Unpacking Directors' Duties to Creditors: A Close Look at the *OP3 International* Decision

The Court of Appeal has, in *Foo Kian Beng v OP3 International Pte Ltd (in liquidation)* [2024] SGCA 10 (***OP3 International***), comprehensively considered the contours of a director's duty to consider the interests of creditors in certain circumstances (**Creditor Duty**). In this important decision, the apex court examined when the Creditor Duty first becomes engaged as well as the nature, scope and content of the duty. It also set out the approach that the court should take when faced with a claim that a director has breached the Creditor Duty.

Our Comments

The significance of this decision lies in the clarifications that the Court of Appeal made to the scope and content of what is termed as the "Creditor Duty". To be clear, there is no direct duty owed by directors to creditors; instead, directors have the obligation to consider the interests of creditors when the company is near insolvent.

The important clarification, in this instance, is the inflexion point at which directors become obliged to consider the interests of creditors. Prior to this case, guidance could be drawn from the UK Supreme Court case of *BTI 2014 LLC v Sequana SA and Ors* [2022] UKSC 25 (***Sequana***), where it was, among other things, held that: (a) "*where the company is insolvent, or bordering on insolvency, but is not faced with an inevitable insolvent liquidation or administration, the directors should consider the interests of creditors, balancing them against the interests of shareholders where they may conflict*"; and (b) "*where an insolvent liquidation or administration is inevitable, the creditors' interests become paramount as the shareholders cease to retain any valuable interest in the company*".

In *OP3 International*, the Court of Appeal broadly endorsed this holding by the UK Supreme Court, and went further in explaining the parameters for determining when the company is bordering on insolvency but not faced with an inevitable insolvency process. This state of affairs, described as "Category 2" in the judgment (and summarised below), is by its nature a fact-specific inquiry. The clarifications provided by the Court of Appeal are useful in helping directors to drill down to the factors that matter in assessing the company's financial state.

Finally, while the focus of the decision is on assessing the content of a director's duty when the company is near-insolvent, the Court of Appeal has once again affirmed the long-standing notion that the court will be slow to second-guess the honest, good faith commercial decisions made by a director to afford the company the best possible chances of revitalising its fortunes. This is important insofar as it affirms that the courts will be slow to second-guess good faith attempts at restructuring the company, even if they turn out to be unsuccessful. This means that directors would be allowed some leeway in steering the company through a restructuring, and the courts would minimise any hindsight bias in scrutinising their decisions at a later stage, provided that the commercial decisions were taken in good faith.

Background

The appellant, Mr Foo Kian Beng (**Mr Foo**), was the sole director and shareholder of the respondent, OP3 International Pte Ltd (**OP3**), a company engaged in the provision of, among other things, construction services.

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In July 2013, Smile Inc Dental Surgeons Pte Ltd (**Smile Inc**) engaged OP3 to provide fitting out works at one of its clinics. After the works were completed, mould appeared on the clinic walls and the clinic flooded twice in 2014.

In May 2015, Smile Inc commenced legal proceedings against OP3, alleging, among other things, that OP3's failure to exercise a reasonable standard of care, skill, and diligence in designing and executing the fitting out works had caused it to suffer damages in the sum of $1,807,626 (**Suit 498**).

While Suit 498 was ongoing, Mr Foo caused OP3 to pay him in December 2015, July 2016 and December 2016 dividends totalling $2.8 million (**Disputed Dividends**) and to repay him in December 2015 and in 2017 loans totalling $820,746 which he had earlier extended to OP3 (**Disputed Payments**).

The decision on liability in Suit 498 was handed down in October 2017, and the decision on damages in November 2019. OP3 was found liable to Smile Inc for the sum of $534,189.19. When OP3 failed to satisfy the judgment debt, it was ordered on 3 April 2020 to be wound up.

In February 2021, OP3's liquidator commenced an action in OP3's name against Mr Foo to recover the Disputed Dividends and Disputed Payments, claiming that, in authorising such payments to himself, Mr Foo had breached his director's fiduciary duty to act in the best interests of OP3 under the common law and/or his duty to act honestly under section 157(1) of the Companies Act (**Companies Act**), when the company was financially parlous.

The High Court's Decision

The General Division of the High Court (**High Court**) found in favour of OP3, noting that the Creditor Duty is first engaged when a company is "*financially parlous*" and that this is a state of affairs less severe than being "*on the verge of insolvency*".

The High Court also found that OP3's potential liability in Suit 498 was reasonably likely to materialise when Smile Inc served the statement of claim on OP3 on 25 May 2015, and that the value to be ascribed to Suit 498 as a contingent liability ranged between $441,000 and $514,500. While accounting for this quantum of contingent liability would not have caused OP3 to be insolvent or in a financially parlous state as at 31 December 2015 or in July 2016, it did render OP3 balance sheet insolvent as at 31 December 2016 and 31 December 2017, such that Mr Foo was obliged to consider the interests of creditors in making decisions for OP3 at those times.

Mr Foo appealed against the High Court's finding that he had breached the Creditor Duty by authorising the payment of the Disputed Dividends and Disputed Payments.

The Court of Appeal's Decision

The Court of Appeal dismissed Mr Foo's appeal.

In doing so, the Court of Appeal restated the nature, scope and content of the Creditor Duty.

Nature of Creditor Duty

The Court of Appeal first examined the principles relating to the nature of the Creditor Duty, as follows:

(a) **Fiduciary duty owed to the company**: The Creditor Duty is a fiduciary duty owed by directors to the *company*, and not directly to creditors. Creditors therefore cannot sue directors for breach

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of the duty. The proper plaintiff in any such action is presumptively the company, with any financial award resulting from a successful action inuring for the company's benefit, though it may in practical terms later be distributable among the company's creditors.

The Court of Appeal also, in *obiter* comments, expressed its provisional views that, while it is a "*practical reality*" that a company does not commonly bring a claim for breach of the Creditor Duty against a director when it has yet to enter into liquidation proceedings, it doubted that *only* a company in liquidation may bring a claim against a director for breach of the duty.[1] It further noted Lady Arden's observation in *Sequana* that the Creditor Duty is enforceable at all times prior to liquidation of the company and by shareholders if necessary, by way of a derivative action, with such shareholder action being said to provide a clear line of corporate responsibility and accountability during what may be a critical period for the company. However, as the question whether liquidation operates as a condition precedent to the commencement of an action for breach of the Creditor Duty did not arise on the facts of this case, the Court of Appeal left open for consideration on a future occasion the issue as to precisely when a claim for breach of the duty may be brought.

(b) **Shareholders' and creditors' interests broadly aligned when company is financially healthy**: While the predicate duty is a duty to act in the company's best interests (this enjoins directors to have regard to the interests of different stakeholders, including creditors) at all times, when the company is financially healthy, directors would be justified in treating shareholders' interests as a proxy for the company's interests and in attributing less or even no discrete weight to creditors' interests. That said, a director is not permitted to act in complete disregard of creditors' interests; acting in a way that is directly adverse to those interests will evidence failure to act in the company's best interests, e.g., where the director acts with the intent of defrauding creditors.

(c) **Creditors' interests assume greater prominence during financial distress**: As a company approaches insolvency, there is a shift in who may be said to be the company's main economic stakeholder. Creditors will displace shareholders as the primary bearers of the risk of loss arising from how directors exercise powers when the company is insolvent, since an insolvent company effectively trades and conducts its business with money from its creditors, even as they generally have no control over the conduct of the company's business. The law responds to this misalignment of incentives between those running the company and those bearing the consequences of actions undertaken by a financially distressed company by enjoining directors of such firms to take corporate decisions with the interests of creditors in mind. This is to constrain directors from transferring the risks of continued trading to creditors as shareholders usually have nothing to lose and everything to gain, and creditors, on the other hand, have everything to lose and nothing to gain by the continued trading of a company on the cusp of insolvency.

(d) **Creditors to be treated as a single class**: Creditors should be viewed as a single class for the purpose of the Creditor Duty, even though their respective positions may differ. This is because their identities constantly change as long as debts continue to be incurred and discharged by the company. Treating the interests of the creditors as a class would be consistent with the underlying aim of the Creditor Duty in that the duty seeks to redress the fact that the risks of

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[1] As indicated by the High Court in *Voltas Limited v Ng Theng Swee and another* [2023] SGHC 245.

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continued trading by the company has shifted from one stakeholder (the shareholders) to another (the creditors). Where the company has entered into judicial management or winding up, creditors who may have been unfairly prejudiced *vis à-vis* other creditors by actions undertaken by directors potentially have a remedy under the statutory unfair preference regime under section 225 of the Insolvency, Restructuring and Dissolution Act 2018.

(e) **Director's actions to be assessed objectively**: In an action for breach of the Creditor Duty, the relevant question is whether the director had exercised his discretion in good faith in what he considered (and not what the court considers) to be in the company's best interests, as understood with reference to the company's financial state at the material time. While the duty is subjective in that sense, the court will assess the director's claim objectively by asking whether the view the director claims to have formed was credible or reasonably open to him, given the information available at the time. In so doing, the court may infer that a director was not acting honestly if the transaction was objectively not in the company's interests. That said, the court will be slow to interfere with commercial decisions made honestly but which, in hindsight, turned out to be incorrect. As directors do not operate with the benefit of hindsight, clarity and practicality must be prioritised and the law must be developed with this in mind.

(f) **Director not absolved from breaches of other duties**: As an action for breach of the Creditor Duty focuses on the director's subjective intentions in committing a company to a course of action, it is theoretically possible, though perhaps uncommon, for him to have honestly believed that he had acted in the company's best interests and complied with the Creditor Duty even though his actions might have fallen below the objective standard of care and diligence expected of a director. In these circumstances, it remains open to a company to allege that the director had acted in breach of the duty of care and diligence owed to the company.

Scope and content of Creditor Duty

The Court of Appeal then articulated the framework within which to approach a claim that a director has acted in breach of the Creditor Duty:

(a) **First, the court should objectively ascertain the company's financial state at the time the impugned transaction was entered into. Alternatively, the financial state likely to arise as a result of entering into the transaction should be ascertained.** Affirming its holding in *Dynasty Line Ltd (in liquidation) v Sukamto Sia* [2014] 3 SLR 277[2] that the court is not concerned with whether the company was technically insolvent or whether it would have been appropriate to liquidate the company, the Court of Appeal highlighted that a "*strict and technical application*" of the "going concern" test and the "balance sheet" tests should be avoided (although they may provide useful indicia of the company's financial health). These tests must be applied with the degree of flexibility appropriate to the rationale and context of the Creditor Duty, recognising that creditors may not always insist on prompt payment. The court should engage in a "*broader assessment of the surrounding circumstances*", including the company's claims, debts, liabilities and obligations.

[2] Our Joy Tan was part of the team which represented the second respondent in Civil Appeal No 105 of 2013.

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The court should objectively determine which of the following three financial stages the company was in when the transaction was entered into or which was likely to result from the company entering into the transaction:

(i) Category one: Where all things, including the contemplated transaction, having been considered, the company is solvent and able to discharge its debts.

(ii) Category two: Where a company is imminently likely to be unable to discharge its debts. This encompasses cases where a director ought reasonably to apprehend that the contemplated transaction will render it imminently likely that the company will not be able to discharge its debts. It is no excuse for a director to claim that he did not appreciate how dire the company's financial state was if he ought reasonably to have done so. The court should assume the vantage point of that director and consider which factors he ought reasonably to have then taken into account in assessing whether the contemplated transaction would result in imminent corporate insolvency.

A non-exhaustive list of relevant factors includes: (A) the company's recent financial performance, in particular whether its financial performance has been improving or deteriorating as well as the duration and extent of any such improvement or deterioration; (B) the industry that the company operates in, including its recent and future prospects; and (C) other external developments, e.g., geopolitical ones, which may impact the company's business. These factors may affect a company's financial performance and are also capable of being known to directors when they make decisions. There is therefore little risk of holding directors to unrealistic standards.

(iii) Category three: Where corporate insolvency proceedings are inevitable. The Court of Appeal took the view that a clear shift in the economic interests in the company (from the shareholders to the creditors as the main economic stakeholders of the company) would occur where insolvent liquidation or administration (or judicial management under Singapore law) is inevitable.

(b) **Second, the court should examine the director's subjective intentions and determine whether he acted in what he considered to be the company's best interests.** The company's financial state would provide a useful analytical yardstick against which the subjective *bona fides* of the director may be tested. The analysis to be undertaken at this stage with reference to the three financial states the company may be found to have been in at the time a disputed transaction was entered into (see (a) above) is as follows:

(i) Category one: Where a company is financially solvent and able to discharge its debts, a director typically does not need to do anything more than act in the best interests of the shareholders to comply with his fiduciary duty to act in the company's best interests. The Creditor Duty does not arise as a discrete consideration in these circumstances. The underlying fiduciary duty is owed to the company and acts that a director undertakes to defraud creditors will suffice to ground a breach of his duty to act in the best interests of the company even at this juncture.

(ii) Category two: In this intermediate zone, the court will scrutinise the director's subjective *bona fides* with reference to the potential benefits and risks of the transaction to the company. It will be slow to second-guess the director's honest, good faith commercial

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decisions to afford the company the best possible chances of revitalising its fortunes. If a director considers in good faith that he can and should act to promote the company's continued viability and that there is a way out of its financial difficulties which will benefit shareholders and creditors, he is not obliged to treat creditors' interests as the exclusive or primary factor in determining what the company should do next.

Conversely, transactions undertaken at this time which appear to exclusively benefit shareholders or directors will attract heightened scrutiny. Declaration and payment of dividends or the repayment of shareholders' loans during this period would weigh heavily against a director as shareholders are, in the usual course, the exclusive beneficiaries of such transactions. The more the transaction exclusively benefits shareholders or directors (and not the company as an entity), the more closely a court will scrutinise the director's decision to determine whether he had breached the Creditor Duty.

(iii) Category three: Where corporate insolvency proceedings are inevitable, there is a clear shift in the economic interests in the company (from the shareholders to the creditors as the main economic stakeholders of the company) since its assets at this stage would be insufficient to satisfy creditors' claims. In the context of liquidation, shareholders as residual claimants will stand to recover little or nothing. The Creditor Duty therefore operates here to prohibit directors from authorising corporate transactions (e.g., payment of dividends) that have the exclusive effect of benefiting shareholders or themselves at the expense of the company's creditors.

(c) **Third, if the court finds that a director had acted in breach of the Creditor Duty, it should consider whether it is appropriate to relieve him of liability under section 391 of the Companies Act**. Section 391 allows the court to relieve an officer of the company from liability for negligence, default, breach of duty or breach of trust. The court may exercise its discretion to do so on the cumulative account of the director having acted honestly and reasonably, and insofar as it is fair for the court to excuse him for his default. The burden lies on the director to prove these matters. Section 391 is potentially relevant where directors may, in good faith, have misjudged the company's financial state and failed to adequately consider the creditors' interests in undertaking certain acts on the company's behalf – although, in the Court of Appeal's view, such cases are likely to be few and far between.

Application of framework to the facts

On the basis of the approach set out above, the Court of Appeal found that OP3's financial statements reflected that it was in poor financial health at the end of 2016 and 2017 and agreed with the High Court's finding that OP3's contingent liability in Suit 498 was reasonably likely to materialise and should have been taken into account in assessing OP3's solvency when the Disputed Dividends and Disputed Payments were paid to Mr Foo. OP3 was then not only burdened with this contingent liability but also mired in a rapidly deteriorating operating environment.

It also found that Mr Foo had failed to consider the interests of OP3's creditors and breached the Creditor Duty. The timing and quantum of the withdrawals pointed to Mr Foo extracting as much as he could from OP3 in the face of its declining business and impending corporate liability.

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Finally, the Court of Appeal declined to relieve Mr Foo of liability under section 391 of the Companies Act, finding that Mr Foo had not acted honestly (i.e., "*without deceit or conscious impropriety*"), having enriched himself at the expense of OP3's creditors at a time when OP3's business was on a steep decline and with the knowledge that that there was some merit to Suit 498. This demonstrated that he had not acted reasonably and that it would not be fair to excuse him from liability.

The Court of Appeal therefore upheld the High Court's finding that the Creditor Duty was engaged when Mr Foo authorised the Disputed Dividends and Disputed Payments dismissed the appeal with costs.

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