Singapore Court of Appeal Clarifies Test for Determining Company's Inability to Pay Debts and Right to Appeal Winding Up

In *Sun Electric Power Pte Ltd v RCMA Asia Pte Ltd (formerly known as Tong Teik Pte Ltd)* [2021] SGCA 60 ("***Sun Electric***"), the Singapore Court of Appeal held that:

(a) The cash flow test is the sole test under section 254(2)(c) of the Companies Act (re-enacted as section 125(2)(c) of the Insolvency, Restructuring and Dissolution Act ("**IRDA**")); and

(b) A company has the right to appeal a winding up order regardless of whether a stay order is granted, and its directors can control the conduct of the appeal.

The Court of Appeal also stated, in *obiter*, that a company which partially pays off a statutory demand within three weeks, causing the remaining amount payable to fall below the prescribed threshold (which was $10,000 under the Companies Act and now $15,000 under the IRDA), will not be deemed to be unable to pay its debts under section 254(2)(a) of the Companies Act (re-enacted as section 125(2)(a) of the IRDA).

Our Comments

The decision has important ramifications for winding up applications based on section 125(2)(c) of the IRDA (which gives the Court a ground for winding up a company if *"it is proved to the satisfaction of the Court that the company is unable to pay its debts"*).

Prior to *Sun Electric,* two tests were relevant to this provision, with neither test being conclusive: (1) the cash flow test; and (2) the balance sheet test (*Kon Yin Tong and another v Leow Boon Cher and others [2011] SGHC 228, at* [30]-[44]). *Sun Electric* has departed from this position by rejecting the balance sheet test in favour of the cash flow test.

The decision is also significant for winding up applications based on section 125(2)(a) of the IRDA (the statutory demand procedure). It is now more difficult to wind up a company through a statutory demand, as partial payment within the prescribed three-week period will be sufficient to fend off a winding up application, so long as the remaining amount payable is less than the prescribed threshold of $15,000.

Lastly, the decision serves as a warning to directors against bringing unmeritorious appeals to winding up orders, as they may have to personally pay the costs incurred in bringing the appeal and may be personally responsible for party and party costs awarded in favour of the respondent.

This update takes a look at the Court of Appeal's decision.

Background

The appellant (Sun Electric Power Pte Ltd) had applied to place itself into interim judicial management and judicial management. The respondent (RCMA Asia Pte Ltd) objected to these applications. The applications were dismissed and the court ordered a total of $11,500 in costs to be paid to the respondent.

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The respondent's solicitors sent a statutory demand to the appellant's registered office, requiring the appellant to make payment of $11,568.88, being the amount of the costs awarded and accrued interest.

On the 22nd day after the statutory demand was served, the appellant paid $3,000 into the respondent's solicitors' client account, reducing the balance to $8,568.88.

The respondent filed an application for the appellant to be wound up ("**Winding Up Application**").

The Winding Up Application was filed under the Companies Act (as the IRDA had not been enacted at that time). The provisions on winding up under the Companies Act are materially similar to those under the IRDA.

At first instance, the High Court ordered the appellant to be wound up. It found that both section 254(2)(a) and section 254(2)(c) of the Companies Act were fulfilled.

The appellant appealed under the directions of the sole director of the appellant ("**Director**").

The Court of Appeal's Decision

The Court of Appeal dismissed the appeal and ordered the Director to pay $50,000 to the respondent, inclusive of disbursements, as costs of the appeal. The following are the key points decided by the Court of Appeal.

Company has right to appeal even if stay order is refused

The respondent argued that the Director and the appellant's solicitors did not have authority to act for the appellant because there was no stay of the winding up order and upon a company's liquidation, its directors are *functus officio.*

The Court of Appeal rejected this contention. It was clear from the legislative framework that a company has the right to appeal a winding up order even without leave of Court of Appeal. Preventing the company from appealing by refusing to grant a stay would circumvent this framework.

The Court of Appeal found that it was a necessary corollary of the company's right to appeal that its directors be allowed to control the conduct of the appeal. It would be illogical to entrust the conduct of the appeal to the liquidator because the very object of the appeal was to revoke the winding up order.

However, it was impermissible for directors to whittle down the company's funds to pursue an unmeritorious appeal. To address this concern, the Court of Appeal set out two general rules:

(a) First, the directors controlling the conduct of the appeal should expect to pay any costs incurred by the company in prosecuting the appeal out of their own pockets, instead of using the funds of the company.

(b) Second, the directors controlling the conduct of the appeal should expect to be personally responsible under Order 59 r 2(2) of the Rules of Court for the payment of any party and party costs awarded in favour of the respondent if the appeal fails.

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Cash flow test is the sole applicable test under section 254(2)(c) of the Companies Act

Section 254(2)(c) of the Companies Act provides that a company shall be deemed to be unable to pay its debts if:

> *"(c) it is proved to the satisfaction of the Court of Appeal that the company is unable to pay its debts; and in determining whether a company is unable to pay its debts the Court of Appeal shall take into account the contingent and prospective liabilities of the company."*

The Court of Appeal held that the cash flow test is the sole applicable test under this provision. The Court of Appeal gave three reasons for this.

First, the plain words of the provision imply only a single test, namely, whether *"it is proved to the satisfaction of the Court of Appeal that the company is unable to pay its debts".* In contrast, where Parliament intended to have separate insolvency tests, it has explicitly stated so (e.g., section 100(4) of the Bankruptcy Act).

Second, this interpretation is supported by case law from the United Kingdom ("**UK**"). As of 1985, the UK equivalent of section 254(2)(c) was section 518(e) of the UK Companies Act 1985 (c 6). The cases applying section 518(e) did not distinguish between the cash flow and balance sheet tests and only applied a single test.

Third, the balance sheet test compares a company's total assets with its total liabilities, but this ratio has no direct correlation with whether a company *"***is** *unable to pay its debts".* A company may have total liabilities that exceed its total assets by ten times, but these liabilities may only materialise in a hundred years, which means that the company will be able to pay its debts for the next hundred years. Conversely, a company may have total assets which are ten times the total liabilities, but these assets may all be illiquid and only realisable in a hundred years, whereas the liabilities may all be current.

As to what the cash flow test entails, the Court of Appeal stated that the test assesses whether the company's current assets exceed its current liabilities, such that it is able to meet all debts as and when they fall due. "Current assets" and "current liabilities" refer to assets which will be realisable and debts which will fall due within a 12-month timeframe.

It is necessary to have a flexible timeframe in mind when assessing the current assets and liabilities of a company because a consideration of only present debts and assets could potentially lead to absurd outcomes. A company may have a debt of $10,000 today, but may be due to receive an incoming payment of $1 million tomorrow. It would be unfair and illogical to wind up the company on the basis that it could not pay its debts today when it would be more than able to do so tomorrow. Conversely, a company may have $10,000 in hand and no debts due today, but if the company would be due to pay a prospective debt of $10 million tomorrow, one can hardly say that it is cash flow solvent.

The Court of Appeal also set out a non-exhaustive list of factors which should be considered under the cash flow test:

(a) The quantum of all debts which are due or will be due in the reasonably near future;

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(b) Whether payment is being demanded or is likely to be demanded for those debts;

(c) Whether the company has failed to pay any of its debts, the quantum of such debt, and for how long the company has failed to pay it;

(d) The length of time which has passed since the commencement of the winding up proceedings;

(e) The value of the company's current assets and assets which will be realisable in the reasonably near future;

(f) The state of the company's business, in order to determine its expected net cash flow from the business by deducting from projected future sales the cash expenses which would be necessary to generate those sales;

(g) Any other income or payment which the company may receive in the reasonably near future; and

(h) Arrangements between the company and prospective lenders, such as its bankers and shareholders, in order to determine whether any shortfall in liquid and realisable assets and cash flow could be made up by borrowings which would be repayable at a time later than the debts.

Applying the cash flow test and considering the evidence, the Court of Appeal found that there was no reason to disturb the Judge's findings that the appellant was insolvent.

Partial payment of debt demanded in statutory demand

In light of the above, it was not necessary to discuss whether the alternative ground for winding up under section 254(2)(a) of the Companies Act was made out. Nevertheless, the Court of Appeal proceeded to make some observations on section 254(2)(a). Section 254(2)(a) of the Companies Act deems a company to be unable to pay its debts if:

> *"(a) a creditor by assignment or otherwise to whom the company is indebted in a sum exceeding $10,000 then due has served on the company by leaving at the registered office a demand under his hand or under the hand of his agent thereunto lawfully authorised requiring the company to pay the sum so due, and the company has for 3 weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor"*

The Court of Appeal decided that a company which makes partial payment of the debt demanded in a statutory demand within the prescribed three-week period, such that the remaining amount payable falls below $10,000, should not be deemed to be unable to pay its debts.

The Court of Appeal stated that an alternative interpretation would lead to two absurd results.

First, if a creditor serves a statutory demand on a company for $9,999, the company will not be deemed to be unable to pay its debts even if the company neglects to pay a single cent. In contrast, if a creditor serves a statutory demand for $10,000 and the company pays $9,999.99, the company would still be deemed to be unable to pay its debts, even though it only owes one cent.

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The second "absurdity" is as follows. Company A owes $9,999 and has no current assets, while company B owes $10,000 and has current assets of $1. No statutory demand can be issued against company A. On the other hand, a statutory demand can be issued against company B, and thereafter, it will only be able to pay $1 and reduce its debt to $9,999. The position of company A thus becomes exactly the same as company B, but company B would be deemed to be unable to pay its debts whereas company A would not.

Further, the legislative history of the provision supported this interpretation. Over the years, Parliament has increased the threshold figure stipulated in section 254(2)(a). According to the Court of Appeal, the logical inference was that Parliament did not want companies to be deemed to be unable to pay their debts if the outstanding debt was too low in the light of current economic conditions and inflationary trends.

If you would like information or assistance on the above or any other area of law, you may wish to contact the Partner at WongPartnership whom you normally work with or the following Partners:

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