A QUICK REFERENCE GUIDE FOR COMPANIES IN FINANCIAL DISTRESS

Posted on October 31, 2019

Category: CNPupdates

General disclaimer
This article is provided to you for general information and should not be relied upon as legal advice. The editor and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents.

Date Published: 31 October 2019

Authors and Contributors: Subramanian Pillai, and Daphne Tan.

Introduction

The Ministry of Trade and Industry's consecutive cuts to its forecast of Singapore's GDP growth and the Monetary Authority of Singapore's most recent quarterly brief signal that Singapore may be approaching a period of economic downturn. Statistics from the Ministry of Law indicate this to be so, as applications for corporate insolvencies have steadily increased since 2011. At the industry level, worse-than-expected performance in trade and manufacturing has been identified as the primary cause for the Ministry of Trade and Industry's cuts. The likelihood of recovery in these sectors in the near term has also, unfortunately, been expressed to be muted at best, with negative spillover effects anticipated to affect the trade-related services that have hitherto remained resilient in the face of the slowing global economy, such as transportation and storage.

Though optimism has been expressed as to the performance of other sectors such as ICT and business services, the subdued prospects of the key industries identified above and strong headwinds that Singapore is expected to face for the remainder of the year make it likely that more and more companies will come to experience financial distress in the near term. Consequently, for many companies in the affected sectors, the threat of insolvency may loom large on the horizon. However, insolvency need not be a *fait accompli*, and this CNPUpdate provides a brief overview of the options that are available to companies in financial distress under Singapore law, with a particular focus on how companies can attempt to recover, rescue or restructure their business and emerge therefrom.

What does financial distress look like?

A company is said to be in financial distress if, for example, and amongst other things, it is unable to generate sales and revenue, struggles to obtain credit, has payables that consistently exceed its receivables, and/or is unable to obtain or purchase stock or supplies from its usual suppliers. Companies in this situation will soon find themselves cash-flow insolvent if they are unable to raise funds and/or pay their obligations as and when they eventually fall due and/or if they are unable to negotiate the delayed payment of their obligations.

What happens when a company is in financial distress?

In the event a company's debt to anyone creditor exceeds S$10,000 and the company is unable to pay or compound this debt to the satisfaction of the creditor within three (3) weeks from the creditor's service of a statutory demand, the creditor is free to apply to the High Court of Singapore for the company to be compulsorily liquidated. Once the High Court has ordered that a company be compulsorily liquidated, a

General disclaimer
This article is provided to you for general information and should not be relied upon as legal advice. The editor and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents.

liquidator (a public accountant who is not the auditor of the company, and who typically specializes in liquidation) will take over the management of the company and will:

- attempt to recover and realise the company’s assets in a way that is most advantageous to the company;
- investigate the affairs of the company and the conduct of its directors and officers;
- review and adjudicate the claims of the company’s creditors; and
- distribute the company’s assets in accordance with the law.

In other words, the company’s business will be shut down, the company’s assets sold and the proceeds of sale distributed to its creditors on a *pari* passu basis in accordance with the priority accorded to them by law, and the company dissolved.

How can a company recover from financial distress and avoid compulsory liquidation?

A company in financial distress can enter into a scheme of arrangement with its creditors. It can also, in the course of entering into a scheme of arrangement, apply for super-priority for rescue financing in the event it is unable to obtain financing on a non-priority basis. A company in financial distress can also enter into judicial management (similar to administration in the United Kingdom) and the company can, whilst under judicial management, enter into a scheme of arrangement and in the course of entering into a scheme of arrangement, apply for super-priority for rescue financing.

These options are available to companies incorporated in Singapore and foreign companies which are not registered in Singapore but which have a substantial connection with Singapore, provided that the company is not already the subject matter of liquidation proceedings. Each of these options involves an application to the High Court of Singapore and avails the company of a moratorium (a temporary prohibition) during which legal proceedings (including arbitration) cannot be brought or continued against the company. This moratorium prevents the company from being prematurely forced into insolvency and allows the company to focus its efforts and resources on recovery.
We provide a brief outline of these options below.

Schemes of arrangement

What is a scheme of arrangement?
A scheme of arrangement is an agreement between a company, its shareholders, and creditors in relation to the company’s debt and the restructuring and/or compromise thereof. Generally speaking, in a scheme of arrangement, the creditors of the company agree to compromise their claims against the company in exchange for the company’s commitment to repay the creditors in accordance with the terms of the scheme, as the creditors’ collective compromise would result in a more favourable rate of recovery.

General disclaimer
This article is provided to you for general information and should not be relied upon as legal advice. The editor and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents.

Why would the company's creditors agree to enter into a scheme?
Simply put, the creditors, in a scheme, will each be repaid a lower amount than is owed to them. However, in entering into a scheme, it is more likely that the creditors will, as a collective body, be repaid some of the monies due to them. If the creditors reject the scheme and choose to bring their individual claims against the company and force the company into liquidation, the creditors must note that the company's assets will be distributed in accordance with the ranking of claims prescribed by the law. Apart from secured interests such as fixed charges and retentions of title, and claims by beneficiaries of a trust under which the company is trustee, the ranking of claims against a company can be summarized as, in descending order:

- First, the costs and expenses of liquidation;
- Second, the preferential debts prescribed under the Companies Act (which are, generally speaking, the company's debt obligations to its employees), which will be accorded greater priority in the event the company's assets are insufficient to meet its debt obligations to its general creditors to the extent of preceding the interests of holders of debentures under any floating charge;
- Third, debts secured by floating charges;
- Fourth, work injury compensation and tax liabilities;
- Fifth, unsecured creditors; and
- Sixth, the shareholders of the company.

It is apparent that unsecured creditors do not rank highly, and the unfortunate reality is frequently that the company may not have enough assets remaining after paying its employees to satisfy the amounts that remain owing to its unsecured creditors. If the creditors of the company enter into a scheme, however, the company is effectively allowed to continue to survive and do business and attempt a recovery, making it more likely for the company's unsecured creditors to recover something from the company.

How can the company enter into a scheme of arrangement with its creditors?
A scheme of arrangement can be pre-agreed between the company and its creditors (in which case the scheme is considered to have been "pre-packed"). Alternatively, schemes can be agreed after the majority of appropriately-classified creditors representing at least 75% of the creditors of the company in value have agreed to the scheme in a formal meeting of the creditors summoned pursuant to a court order, in accordance with the Companies Act. Regardless of whether the scheme is pre-packed or otherwise, the sanction of the High Court must be obtained and, once obtained, will bind all of the company's creditors, including those who object to the scheme.

If the company has yet to propose a scheme but intends to propose one, the company can apply for a moratorium under section 211B of the Companies Act. Upon the filing of an application under section 211B, an automatic interim 30-day moratorium applies. Whilst the company need not have proposed a scheme if applying for a moratorium under section 211B, the company must have prepared a draft proposal that is sufficiently detailed so as to enable the High Court to consider its feasibility. If on the other hand, the company has already proposed a scheme, the company, its shareholders, or creditors may apply for a moratorium under section 210(10) of the Companies Act.

General disclaimer
This article is provided to you for general information and should not be relied upon as legal advice. The editor and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents.

What are some of the factors that the company and/or its shareholders/directors should consider in relation to the terms of the scheme?

Companies typically grant various forms of security to their creditors and/or counterparties to secure their obligations to them. Typical examples of such security include fixed and floating charges, pledges over assets, and mortgages over property, and in some cases the directors and shareholders of the company (including corporate shareholders) may also have executed personal (or corporate) guarantees to secure the company's obligations. The mere fact that a scheme of arrangement has been sanctioned does not mean that providers of security (namely, the company and, where applicable, its directors and/or shareholders (including corporate ones)) have been discharged from their obligations to the creditors to whom they have provided security. The scheme must expressly provide for the discharge for that to be the case. Providers of security should remember to negotiate for a term providing for the discharge to be included in any scheme of arrangement. Providers of security should also note that they are entitled to apply for leave to propose a scheme. There is nothing in the Companies Act which prohibits such providers from doing so. Note, however, that providers of security must satisfy the court that there is a nexus or connection between the obligation from which they are seeking release and the company's debt.

Super-priority for rescue financing

What is super-priority and how does a company applying for super-priority help the company obtains rescue financing?

A company in financial distress may, in the course of applying for the court's sanction of a scheme of arrangement, apply for super-priority for rescue financing. Companies regularly obtain external financing in the normal course of business. However, a company that is in financial distress may have substantial difficulty raising external financing as lenders may be unwilling to lend monies to a company that is in financial distress for various reasons. First, such a company is less likely to be able to repay the debt with interest in full and poses a higher credit risk, with the consequence that financiers are naturally less willing to provide financing without enhanced security. Second, the transactions entered into by a company approaching insolvency, including security interests, may be avoided in the event the company enters into insolvency, rendering the enhanced security susceptible to avoidance in the event the company's attempt at recovery fails.

Beleaguered companies may, therefore, wish to consider applying for the court's approval to grant rescue financiers super priority in the ranking of claims against the company. Indeed, rescuers may require super-priority as a condition to finance the company. Super-priority can be granted such that the company's debt to the rescue financier will rank *pari passu* with the level of priority sought and can be granted such that the company's liabilities to the rescue financier ranks as favourably as *pari passu* with the cost and expenses of liquidation (i.e., the highest rank) in the appropriate case. In practice, however, this makes it more likely that the assets of the company will be depleted prior to distribution to the next class of claims in the debt waterfall in the event the company's attempted recovery fails.

General disclaimer
This article is provided to you for general information and should not be relied upon as legal advice. The editor and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents.

How can the company obtain this super-priority?
An application for super-priority for rescue financing can be made in the course of the company's application to the court for its sanction of a scheme of arrangement. In addition to establishing that the company has made reasonable efforts to obtain rescue financing on a non-priority basis, an application for super-priority must set out the level of priority sought and the rationale therefor.

Judicial management

What is judicial management?
Judicial management is a form of "professional-in-possession" or "PIP" (as opposed to "debtor-in-possession" or "DIP") restructuring where a judicial manager (a public accountant who is not the auditor of the company) takes over the affairs of the company and attempts to rehabilitate the company for the duration of the judicial management order. The judicial manager can, once appointed, carry on the business of the company, avoid or affirm certain transactions entered into by the company within the applicable period of time prescribed by the law, borrow money and grant security over the company's property, pay the company's debts, and/or enter into a scheme of arrangement on the company's behalf. The directors of the company cannot act for and on behalf of the company for the duration of the judicial management order, and in contrast to a scheme of arrangement under which control of the company remains with its directors and officers, the "possession" of the company is no longer said to lie with the debtor, i.e. the company, per se.

***How can the company enter into judicial management*?**
A court order is presently required in order to place the company into judicial management. The application is to be made to the High Court, and the creditors, directors, and shareholders of a company may apply. Once the Insolvency, Restructuring and Dissolution Act has come into force, the creditors of the company can resolve to place the company under judicial management instead.

A judicial management order can be extended. However, judicial management is a temporary measure only, and an order for judicial management will not be extended indefinitely. Note, also that:

- a judicial management order will only be granted if the company's business appears to still be viable and if it can be shown that there is a reasonable prospect that the company can be rehabilitated; and
- any creditor that has appointed or is entitled to appoint a receiver and manager over the whole or substantially the whole of the company's assets may block the application, unless it can be established that the public interest requires the making of the order for the judicial management.

A temporary statutory moratorium applies once an application for judicial management has been filed, and a more extensive moratorium will come into effect if the application is granted.

General disclaimer
This article is provided to you for general information and should not be relied upon as legal advice. The editor and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents.

My company or debtor is in financial distress, but I am confident that it can recover given the chance. Which of these options should I prefer?

The principal difference between a scheme of arrangement and entering into judicial management is management control over the company. When a company enters into judicial management, a third party – the judicial manager – enters into the company and exercises management control over the company. If you are confident in the company's ability to recover under the management and direction of its existing directors and officers (who typically possess more domain and expert knowledge of the company's business and operations, and are therefore in usual circumstances immediately apprised of the company's capabilities and strengths), a scheme of arrangement may be more suitable.

On the other hand, if you feel that the company has a better chance at recovery under the care of a public accountant due to their accounting expertise or if you simply prefer the company to be run by an independent professional for corporate governance purposes or in order to protect management from incurring personal liability for trading while the company is insolvent, a judicial management order may be more appropriate.

What are the company's options if it cannot recover?

If rescue and/or restructuring have failed, the company is vulnerable to be compulsorily liquidated. Directors of companies that have been compulsorily liquidated may, in certain circumstances, be deemed unfit and be disqualified from acting as a director and from acting or taking part in the management of a company for up to 5 years. The compulsory liquidation of a company is therefore not inconsequential and is something that should be avoided if possible.

Conclusion

Although financial stress and the risk of insolvency continually heighten as the economy approaches a downturn, insolvency needs not be a *fait accompli*. Singapore's restructuring laws provide financially distressed companies with a number of options with which recovery and rehabilitation can be attempted. If you wish to obtain further information on this update or wish to discuss how you may recover, rescue or restructure your business, please feel free to contact us.

General disclaimer

This article is provided to you for general information and should not be relied upon as legal advice. The editor and the contributing authors do not guarantee the accuracy of the contents and expressly disclaim any and all liability to any person in respect of the consequences of anything done or permitted to be done or omitted to be done wholly or partly in reliance upon the whole or any part of the contents.