The Test for Insolvency – When is a company unable to pay its debts?

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The solvency of a company is relevant in a myriad of circumstances in the Companies Act and directors are often called upon to make solvency statements. Creditors are also often required to establish that a company is unable to pay its debts if a winding up order against the debtor company is sought.

This update follows from the recent Singapore Court of Appeal decision in *Sun Electric Power Pte Ltd v RMCA Asia Pte Ltd* [2021] SGCA 60 which clarified what is the sole applicable test for insolvency where the words "unable to pay its debts" are used in the Companies Act.

Facts

The respondent was a creditor of the appellant and sent a statutory demand to the appellant in 2019. The appellant only repaid part of its debt after the expiry of the prescribed period. The respondent brought an action in 2019 seeking an order that the appellant be wound up under the Companies Act on the grounds that the appellant was unable to pay its debts.

The respondent argued inter alia that the appellant was unable to pay its debts because it was cash flow insolvent and balance sheet insolvent. The trial judge accepted both grounds.

On appeal, the appellant submitted that the trial judge had erred in accepting both the cash flow and the balance sheet tests for insolvency. According to the appellant, the cash flow test should be the dominant test, and based on this test the appellant should not be deemed as unable to pay its debts.

The Court of Appeal accepted that the cash flow test was the sole applicable test for insolvency in determining whether a company may be wound up by the Court under the Companies Act. However, the appellant failed to establish that it was not insolvent under the cash flow test. On this ground, the Court affirmed the trial judge's decision to wind up the appellant.

What does it mean when a company is "unable to pay its debts"?

The Court of Appeal made clear its rejection of the balance sheet test on the basis that a comparison of a company's total assets with its total liabilities has no direct correlation with whether a company is unable to pay its debts. This overturned a line of cases going back to *Re Great Eastern Hotel (Pte) Ltd* [1988] 2 SLR(R) 276, which had taken the view that both the balance sheet and cash flow tests were applicable to determine whether the Court may order the winding up of a company under the Companies Act.

The Court of Appeal made the following clarifications on how the cash flow test should be applied:

a. The cash flow 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.
b. Current assets and current liabilities refer to assets which will be realisable and debts which will fall due within a 12-month timeframe.
c. The Court should take a flexible rather than technical approach when taking into account debt and income which would be due in the reasonably near future. For example, the Court should not expect a company to liquidate its assets immediately. The Court should also consider debts which may not have been demanded and which may not be due.

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 due in the reasonably near future;
b. whether payment is being demanded or 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;
g. any other income which the company may receive in the reasonably near future; and
h. arrangements between the company and prospective lenders to make up any shortfall by borrowings which would be repayable at a time later than the debts.

Significance

Where a company proposes to undertake certain corporate actions governed by the Companies Act, such corporate actions may only be undertaken if the company is solvent or if its directors make solvency statements to confirm that the company is able to pay its debts. These include:

a. a proposed redemption of preference shares out of the capital of the company;
b. a proposed giving of financial assistance for the acquisition of the company's own shares or the shares of its holding company;
c. a payment made by the company in consideration of any share buyback;
d. a proposed reduction of the company's share capital which involves a distribution of cash or assets or a release of any liability owed to the company; or
e. an amalgamation proposal.

Notwithstanding that the Court of Appeal's clarification of when a company is unable to pay its debts was with respect to the now repealed section 254(2)(c) of the Companies Act, it still has broad implications as the words "unable to pay its debts" are used ubiquitously in the Companies Act. Making a solvency statement without having reasonable grounds for the statement is an offence under the Companies Act, for which directors may be liable for a fine of up to $100,000 or imprisonment for up to 3 years or both. Henceforth, that a company's assets exceed it liabilities will no longer be a sufficient basis for a director to make a solvency declaration.

If you have any queries on how these developments may affect your business or would like to obtain advice, please do not hesitate to get in touch with us.

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