



Managing Internal and External Insolvency: A Checklist For In-House Counsel

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INTRODUCTION

In this update, we highlight several key points that in-house counsel should take note of and steps they can take when dealing with internal and external insolvency. Internal insolvency refers to a situation where the employer company (“**Company**”) becomes insolvent, whereas external insolvency refers to a situation where the Company is a creditor and its debtor becomes insolvent. In both situations, timely and appropriate action by in-house counsel is crucial in placing the Company in an advantageous position.

This update is divided into three parts. First, we highlight steps in-house counsel should take when the Company is being wound up. Second, we suggest various practical steps that can be taken when the Company is faced with internal or external insolvency. Lastly, we indicate various strategies in-house counsel can use to prevent hidden insolvency risks in the Company’s transactions.

1. WHAT ARE THE STEPS THAT IN-HOUSE COUNSEL SHOULD TAKE WHEN THE COMPANY IS PREPARING TO BE WOUND UP?

Step 1: Determine whether the Company is solvent

- (a) The most expedient route for liquidation is a voluntary (i.e., out-of-court) winding up. The management and finance team should be approached to prepare an updated set of accounts so that an informed view can be taken on whether the Company is solvent – this will determine whether the voluntary winding up proceeds as a members’ voluntary winding up (“**MVWU**”) or creditors’ voluntary winding up (“**CVWU**”).
- (b) In an MVWU, the members of the Company steer the winding up process, whereas in a CVWU, it is the creditors who do so. Here, “solvency” refers to the ability of the Company to pay its debts in full within 12 months of the commencement of the winding up (section 163(1)(b) of the Insolvency, Restructuring and Dissolution Act 2018 (“**IRDA**”).

Step 2: Brief the directors about their role in winding up

- (a) Directors play an important role in placing the Company in winding up. For example, directors need to lodge a statutory declaration as to the solvency status of the Company and prepare a statement of affairs detailing the assets and liabilities of the Company (see section 141 IRDA for court-ordered winding up; section 163(2) IRDA for MVWU and CVWU; and section 166(4) IRDA for CVWU). Further, in a CVWU, one director needs to

attend the meeting of creditors to disclose the Company's affairs and the circumstances leading up to the proposed winding up (section 166(5) IRDA).

- (b) In-house counsel should brief the directors about these roles, so that the directors are able to properly discharge their functions.

✔ Step 3: Find a suitable liquidator

- (a) In both an MVWU and CVWU, the Company has to nominate a liquidator (sections 164(1) and 167(1) IRDA). When searching for a suitable candidate, in-house counsel should consider, among other things: (i) whether the assets of the Company are sufficient to justify the fees charged by the liquidator; and (ii) whether the winding up requires a liquidator with experience in a particular industry or asset class.

✔ Step 4: Put a stop to undervalue transactions and unfair preferences

- (a) If an asset is transacted at an undervalue (section 224 IRDA) or transferred preferentially to a creditor (section 225 IRDA), it can be clawed back by the liquidator. In-house counsel should advise the Company's management against engaging in such transactions if the Company is preparing to be wound up.
- (b) In particular, the management and board may need guidance on what should be identified as critical payments (i.e., payments necessary to preserve the day-to-day business) so the Company is less likely to end up making preferential payments where vendors and suppliers insist on their outstanding dues being paid before continuing to provide goods and services. In insolvency or pending insolvency, cash management should be handled differently and in-house counsel should engage with the operations and financial teams to understand the immediate cash needs of the business. This is elaborated upon below.

✔ Step 5: Advise directors and officers about common law and statutory duties

- (a) At common law, when a company is insolvent or approaching insolvency, directors have a duty to have regard to creditors' interests. Further, under section 239 IRDA, persons (such as the directors and officers of an insolvent company) who cause the company to incur debts which it has no reasonable prospect of paying in full, and know or ought to have known that this would be the case, may be held personally liable for the debts and may be guilty of an offence.
- (b) Thus, if the Company is soon to be wound up, in-house counsel should warn the directors and officers that they may be held personally liable if they cause the Company to incur further debts or continue to transact business without due regard to creditors' interests.

✔ Step 6: Limit damage to wider corporate group

- (a) If the insolvent company is part of a larger corporate group, active steps to limit the damage to other group entities should be taken where possible so that those related entities can continue operating with minimal disruption. Where related entities have key

trading partners, the management or representatives of those entities should be advised to arrange meetings or calls just before or immediately after the winding up commences so as to assure those counterparties that it is business as usual and how/why the related entities can continue operating unaffected.

- (b) In terms of liabilities, in-house counsel should ascertain whether other group entities have claims against the insolvent Company, and make sure to assert these claims in the winding up. Where applicable, such claims may be set off against the claims of the insolvent Company, rendering the other group entity a *de facto* secured creditor to the extent of the set-off.
- (c) In terms of assets, the ownership of assets in a corporate group can sometimes be unclear. In-house counsel should prevent the liquidator from collecting assets which are properly owned by other group entities.

2. WHAT ARE THE PRACTICAL STEPS THAT IN-HOUSE COUNSEL CAN TAKE FOR INTERNAL AND EXTERNAL INSOLVENCY?

2.1 Internal insolvency

- (a) **Create breathing space for the Company to assess whether restructuring or winding up is the best course of action**
 - (i) When a Company approaches insolvency, in-house counsel should consider steps to relieve pressure on the Company's finances. Possible methods of achieving breathing space include applying for a moratorium against proceedings under a scheme of arrangement or judicial management process,¹ or a voluntary judicial management process with the approval of the Company's creditors.²
 - (ii) The Company can also take measures outside of formal restructuring procedures. For example, it can establish a standstill agreement with its creditors to set out conditions, milestones, timelines and processes for working towards a consensual workout.³

¹ For more information on schemes of arrangement and judicial management, please refer to pages 3 to 5 of our previous update *Non-performing Corporate Loan Toolkit for Banks* (April 2022) ([Special Update: Non-Performing Corporate Loan Toolkit for Banks](#)).

² For more information on placing a company in judicial management with the approval of the company's creditors, please refer to our previous update *Insolvency, Restructuring and Dissolution Act – Key Changes from the Financiers' Perspective* (February 2021), in particular, the discussion on judicial management by a resolution of creditors at page 3 ([LegisWatch: Insolvency Restructuring and Dissolution Act - Key Changes from the Financiers Perspective](#)).

³ For more information about consensual workouts, please refer to our previous update *Non-performing Corporate Loan Toolkit for Banks* (April 2022), in particular, the discussion on consensual workouts at pages 2 to 3 ([Special Update: Non-Performing Corporate Loan Toolkit for Banks](#)).

- (b) **Ascertain the size of the cash gap and how much “runway” the Company has to take more invasive/permanent action or measures (such as a restructuring, asset disposals to raise money, winding up, etc.)**
- (i) Insolvency rarely occurs due to a sudden trigger and is often a result of a combination of factors such as market conditions, unanticipated events (such as the insolvency of a key supplier or a change in regulations), inadequate planning and fiscal management, etc. When such “distress” factors arise, in-house counsel should direct the management’s attention to two key questions: (1) what the cash gap is (or is going to be); and (2) how long the Company can carry on, taking into account existing cash/easily realisable assets and ordinary course of business expenses (the largest of which tends to be salaries and rent).
 - (ii) It is helpful to also prepare a list of key vendors whose continued support is required for the Company to be able to ride out its insolvency. These parties would often need to be paid in full to continue providing essential goods and services to the Company as it seeks to manage and overcome its insolvency.
 - (iii) By identifying the “runway” (how many months before the Company is unable to continue operating due to lack of funds) and the quantum of the “hole”, targeted efforts can be undertaken to bridge the liquidity crisis before it arises and balloons. If a missed payment triggers default interest and cross-defaults, it may deepen the Company’s insolvency at a time when cash is critical. Identifying in advance how much cash is needed, and when, can greatly aid in staving off the liquidity crisis and buy more time for finding a solution to the Company’s distress factors.
- (c) **Review loan documents, lease agreements, employment contracts and other key contracts to ascertain rights of counterparties**
- (i) Timing matters. The commencement of winding up proceedings constitutes an event of default for many contracts, and the Company being wound up may be liable for penalties and damages. If there are ongoing projects and pending contracts, an assessment should be undertaken to determine the stage at which these matters are and whether it would put the Company in a better position if certain milestones (particularly for infrastructure projects) which are on the verge of being reached are achieved before commencing winding up proceedings. This may help minimise the damages that the Company can be liable for due to the early termination of the contract/project.
 - (ii) As a general rule, the review of key contracts (including employment contracts of key individuals) should be undertaken to better prepare for an orderly insolvency process with as little “fallout” as possible.
 - (iii) In reviewing contracts, the first question which in-house counsel should ask is whether an event of default has occurred, arising from the Company’s insolvency or another reason.

(iv) If an event of default has occurred, the next question would be: what remedies are available to the counterparty? In-house counsel should pay particular attention to whether the counterparty is entitled to terminate the contract and, if the counterparty holds security, whether it is entitled to enforce its security.

(d) **Identify and communicate with key creditors**

(i) Cooperation of key creditors is essential to any restructuring effort, and such cooperation can be achieved only by communicating with these creditors. Special emphasis should be placed on secured creditors (particularly bank lenders), who usually have greater influence over the Company's operational challenges. Also important are the Company's landlords and creditors who supply goods or services essential to the Company's business. In-house counsel should keep these creditors informed about the progress of the restructuring, and assure them that their rights are not being prejudiced.

(ii) Although external counsel may eventually take over communications with creditors, in-house counsel can play a crucial "first responder role" by starting a dialogue before the engagement of external counsel. Even after the engagement of external counsel, in-house counsel will likely have a better understanding of the Company's key creditors than external counsel, and can provide valuable advice to external counsel in this regard.

(e) **Prepare a public relations narrative**

(i) The publicity and communications angle is often overlooked. However, preparing a template for management and staff to use internally and externally will go a long way in managing the reaction of external parties and staff to news of the Company's insolvency. Companies that do not carry out engagements and go silent after news breaks of their insolvency trigger knee-jerk reactions from stakeholders and counterparties who would then assume the worst and take harsher measures than necessary to protect themselves.

(ii) A common gripe among stakeholders is lack of transparency and communication when a company is in distress. Facilitating regular and effective dialogue minimises the number of hostile parties in the insolvency and support can then be more easily obtained for any restructuring plan that is later proposed. Plans proposed after a long silence following an insolvency announcement are often viewed with deep suspicion and obtain little traction.

(iii) By preparing a template of what to say, the Company projects a clear and coherent narrative that in turn allays concerns and curtails speculation by key creditors and stakeholders.

(f) **Obtain expert advice**

- (i) Weathering an internal insolvency can be a stressful and challenging period for the Company and its employees as it is often the first experience many employees have in dealing with an insolvency-related situation. Engaging insolvency specialists can therefore help in best positioning the Company to weather the Company's insolvency, and avoid any unexpected pitfalls.

2.2 **External Insolvency**

(a) **Constantly observe the financial health of debtors and key trading parties and take pre-emptive measures to protect the Company**

- (i) In-house counsel should take note of whether debtors are showing signs of distress such as defaulting on their loans or increased laying off of staff. If so, it would be prudent to press for urgent repayment to recoup as much as possible before the debtor goes into liquidation. If the Company has leverage over the debtor (for example, due to an ongoing trading relationship), that should be utilised to procure recovery of outstanding debts.
- (ii) Where there is indication of key trading partners exhibiting poor financial health, in-house counsel should warn management to slow down further business dealings or procure more conservative terms such as upfront payments, shorter credit terms or cash on delivery.

(b) **Consider applying to wind up debtors**

- (i) Winding up an insolvent debtor will allow the Company to obtain partial payment of its debt. After a debtor is placed into liquidation, the liquidator will sell the debtor's assets and distribute the proceeds to the creditors.
- (ii) Generally, the easiest way for a creditor to wind up a debtor is to serve a statutory demand for a sum exceeding S\$15,000. If the debtor neglects to pay the debt within three weeks of the service of the demand, it will be deemed to be unable to pay its debts (section 125(2)(a) IRDA), which is a ground for winding up a company (section 125(1)(e) IRDA). This resolves many of the evidential difficulties of proving that the debtor is insolvent.
- (iii) Thereafter, the Company can file an application to wind up the debtor. There are a variety of procedural requirements which need to be fulfilled when applying to wind up a debtor, so added care should be taken and engaging external counsel should be considered.
- (iv) For example, the Company will have to obtain the written consent of a licensed insolvency practitioner to act as liquidator. In-house counsel should note that prospective liquidators often require petitioning creditors to provide an indemnity to cover the prospective liquidator's costs, should the assets of the debtor be insufficient

to cover such costs. If no such indemnity is provided, the liquidator may refuse the appointment.

(v) For more information on liquidation, please refer to our previous update on non-performing loans.⁴

(c) **Consider whether the Company should invoke its legal rights or renegotiate with the debtor**

(i) If allowed under a loan or security agreement (where applicable), the Company may consider realising its security over the debtor's asset or exercising rights to accelerate the repayment of the loan upon an event of default.

(ii) Where the security is realised and the Company is considering a sale of the asset, it may be necessary to seek external legal advice as to the steps that should be taken. In particular, the debtor is entitled to any excess monies from the sale and monies may have to be distributed to other parties who also have security over the particular asset.

(iii) However, such actions inevitably strain the commercial relationship between the Company and the debtor. Where the debtor is only facing short-term liquidity issues and its business is generally profitable, a renegotiated payment schedule may be in the interest of both parties.

3. WHAT ARE THE KEY STRATEGIES IN-HOUSE COUNSEL CAN USE TO PREVENT HIDDEN INSOLVENCY RISKS IN THE COMPANY'S TRANSACTIONS?

3.1 Obtain adequate and appropriate security

(a) First, where possible, the Company should obtain adequate security for its transaction. For instance, in a transaction involving the sale of goods, a well-drafted retention of title clause can allow the seller to retain title to the goods sold until the debt has been fully repaid. Taking security through an assignment, mortgage or charge over the debtor's existing assets should also be considered where necessary to protect the Company's position in the event the counterparty fails to repay its debts. Some thought should be given to understand the nature of the asset and the ease and costs of enforcing the security if the need arises.

3.2 Obtain guarantees / third party security

(a) Apart from obtaining security over the debtor's assets, the Company can consider obtaining guarantees from the debtor company's directors/shareholders and security over assets of other companies in the debtor's corporate group.

⁴ *Non-performing Corporate Loan Toolkit for Banks* (April 2022) ([Special Update: Non-Performing Corporate Loan Toolkit for Banks](#)), see in particular pages 5 to 6.

- (b) This depends on the strength of the Company's bargaining power in the relationship and should be balanced with the importance of preserving the commercial relationship and goodwill with the debtor company.

3.3 Clearly define events of default and incorporate information rights

- (a) The transaction and any security agreements should clearly stipulate the events of default and the rights and powers the Company can exercise in the event of the debtor company's default. This would allow the Company to act swiftly to protect its position should the need arise.
- (b) Access to information when the debtor has defaulted is useful in enabling the Company to make an informed decision whether to forbear suing or aggressively pursuing legal action. In-house counsel would need such information to make an informed decision as to whether incurring costs to pursue legal action is optimal or simply throwing good money after bad.

3.4 Due Diligence

- (a) Before the Company enters into a major transaction, in-house counsel should conduct due diligence on the counterparty for insolvency-related issues. For example, in-house counsel should:
 - (i) Conduct cause book searches to ensure that there are no winding up or judicial management applications against the counterparty as well as no ongoing litigation against the counterparty, its directors and key shareholders; and
 - (ii) Conduct a search with the Accounting and Corporate Regulatory Authority to see what charges the counterparty's assets are subject to.

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 Partner:



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