receivership. No minutes book was kept and the company's accounts were not prepared in accordance with the approved accounting standards as "there was no provision for amortisation of goodwill and inadequate provision for depreciation."¹³ The non-executive directors relied on the managing director, Linke to keep them informed as to the company's financial position. They were given information verbally about the general nature of the company's financial position on a monthly basis and were satisfied with verbal assurance as to why the accounts were not produced. When the company wanted to acquire new service stations and this was communicated to the non-executive directors, they did not inquire as to the source of the funds to finance the acquisition, the value of the business and whether the company had sufficient assets and working capital to enable it to carry on the business.

Held:

The non-executive directors of a company were held to be negligent in failing to monitor the company's financial position and that they had breached their duty to the company pursuant to s 232(4)¹⁴ and at common law to cause the company to cease trading when it was insolvent and trading at a loss. The court held that while a non-executive director was not obliged to inspect in detail the day-to-day operation of the company, he has a duty to *be aware of the true financial position of the company and to act appropriately* if there are reasonable grounds to expect the company is unable to pay its debts. One of the failures of the non-executive directors is not to request for the financial accounts of previous years. This was despite them asking for explanation as to why the company's financial accounts were not given or communicated to them regularly. The court noted that "a prudent director, let alone one who was also an investor, should seek the financial accounts for a number of previous years."¹⁵

The court stated that:

"what is reasonable, therefore, is related in part to the extent of the enquiries that the director has made and should have made about the company's solvency ... A director should ask for and receive figures on a more or less regular basis. If that is sought and it reveals no difficulties and the director has no other reason to suspect the company may not be able to pay its debts as they fall due, then the director may be shown to have acted reasonably. Directors cannot be required to make their own further investigations or to 'audit' the accounts provided, unless they have particular responsibilities or expertise, and they can only be required to seek more information if the company's accounts, together with any other information from the company's executives, put them on enquiry."¹⁶

There are basic statutory responsibilities in relation to keeping and maintaining company's accounts and books. These duties includes:

- The duty to ensure that the company kept a minute book (s 258).

¹³ Ibid, para 112.

¹⁴ Section 232(4) of the *Corporations Law* states that "An officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his or her powers and the discharge of his or her duties." While the case is decided based on the *Corporations Law* and is different in wording from the present dual-standard of care to be found in current corporate legislation, the case law developed in Australia had interpreted the section according to the dual-standard of care.

¹⁵ [2001] SASC 91, para 119.

¹⁶ Ibid, para 105-106 of the judgment citing *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423.

- That the company kept accounting records which correctly recorded and explained its transactions and financial position and which allowed for the preparation of true and fair accounts capable of audit (s 289).
- There is the duty of directors after the conclusion of a financial year to make out a profit and loss account and balance sheet which gave a true and fair view of the company's state of affairs at the end of the relevant accounting periods (ss 292 and 293). In doing so they must first take reasonable steps to ascertain what had been done about writing off bad debts and making provision for doubtful debts, and cause all known bad debts to be written off and adequate provision to be made for doubtful debts (s 294(2)) and whether any current assets are unlikely to realise, in the ordinary course of business, their value as shown in the company's accounting records and, if so, to cause the value of those assets to be written down or cause adequate provision to be made (s 294(3)) and whether the value of any non-current asset is shown in the company's accounting records at an amount that, having regard to the asset's value to the company as a going concern, exceeded the amount that it would have been reasonable for the company to spend to acquire the asset as at the end of the financial year and, if so, make adequate provision or include any necessary information or explanations in the accounts (s 294(4)).
- Directors are obliged, for each accounting period, to state whether the company's profit and loss account gave a true and fair view of the company's profit and loss for the accounting period (s 301(2)(a)), the balance sheet gave a true and fair view of the company's state of affairs as at the end of the accounting period (s 301(2)(b)) and, in their view, there were reasonable grounds to believe that the company would be able to pay its debts as and when they fell due (s 301(5)).
- Directors are obliged to ensure that the company's financial statements for the relevant accounting periods complied with the prescribed requirements relevant to the financial statements (s 297(1)), and that the company complied with relevant accounting standards (s 298) and that an annual general meeting of the company is held at least once in every calendar year and within a certain time after the end of the relevant financial year (by 31 December) and to lay the company's financial statements before the annual general meeting.¹⁷

Nonetheless, while the non-executive directors were in breach of their common law duty and statutory duty of care, skill and diligence, they were not liable for damages as their negligence did not cause the damages suffered by the company as the loss were due to transactions entered into prior to them joining as directors.

Duty to demonstrate skill

12.018 There is no legal requirement that a director must possess any specific set of skill to be eligible for appointment as a director. The common law rule laid down in *Re City Equitable Fire Insurance* does not require a director to have any qualifications or skill to be appointed to the board. The CA 1965 also does not specify any skill set or qualification for a director. However, the case law development has identified certain basic skill for directors: the ability to understand the fundamentals of the business, monitor performance and review financial statements regularly.¹⁸ Directors must demonstrate a *basic level of financial literacy*, which includes the ability to read and understand the financial statements.¹⁹

¹⁷ At pp 126-127.

¹⁸ *R v Moses* [2011] NZHC 646; *Davidson v Registrar of Companies* [2010] NZHC 1497; [2011] 1 NZLR 542.

¹⁹ *Australian Securities and Investment Commission (ASIC) v Healey (No 2)* [2011] FCA 1003.

This basic skill is also necessary as directors have a series of statutory obligation in relation to company's financial statements to ensure that the financial report presented to the general meeting, and for submission to the regulators, is made in accordance with accounting standards and give a true and fair view of the company's financial position.

For public listed companies, the Bursa Malaysia Listing Requirements (BMLR) requires specific skill or qualifications for a director who is a member of the audit committee. The BMLR requires the audit committee to comprise at least three members who must all be non-executive directors and to be made up mainly of independent non-executive directors. At least a member must have accounting qualifications and experience which is defined as being a member of the Malaysian Institute of Accountants or if not, must have had three years working experience and must have passed the examination as recognised under the *Accountants Act 1967* or be a member of any associations of accountants as specified under the *Accountants Act 1967*.²⁰ The Malaysia Code on Corporate Governance 2007 recommends that an audit committee should be made up of at least three members, all of whom must be non-executive directors with a majority of independent non-executive directors.²¹ All members of the audit committee should be financially literate. There is however, no guidance from the Code as to what is meant by financial literacy.

12.019 When a director accepts appointment to a committee where special skill is required, he can be considered to have represented that he has the *additional* knowledge, skill and experience required to qualify for that position.²² Where a director is appointed to the board due to special skill or expertise, whether the director has breached his duty of care, skill and diligence depends on what other people having the same skill would have done under the circumstances. Certain identifiable skill may also attach to specific position. For example, there are identifiable skills attaching to the particular office as chief financial officer²³ or the customary and ordinary responsibilities of chairman of listed companies as was decided in *Australian Securities and Investment Commission v Rich* (2003) 44 ACSR 341; 21 ACLC 450 and *Australian Securities and Investment Commission v Adler* (2002) 20 ACLC 576. In these cases, the court considered the fact that the director had accounting experience and had served as finance director of other listed companies to hold him liable for breach of duty of care, skill and diligence. The skill and experience he had acquired from these responsibilities were relevant to determine whether he had exercised due care as the chairman of the company and chairman of the audit committee. The court stated that: "[a] person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. The duty will vary according to the size and business of the particular company and the experience or skills that the director *held himself or herself out to have* in support of appointment to the office."²⁴

²⁰ Paragraph 15.09 of the BMLR.

²¹ The Malaysian Code on Corporate Governance 2000 recommends that there should be at least three members on the audit committee. The 2000 Code does not require that all audit committee members must be non-executive directors, although a majority must be non-executive directors.

²² *ASIC v Vines* (2003) 48 ACSR 291.

²³ *ASIC v Vines* [2005] NSWSC 738; *Vines v ASIC* [2007] NSWCA 75.

²⁴ [2004] NSWSC 172 (revised – 14/05/2004), para 18.

Where a director is not appointed to a particular position, and where he has special skill and expertise, in evaluating the higher standard of care to be imposed, the court should consider whether his special skill are those that is relevant to the matter that the board is considering. In *Gold Ribbon (Accountant) Pty Ltd v Sheers* [2006] QCA 335, it was held that a non-executive director who has special skill is bound to give the company the benefit of his skill and experience and cannot simply assert that he had relied on the officers and executive directors of the company. Thus, the non-executive director who has extensive lending experience was held in breach of the duty for failing to ensure that the company's lending scheme complied with accepted lending practices that included the system to ensure that prospective lenders had the ability to pay the loan.

12.020 Directors are allowed to defer to the views of other directors with greater experience or expertise than him. Decision making at the board level must be made collectively and views are exchanged to consider matters presented before the board. A good board will be made up of people with different experience and expertise. Where there is a director who has a record and reputation for outstanding skill and experience in the company's business activity, his fellow directors are entitled to give a high degree of deference and trust to his views as to what is in the company's best interests.²⁵

Duty to exercise diligence

12.021 Section 132(1A) requires a director to exercise diligence. Diligence relates to the degree of involvement of a director as well as the quality of his involvement and the attention that he gives to managing or supervising the management of the company's affairs. The traditional approach in *Re City Equitable Fire Insurance* was that directors are not required to give continuous attention to the affairs of the company and a director's duty arose *intermittently* while performing his functions at board meetings.²⁶ This is no longer good law. This traditional view focused on board meetings and measured a director's diligence to attendance at board meetings only and based on matters brought to the director's attention. The modern rule requires a director to keep himself reasonably informed of the company's affairs and financial position. This is not confined to matters brought to his attention during board meetings only.²⁷

Relevance of board meetings

12.022 Duty to exercise diligence has often been evaluated based on attendance at board meetings. However, non-attendance at board meeting is not a breach of duty in itself. Directors are not obliged to attend all board meetings and failure to attend some of the meeting does not automatically give rise to a breach of duty. Board meetings provide a forum where directors are able to raise questions related to the company's affairs and business to management and request for explanation or clarification. Persistent failure to attend board meetings is an indicator of the director's inability to be involved in managing or supervising management of the company and is an indicator of poor quality of attention.

²⁵ *Madoff Securities International Ltd v Raven & Ors* [2013] EWHC 3147 (Comm).

²⁶ [1925] Ch 407 at p 428.

²⁷ *Planassurance PAC Formerly known as Patrick Lee PAC v Gaelic Inns Pte Ltd* [2007] 4 SLR 513.

He may not be able to acquaint himself with the company's business and financial status by his constant absence from board meetings.

In *Dorchester Finance Co Ltd v Stebbings* [1989] BCLC 498, the two non-executive directors who were accountants had, signed blank cheques which were misappropriated by another director. They were no board of meeting for directors of Dorchester. The court held that complete passivity and inactivity was a breach of the duty of care, skill and diligence.

Evidence of signing off of fictitious board minutes is instrumental in holding directors liable for breach of duty of care, skill and diligence. In *Australian Securities and Investment Commission v Loiterton* [2004] NSWSC 172,²⁸ there was evidence to show that the company's business was not making profit as stated in the management's accounts and that "he should have exercised care and diligence as a director (with his skills as an accountant) to pursue further inquiry about the size of these fees, their source, and their basis. ... there was ample evidence from which Sapier should have registered a concern, including the minute that he settled placing him at a meeting that did not occur."

In *Weaving Macro Fixed Income Fund Ltd (In Liquidation) v Stefan Peterson and Hans Ekstrom*,²⁹ the Grand Court of the Cayman Island recently gave judgment against two independent directors of a hedge fund, managed by Weaving Capital (UK) Ltd for \$111m each for breach of duty. There was evidence that the board signed minutes of board meetings which were never actually held and that minutes were approved as a matter of fact without inquiring whether or not they were true.

Degree of diligence

12.023 The degree of diligence will vary according to a number of factors, including the circumstances of the director's appointment and the size of the company's operations. While all directors must be diligent, it cannot be expected that non-executive directors can contribute the same amount of time and effort to the company when compared to executive directors. Where the company's operations is modest, the directors would be able to be more involved in the company's operations and because it is not a public listed company, there may not be any requirements for non-executive directors. For example, in a company with a small operation, "the company's system of control is often dependent on the close involvement of the directors, who are better acquainted with the employees and officers. If there is fraud by an employee of the company, a director may be more likely to have his suspicions aroused than would his counterpart in a large, anonymous, public company."³⁰ However, a non-executive director who took a backseat in the management of the company is not exempted from the need to exercise a modest level of scrutiny as to the goings-on in the company. In *Planassurance PAC formerly known as Patrick Lee PAC v Gaelic Inns*

²⁸ At para 330.

²⁹ See <http://www.hedgeweek.com/2011/09/12/130684/corporate-governance-and-weaving-judgment>. Despite the decision by the court, the Serious Fraud Office of the UK has announced that it was not proceeding with the investigation and not prosecuting Magnus Peterson, the former CEO. However, the liquidator has indicated the intent to bring a civil fraud case against several persons including directors due to financial misreporting: see "Serious Fraud Office criticised for closing Weaving Capital investigation" (Thursday 22 March 2012) <http://www.telegraph.co.uk/finance/financial-crime/8750929/Serious-Fraud-Office-criticised-for-closing-Weaving-Capital-investigation.html> (accessed on 21 March 2012).

³⁰ At p 551.

Pte Ltd [2007] 4 SLR 513, the non-executives argued at their trial that since they were not involved in the day-to-day management of the company, their duty was only to attend board meetings and deliberate on matters presented to them at the board meeting. The court rejected this argument.

In situations where an alternate or substitute director is appointed, it cannot reasonably be expected for the alternate director to attend every board meeting because his duty as director only arises in accordance with the terms of his appointment, usually in the absence of the original director. Similarly, the original director who has appointed an alternate or substitute director cannot be held liable for any financial loss suffered by the company when he was not in office.

12.024 Although attendance at directors' meetings is an important indicator of a director's diligence, a director can still be held liable despite attending board meetings if he has not exercised reasonable care, skill and diligence in evaluating issues presented to the board for decision at these board meetings.

CASE EXAMPLE

Australian Securities and Investment Commission v Hellicar [2012] HCA 17

This case involved the James Hardie group which wanted to reincorporate in a different jurisdiction. The company was concerned about potential liability to future torts claimants in Australia in relation to injury caused by the company's asbestos products. As part of the reincorporation exercise, the company established a medical compensation fund to be used to fulfil future asbestos related liability claims. The company made an announcement that the medical compensation fund would be sufficient to cater to these future claims. The Medical Research and Compensation Foundation, which was capitalised with \$293 million to fund future asbestos compensations claims. As a result the reincorporation was approved. The sum of \$293 million was arrived at through a valuation report commissioned by James Hardie in February 2001 which stated that future claims could amount to \$286. This figure however was revised later that year to \$574.3 million and subsequent valuation indicated a further increase, highlighting the fact that the Foundation was underfunded. In December 2003, the Foundation announced that it would be unable to meet future compensation claims as the amount it had was insufficient.

The regulator, Australian Securities and Investment Commission (ASIC) brought an action against the directors for breach of the statutory duty of care, skill and diligence (in *Australian Securities and Investments Commission v Macdonald (No 11)* (2009) 256 ALR 199). It was argued that the directors' conduct in approving the release of the announcement was a breach of duty as this was in contravention of the company's disclosure obligation. This was because the directors had allowed the announcement to be made despite knowing that the announcement was not accurate.

At the trial court, it was held that s 180 of the *Corporations Act 2001* dealing with duty of care, skill and diligence was breached when the board failed to ensure that the draft announcement that there were sufficient funds to pay compensation was not misleading or deceptive. This was because despite evidence that there were uncertainties as to actuarial calculations, the board allowed an emphatic announcement that the funds were fully funded; in other words the statement did not contain any qualification and was too unequivocal. The directors appealed to the Court of Appeal and the decision of the trial court was reversed.

At the Court of Appeal, ASIC did not succeed in attaching liability for breach of duty of care on the directors regarding the company's inaccurate announcement to the stock exchange. The trial court's decision was set aside as there was no evidence that the directors had approved the contents of the announcement. Nonetheless, while the appeal case was not decided in favour of ASIC, the court did not reject the argument that an aspect of the duty of care, skill and diligence is to ensure that the company complies with the continuous disclosure obligation and ensure that information submitted to the stock exchange is accurate and not false or misleading. ASIC then appealed to the High Court of Australia.

Held:

The High Court decision affirmed the decision of the trial court. The High Court found that the Court of Appeal was wrong to conclude that ASIC did not prove that the draft ASX announcement in question was tabled and approved at the board meeting. Thus, the High Court affirmed the view of the trial court that the failure of the directors to take reasonable steps to ensure that a company complies with its obligations that led to the company being exposed to and imposed with pecuniary penalty amounted to breach of duty of care.

Delegation and reliance

12.025 Under the common law and the CA 1965, directors are allowed to delegate the exercise of their powers. This rule recognizes that it may not be possible for a directors of a company with a large operation to personally manage the company's affairs and business. In *Vita Health Laboratories Pte Ltd & Ors v Pang Seng Meng* [2004] 4 SLR 162:

“It would be wholly impractical to expect directors to be omniscient or to personally discharge all corporate powers and functions. The larger the business, the greater the commercial need for delegation. The more specialised functions are, the greater the need for independent operations and powers. Legal pragmatism imbued with latitude towards business efficacy is crucial in assessing a director's delegation of duties. Admittedly, he must reasonably believe that his subordinates will competently discharge their duties in the company's interests. Other than that, it is fair to say that there is no acid test that will provide a definitive answer. It can however be safely assumed that the court will be reluctant to take to task a director who has bona fide delegated his functions and/or powers to competent subordinates.”

12.026 Section 132(1F) allows directors to delegate any of their powers “except as otherwise provided by the Act, the memorandum or articles of association”. This means that the CA 1965 may sometimes specify matters that may not be delegated and must be decided by the board. This also means that the memorandum and articles of association may limit the ability of directors to delegate all or certain of their powers. Directors' ability to delegate may also be restricted by the board itself or by the decision of the shareholders at general meeting as some companies might not want certain powers to be delegated. The person to whom power has been delegated must be “reliable and competent in relation to the power delegated”: s 132(1G)(b).

12.027 An important aspect of the duty of care is the *extent* to which directors may delegate certain functions to others and supervise the performance of the delegated powers. Section 132(1F) provides that unless the Act, the memorandum or articles of association or any resolution of the board directors or the resolution of the shareholders at general meeting states otherwise, directors may delegate any of their powers to:

- a committee of directors;
- an individual director;
- an officer;
- any employee;
- any expert; or
- any other person.

12.028 Where delegation of power has been made by the board, there is responsibility to supervise. The exercise of the power by the delegatee is as effective as if the director had exercised it. This means that directors can still be personally liable for the exercise of powers by the negligent delegate if there has been failure in supervision.

In *Re City Equitable Fire Insurance Co Ltd*, the rule was that a director is entitled to trust that other officials to whom power has been delegated will perform such duties honestly provided there are no grounds to suspect otherwise. This rule does not impose on the directors any duty to monitor and supervise. Later cases such as *Equitable Life Assurance Society v Bowley* and *Re Barings plc* [2004] 1 BCLC 180 have rejected the rule as laid down in *Re City Equitable Fire Insurance Co Ltd*.

12.029 In situations where the delegatee is negligent in exercising a power that the directors have delegated, s 132(1G) states that a director will not be responsible if:

- (a) the director believed on reasonable grounds at all times that the delegatee would exercise the power in conformity with the duties imposed on the directors of the company under the CA 1965 and the memorandum and articles of association of the company (if any); and
- (b) the director believed on reasonable grounds, in good faith and after making a proper inquiry if the circumstances indicated the need for the inquiry, that the delegatee was reliable and competent in relation to the power delegated.

To what extent is it reasonable for a director to rely on information provided by others?

12.030 In performing their roles and responsibilities, directors necessarily rely on the advice or information provided by other persons, i.e., an officer of the company or a professional engaged by the company for a specific purpose, for example, a lawyer or a financial adviser.

This information (which may be in the form of professional or expert advice, opinion, reports or statements including financial statements and other financial data) may be provided to the directors by any of the following persons stated under s132(1C):

- (a) any officer of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned;
- (b) any other person retained by the company as to matters involving skills or expertise in relation to matters that the directors believe on reasonable grounds to be within the person's professional or expert competence;
- (c) another director in relation to matters within the director's authority; or

- (d) any committee to the board of directors on which the director did not serve in relation to matters within the committee's authority.

12.031 While the common law traditional rule laid down in *Re City Equitable Fire Insurance* enables directors to rely on others, it did not emphasise the importance of supervision. The traditional rule allows a director to delegate his duties and in the absence of grounds of suspicion, the director is justified in trusting the official. However, this has been replaced by s 132(1D).

132(1D) The director's reliance made under subsection (1C) is deemed to be made on reasonable grounds if it was made—

- (a) in good faith; and
- (b) after making an independent assessment of the information or advice, opinions, reports or statements, including financial statements and other financial data, having regard to the director's knowledge of the company and the complexity of the structure and operation of the company.

To be able to rely on the protection provided by statute allowing reliance on others, the directors are required to consider the "qualification" of the person on whom reliance can be placed (i.e., those identified by the section) and then make an independent assessment of the information. The requirement of "good faith" and "independent assessment" requires directors to analyse the information in an unbiased manner. This does not mean that when directors are required to make an independent assessment of information provided to them that they would have to restart the whole process of gathering the information themselves or that they are required to obtain the advice of some independent professionals. It does require directors to evaluate the information without the directors *suspending* their own knowledge of the subject matter or *ignoring* any facts that may cause doubt as to the appropriateness of the reliance on that person or on the information provided.³¹ In *Biala Pty Ltd v Mallina Holdings Ltd* (1994) 15 ACSR 1, the directors' reliance was held to be unreasonable where the directors knew that the person on whom they relied on is an interested person in a transaction awaiting the board's decision.

Where the directors were informed by its auditor regarding some information in the financial statements which were not addressed by the directors, the directors cannot subsequently state that they had relied on auditors in the preparation of the accounts. In *Khiudin bin Mohd & Anor v Bursa Malaysia Securities Bhd and another application* [2012] 6 MLJ 131, the plaintiff challenged the disciplinary action taken by Bursa Malaysia against him and several other directors for causing the company to breach its listing obligation. This was related to the obligation to ensure that the company's comply with its periodic reporting obligation and to ensure the published information is accurate and not false or misleading. The company did not issue its fourth quarterly report on time which also led to the delay in the issuance of its audited annual accounts. Transmile was supposed to have released its fourth quarterly report for year ending 2006 which was due by end February 2007. The unaudited financial statements which were subsequently issued deviated from the audited

³¹ RP Austin and IM Ramsay, *Ford's Principles Of Corporations Law* (Australia: Lexis Nexis, 2007) 261. *Southern Resources Ltd v Residues Treatment & Trading Co* (1990) 3 ACSR 207 and *Duke Group Ltd v Pilmer* (1999) 73 SASR 64.

statements. The applicants argued that the financial matters of the company rested with the financial department and that they were entitled to rely on internal and external auditors who did not detect any defect. However, the court held that Bursa Malaysia had acted *bona fide* and within its powers. Regarding the argument that the directors could rely on internal and external auditors, the court stated that pure reliance was unreasonable. The directors knew about the audit concern which was highlighted by the external auditor. This was the reason for the delay in the issuance of the fourth quarter results 2006 and which caused the audited annual accounts ("AAA") for year 2006 could not be finalised within time as well as the deviation. A special interim audit report in May 2007 also stated that:

- (i) The Audit Committee and the CEO was fully informed of audit concerns.
- (ii) Overstatement of RM333 million in the Fourth Quarter Results 2006.
- (iii) Overstatement of consolidated revenue of financial year ended 31 December 2005 of RM197 million.

The directors therefore were fully aware of the audit concerns.

CASE EXAMPLE

Australian Securities and Investment Commission (ASIC) v Healey (No 2) [2011] FCA 1003

The non-executive chairman and five other non-executive directors of the Centro Group were presented with the company's 2007 annual report which they had approved. However, the company failed to disclose some short-term liabilities and misclassified current liabilities as non-current.

After the annual reports were submitted to the ASX, two of the companies in Centro group requested on 13 December 2007 for a suspension of trading of their shares until 17 December 2007. The share price for these two companies came down from US\$5.70 to \$1.36 and \$1.42 to \$0.85, respectively. The companies then made announcements on 17 December 2007 stating that the companies were renegotiating some of its debts, and that they had obtained extension until 15 February 2008 for facilities that were maturing before that date. Subsequently, the companies announced that:

- (a) they were undertaking a review of the classification of some of the liabilities/debts, which were stated in the annual report as non-current liabilities to current liabilities;
- (b) that the amount of current liabilities is actually higher than reported in the annual reports.

This resulted in a higher amount of current liabilities for these companies, approximately to \$2.5 billion from \$1 billion and from 0 to \$500 million, respectively.

This non-disclosure had a significant effect on the company's financial position. As this was a failure to comply with the continuous disclosure obligation and exposed company to liability, the directors were alleged to have failed to exercise due care and skill to ensure that the company's financial information was not misleading or inaccurate. ASIC argued that directors have a duty to read and understand the financial statements and to review them so as to enable the directors to determine that the information is consistent with the directors' knowledge of the company's affairs. The board had also failed to verify whether the chief financial officer (CFO) and the chief executive officer (CEO) had signed off on the accounts as required under the *Corporations Act*.