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Malaysia High Court Decides Against Discounting of Related Creditors' Debts in Schemes of Arrangement

The Malaysian High Court in ***Re Top Builders Capital Bhd & Ors v Seng Long Construction & Engineering Sdn Bhd & Ors*** **[2022] MLJU 1** has set out several important points for the sanction of a scheme of arrangement. Some of these issues have been decided for the first time under Malaysian law.

Summary of Decision and Significance

The Court allowed sanction of a scheme of arrangement and this decision clarifies several important principles for scheme of arrangement law in Malaysia.

1. Confirmation that the classification of creditors in a scheme is based on the similarity of legal rights. The classification of creditors has to be decided at the first stage when the Court grants leave for the scheme meeting. At the sanction stage, the Court will be slow to depart from its initial decision. Creditors voluntarily waiving their entitlement under the scheme does not require for them to be classified differently.

2. The threshold test and the different factors in assessing adequate disclosure in the Explanatory Statement for a scheme.

3. The Court upheld the validity of the virtual meeting proceedings – especially taking into account the unprecedented Covid-19 environment. Some of the scheme creditors raised objections that they could only type out questions and receive verbal answers, a lack of 'breakout rooms', and the creditors not being able to ask questions through video or audio. These objections did not invalidate the virtual meeting.

4. The scheme chairman could extend the deadlines for the submission of proof of debt forms for the scheme. The scheme chairman did not require a Court order to do so.

5. Scheme creditors do not have an automatic right to inspect the proof of debt forms of other scheme creditors. There must be some *prima facie* evidence of impropriety to allow that inspection.

6. On whether to discount or disregard certain scheme creditors' votes, especially where they are intercompany or related party creditors, there is no exact mathematical formula or absolute rule. Ultimately, the Court has discretion, and the Court listed out several discretionary factors depending on the facts of the case.

This decision is to be welcomed in clarifying the contentious issues often raised in schemes of arrangement in Malaysia. On the issue of discounting or disregarding related party creditors' votes in a scheme, the Malaysia law approach gives a nuanced and flexible approach by applying discretionary factors. These factors help to balance the interests of opposing creditors and that of the debtor in applying for a successful restructuring and rescue.

Background Facts

Top Builders Capital Berhad (**Top Builders**) and two other companies in the Top Builders Group of companies (**Applicants**) applied for a scheme of arrangement and obtained a restraining order.

Top Builders is a listed company on the Main Market of Bursa Malaysia. The 2nd Applicant company is the 100% subsidiary of Top Builders. In turn, the 3rd Applicant company is the 100% subsidiary of the 2nd Applicant. The Applicants are in the building and construction industry.

Stage 1: Permission to Hold the Scheme Meetings

On 31 December 2020, the Applicants obtained the court order for permission to hold the scheme meetings of its creditors and had obtained a restraining order. All three schemes of the three Applicants had a single class of unsecured creditors. The unsecured creditors were made up of external unsecured creditors (e.g. sub-contractors and other creditors) and also intercompany and other related-party creditors to the Top Builders Group.

Proof of Debt Exercise – Extended Deadlines

After obtaining leave or permission to hold the scheme meetings, the Applicants carried out a proof of debt exercise. The scheme chairman set a first deadline for the

submission of the proof of debt. Then, the scheme chairman extended that deadline and advertised this second deadline for proof of debt.

Under the scheme procedure in the Explanatory Statement, the proof of debt forms would first be adjudicated by the scheme chairman, being the creditor-nominated director appointed under the restraining order. Ong Chee Kwan JC had earlier set out the principles and procedure for this scheme proof of debt exercise in *Re Top Builders Capital Bhd & Ors* [2021] 10 MLJ 327.

Under the scheme procedure, if the creditor or the Applicant raised a dispute on the quantum of the proof of debt, either party could appeal to an Independent Assessor, being the accounting firm of Rodgers Reidy & Co. If there was still a dispute after the Independent Assessor's decision, the aggrieved party could file any necessary application to appeal to the court.

Stage 2: Holding the Scheme Meetings

The Applicants sent out the notice for the scheme meeting along with the Explanatory Statement.

The court order to hold the scheme meetings allowed for the meetings to be held through a virtual platform.

A few days before the scheme meeting, one of the scheme creditors wrote to the Applicants to ask for a copy of the proof of debt forms and the supporting documents of some of the creditors said to be related to the Applicants.

The Applicants replied to explain that those proof of debt forms were properly adjudicated and with the necessary ledgers to support the claim. The Applicants would not provide a copy of the proof of debt forms to this requesting creditor.

On the day of the scheme meeting, one of the scheme creditors, Edwincom, was unable to log in to the virtual meeting platform. Edwincom held 0.05% of the adjudicated scheme debts of the 2nd Applicant.

The virtual meetings of the Applicants proceeded. The virtual meeting platform allowed for a video broadcast of the scheme chairman and the advisors. The scheme creditors would have had to register for an account and log in to the platform. The platform

allowed the scheme creditors to type out their questions. In response, the scheme chairman and the advisers would read out the typed questions and verbally answer those questions. The voting would be through the software available on the virtual meeting platform.

The three scheme meetings passed the required 75% in value present and voting at the scheme meetings:

1. 1st Applicant: **75.09%**
2. 2nd Applicant: **80.90%**
3. 3rd Applicant: **100%**

Late Submission of Proof of Debt Forms

In the midst of completing the adjudication of the proof of debt forms and holding the scheme meetings, several scheme creditors submitted their proof of debt forms late. One tranche of scheme creditors had submitted their forms past the proof of debt deadline but before the holding of the scheme meetings. These creditors either had their proof of debt forms adjudicated and were allowed to vote on the adjudicated sum or where their sums were admitted on a provisional basis for their voting pending the full adjudication.

Another tranche of scheme creditors had submitted their forms after the scheme meetings were held. The Applicants were prepared to adjudicate these forms and to leave the decision to the sanction court on whether to admit the debts or not.

If the proof of debt forms were not admitted into the scheme, under the terms of the scheme, those debts would be treated as extinguished and those creditors would not be entitled to distribution under the scheme.

Stage 3: Court Sanction – the Disputed Issues

With the approvals from the scheme meetings, the Applicants returned to the scheme Court to apply for court sanction of the schemes.

At the sanction stage, there were 6 opposing scheme creditors. They raised, among others, these key issues in opposition to the scheme:

1. Wrong classification of creditors: As the scheme provided that certain intercompany related party creditors would relinquish their right to receive a distribution under the scheme, these related creditors have different legal rights from the other unsecured creditors.
2. Inadequate disclosure in the Explanatory Statement.
3. Objections against the virtual scheme meeting.
4. Scheme Chairman wrongly extended the proof of debt deadlines.
5. Failure to allow inspection of proof of debt forms.
6. Whether to discount the votes or value of the related party creditors' debts.

Decision on these Key Issues

#1: Classification of Creditors – Legal Rights and Slow to Depart from Earlier Assessment

At the earlier leave to convene the scheme meetings stage, all the unsecured creditors were classified in one single class. While the Court's determination at this leave stage is not final, the Court ought to be slow to depart from its earlier determination unless there are material changes in circumstances or fresh consideration placed before the court (see the English High Court decisions in *Re Apcoa Parking* [2014] EWHC 3849 (Ch) and *Re Lehman Brothers* [2018] EWHC 1980 (Ch)).

Here, the classification of the creditors was correctly based on the similarity of legal rights. The appropriate comparator would be a liquidation scenario of the Applicants. In a liquidation, the rights of the related party creditors and the other unsecured creditors are similar. These creditors would only be paid *pari passu* from the surplus funds of the wound-up company.

The first objection: One of the scheme creditors, Seng Long, argued that the related intercompany creditors had voluntarily agreed to waive the payment of their entitlements under the scheme. These related creditors had done so in order to ensure the continuity of the Top Builders Group. Therefore, these related intercompany creditors were no longer interested in the recovery of their debts but were motivated by different interests.

The Court disagreed with this argument. The Court held that thinking logically, if the related intercompany creditors had not agreed to voluntarily waive their scheme entitlement, there would be no objections to being placed in the same class. The

related intercompany creditors' waiver of their entitlements only serves to benefit the creditors as a whole and yet, Seng Long's argument would result in these related creditors being treated separately from the other unsecured creditors.

The second objection: One of the scheme creditors, Star Effort, argued that under the scheme, some of the scheme creditors were being made to release their corporate guarantee claim against Top Builders.

The Court held that it is settled that a scheme of arrangement between a scheme company and its creditors may discharge not only the debts and liabilities of the scheme company but also the debts and liabilities of the guarantors for the same debts and liabilities (see the Malaysia High Court decision in *Sentoria Bina Sdn Bhd v Impak Kejora Sdn Bhd & Ors* [2021] 12 MLJ 690).

#2: Threshold for Disclosure in the Scheme Document

The scheme creditors, Star Effort, raised several arguments on inadequate disclosure in the Explanatory Statement for the scheme.

The Court set out the general principles that while the contents of the Explanatory Statement should generally be clear, complete and not misleading, the Court has recognised that perfection is hardly attainable. As a matter of commercial reality, what is crucial is that the terms of the Explanatory Statement are sufficient to enable the creditors to exercise a commercial judgment on a fully and properly informed basis.

Some additional findings:

1. The scheme creditor challenged that certain creditors were excluded from the scheme. In effect, these excluded creditors would then not be subject to any compromise under the scheme. The Court held that a scheme company is free to select the group of creditors it wishes to enter into a scheme of arrangement with. There is such freedom of choice (see the Malaysian Federal Court decision in *Francis a/l Augustine Pereira v Dataran Mantin Sdn Bhd & Ors and another appeal* [2014] 6 MLJ 56 , the English High Court decision in *Re Bluebrook Ltd and other companies* [2009] EWHC 2114 and the English Court of Appeal decision in *Sea Assets Ltd v Perseroan etc Garuda Indonesia* [2001] EWCA Civ 1869.)

2. There was a complaint that a list of material litigation was not included in the Explanatory Statement – the Court held that it is not a legal requirement to include such a list. It does not assist in explaining the details and effect of the scheme of arrangement.

3. There was a challenge that the Explanatory Statement did not contain figures based on audited financial information. The Court adopted the English High Court case of *Re Sunbird Business Services Ltd* [2020] EWHC 3459 that there is no absolute requirement that the financial information provided to the scheme creditors must be audited. Each case will turn on its own facts, as long as the scheme creditors are drawn to the limitations in the financial information.

#3: The Virtual Scheme Meeting – Taking into Account Covid-19 Circumstances

The Court commented on certain features of the virtual meeting in this case. The questions were typed up and when answers were given, there was a lack of a facility for an immediate follow up to the answers. This was because the proceedings were not conducted via the normal video platforms like a virtual meeting via the Zoom platform, for example.

In addition, there was no facility for participants to engage with one another during the meeting by way of 'breakout rooms'. The scheme creditors argued that this '*defect*' had resulted in the participants not being able to come together to discuss among themselves before casting their votes. This defeated the very notion of a '*meeting*'.

However, the Court was mindful that the available platforms for conducting a virtual meeting of the kind that is envisaged for the scheme meetings may be limited as such meetings are of recent origin. Unlike the Zoom platform, there is a need for a '*bespoke*' platform that can permit registration and verification of the attendees, and the casting and computation of the votes.

In the end, the Court was satisfied that the creditors were already fully aware of the details and effect of the schemes and the consequences if the schemes were approved. The disadvantages raised regarding the conduct of the meeting were not such that would compel the court to withhold the sanction of the schemes.

#4: Extension of Proof of Debt Submission Deadlines

The scheme creditor, Seng Long, raised the objection that the Scheme Chairman had unilaterally extended the proof of debt submission deadline and to admit late proof of debt forms.

The Court did not adopt the Singapore Court of Appeal approach of *The Royal Bank of Scotland NV others v TT International Ltd and another appeal* [2012] SGCA 9 **("*TT International*")** that decided that a scheme chairman would have to first obtain court permission to extend the time for submission of proof of debt forms. The Singapore Court of Appeal did not cite any legal authority in support. In this case, the Court took note of the time-sensitive nature of scheme proceedings and to hold scheme meetings. It would not be practical to delay the scheme meetings while waiting for a prior court order to allow for extended deadlines.

The Court does have the discretion to extend the admission of the proof of debt forms during the sanction hearing. It was held in this case, the Scheme Chairman had acted in good faith by trying to ensure the scheme creditors with legitimate claims would not be substantially prejudiced by submitting their proof of debt forms late.

#5: Threshold for Inspection of Proof of Debt Forms

Some of the scheme creditors raised the issue of the failure to allow inspection of the proof of debt forms of the other scheme creditors, in particular, the related party scheme creditors.

The Court adopted the Singapore Court of Appeal decisions in *TT International* and *Wah Yuen Electrical Engineering Pte Ltd v Singapore Cables Manufacturers Pte Ltd* [2003] SGCA 23 where scheme creditors must produce *prima facie* evidence of impropriety in the admission or rejection of the proof of debt forms by the scheme chairman. Only then could they inspect the proof of debt forms of other creditors. The creditors were at liberty to apply to the Court for a disclosure order, but they did not do so.

#6: Discretionary Factors on Whether to Discount the Votes or Not

The final key issue for determination was whether the class of creditors was fairly represented. This relates to the issue of whether the votes of certain related-party creditors or wholly-owned subsidiary creditors should be partially or wholly discounted. The opposing scheme creditors argued that if a full discount were to be applied to those related entities, then the statutory majority of 75% in value at the meeting would not have been achieved.

This was an important point and the first detailed analysis in Malaysia on the issue of discounting of connected votes in a scheme of arrangement.

First, the Court held that the discounting of the votes of wholly-owned subsidiary creditors is not a universal approach by all courts. There is no absolute rule, nor any exact mathematical formula, for the votes of intercompany creditors and/or related party creditors to be discounted or disregarded.

Second, the issue of whether to discount or to disregard the votes is a matter of discretion for the Court based on the particular facts of the case.

The exercise of discretion can be based on the following factors:

1. Whether the benefits that the creditors would likely derive from the scheme are clearly better than the alternative liquidation scenarios.

2. Whether there is any clear and obvious likelihood of the creditors achieving a better scheme.

3. Whether the exercise of the votes by the intercompany creditors or related party creditors was driven by any special or ulterior interest that was ‘adverse’ to the interests of the creditors.

4. Whether the opposing creditors pressing for such a discount have any self-interest and/or ulterior motive.

5. Whether the adjudicated debts of the intercompany creditors and/or related party creditors are genuine or questionable.

6. Whether the percentage of independent creditors who had voted in the scheme is such that it reflects a desire on the part of an overwhelming majority in value and in number of the scheme creditors wanting the scheme.

Third, the fact that the intercompany creditors or the related-party creditors may have separate or 'special interests' to see the continuity of the Top Builders Group as a going concern. But this alone, without more, cannot be a reason to disregard their votes.

Fourth, there is no evidence that the '*special interests'* of the intercompany or related-party creditors are adverse to the interests of the other scheme creditors. The Court also took on board the fact that a high majority in value and number of the independent creditors had voted in favour of the scheme.

Finally, the Court declined to follow the Singapore Court of Appeal approach in *TT International* in discounting or disregarding the votes of the intercompany creditors or related-party creditors. The Court held that the focus ought to be in the manner in which the related party creditor had exercised its vote rather than its percentage of shareholdings in the applicant company.

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