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Restructuring and Insolvency

## Recent Malaysian Court Decision Sheds Light on Proof of Debt Exercise in Scheme of Arrangement and the Test for Granting Leave to Proceed against Restraining Order

In the recent decision of the Malaysian High Court in *Re Top Builders Capital Bhd & Ors* [2021] 10 MLJ 327 ("**Top Builders**"), Ong Chee Kwan JC examines the proof of debt exercise in a scheme of arrangement ("**SOA**") and the guiding principles governing the granting of leave to proceed with legal proceedings against a financially distressed company that has obtained a restraining order (moratorium) pursuant to a SOA.

This Update provides a summary of the decision and highlights the procedure and approach for the assessment of the proofs of debt for voting in a scheme and sets out the test and considerations when granting leave to a creditor to proceed with its legal proceedings against a company with a restraining order.

### Introduction

The case of *Top Builders* is the first Malaysian decision to explain the rationale as well as set out procedures to be followed for the proof of debt in a SOA. It is also the first Malaysian decision to set out the principles for granting leave for a creditor to proceed with its legal proceedings against a company despite the existence of a restraining order.

Creditors will find this decision of assistance in navigating these potentially contentious issues in its dealings with a debtor company in a debt restructuring under a SOA.

### Brief Facts

In *Top Builders*, Top Builders Capital Berhad, Ikhmas Jaya Sdn. Bhd. ("**2<sup>nd</sup> Applicant**") and Ikhmas Equipment Sdn. Bhd. (collectively, "**the Applicants**") were construction companies in the process of undertaking a SOA pursuant to s366 of the Companies Act 2016 ("**Act**"). In December 2020, the Applicants obtained a restraining order on actions against the Applicants.

Seng Long Construction & Engineering Sdn. Bhd. ("**Proposed Intervener**") was a construction company, which was seeking leave to intervene in the SOA proceedings and to continue its existing proceedings against the 2<sup>nd</sup> Applicant. The proceedings had commenced before the restraining order

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was obtained. The Proposed Intervener claimed that the 2<sup>nd</sup> Applicant owed the Proposed Intervener RM 3.7 million for services rendered. However, the Applicants valued the debt at only RM 560,000 under the Applicants' proposed scheme. The Proposed Intervener complained that aside from the incorrect debt amount, if the SOA went ahead, the Proposed Intervener could potentially be forced to waive its rights to pursue its debt. Thus, the Proposed Intervener sought leave from the Court to continue its proceedings against the 2<sup>nd</sup> Applicant.

The Proposed Intervener's application for leave to continue its proceedings against the 2<sup>nd</sup> Applicant was dismissed because the Proposed Intervener had not gone through the proper legal route towards disputing the quantum of debt. The Court further noted that what the Proposed Intervener was trying to do was to avoid a cram down provision under s366(3) of the Act.

## Key Legal Principles

### 1. Scheme of Arrangement

A SOA is managed and controlled by a debtor company which essentially devises a proposal or a plan for approval by its creditors for the fulfilment of its debt obligations. At the first instance, it is left to the company to determine the claims submitted by the creditors and to propose the pay out to be made to meet its debt obligations for approval by the creditors. The Court plays only a supervisory role in the process.

A SOA application is time sensitive, as it seeks to revive the financially distressed company as a going concern. Therefore, decisions pertaining to the proposed scheme are required to be made as soon as possible. As pointed out by the Court, there is an underlying consideration that the greater good of many will outweigh the interests of a few.

### 2. The Three Stages of a Scheme of Arrangement

There are three main stages of a SOA:

- (a) the company will apply to the Court for an order for meetings of the relevant classes of creditors ("**creditors' meeting(s)**") to be convened;
- (b) the creditors' meeting(s) will be convened; and
- (c) the scheme, if approved by the requisite majority at the creditor' meeting(s), will be sent to the Court for final approval.

In order to preserve the assets of the company and to allow the company to focus its efforts and resources on restructuring and rehabilitating the company through the SOA proceedings, it may be necessary for the company to obtain a restraining order to restrain further proceedings in any action or proceeding against the company.

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### 3. The Proofs of Debt

#### (a) Procedure

In order to determine who can vote at the creditors' meeting(s), the company must first determine who is considered a creditor of the company. This is usually done by the creditors submitting proofs of debt to the company or an appointed scheme manager ("**decision-maker**").

The proofs of debt submitted to the decision-maker would consist of certain documents and information. Usually, these documents would suffice as proof of the validity and the quantum of these debts. The decision maker is entitled to request for further proof, if he deems it necessary.

The powers of the decision-maker are exercised in a summary manner based on the information and documents put before the decision-maker. In the process of evaluating the claims, the decision-maker may have to make fair estimates of certain claims and, if there is little or insufficient material to form a conclusion as to a value, to ascribe a nil or minimal amount to the claims. Where there is a dispute, the decision-maker may either reject the claims or permit the claims, whether in whole or in part. For claims which are more complicated, such as contingent claims (a claim dependent on a future event) or unliquidated claims (claims for which the sum is not fixed), a fair estimate will have to be made, which will require some exercise of discretion.

On occasion, a debt may be rejected. This means that a person will be excluded from attending the creditors' meeting(s) and voting on the proposed scheme. It may be possible for only a part of the proof of debt to be recognised, which would result in the weightage of the creditor's vote being reduced. In some cases, such decisions may be significant as the exclusion of the affected creditor's vote or the rejection of part of its claim may be determinative of the approval or rejection of the proposed scheme.

The decisions made on the proofs of debt, both as to the recognition of a debt (and thereby the status as creditor) and the quantum (and thereby fixing the value to the vote), will be or ought to be made known to the creditors before the creditors' meeting(s). In practice, the adjudicated list of scheme creditors and their respective quanta will later be submitted to the Court for the purpose of distribution of payments pursuant to the terms of the scheme as approved by the requisite 75% of the creditors in value, attending and voting at the creditors' meeting(s).

While acknowledging that the decision at first instance taken by the decision-maker is made in a summary fashion, the interests of the creditors are protected by the availability of appeal to the Court against the first-instance decision.

The task of the Court on an appeal is to examine the evidence placed before the decision-maker in the first instance (together with fresh evidence where appropriate) and to decide on the balance of probability whether the claim against the company is established and if so, in what amount. The appeal should be heard on an expedited basis and preferably together with the application to the Court for the sanction of the scheme. The appeal hearing is a summary disposal and should not be a *de novo* hearing.

If there is any concern that a summary determination of the quantum of claims by the Court may prejudice any party, there is a safeguard in s366(4) of the Act i.e. the Court may grant its approval to a

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SOA subject to such alterations or conditions as the Court thinks are just. This provision vests upon the Court some flexibility to deal with cases where justice requires the quantum of a creditor's claim to be determined through the vigorous process of a trial or arbitration proceedings.

Subject to the above steps, the scheme will invariably provide that the company will be completely and absolutely released and discharged from all claims, obligations and liabilities.

### **(b) Companies Law Amendments**

It is noted that the Companies Commission of Malaysia has proposed amendments to the Act to *inter alia* enhance the provisions relating to SOA. The proposed amendments include having new provisions on the filing, inspection and adjudication of proofs of debt, which *inter alia*:

- (a) fixes a time limit for a creditor of the scheme company to file a proof of debt;
- (b) provides that every proof of debt is to be adjudicated by the person who is appointed by the Court to serve as the chairperson of the court-convened meeting; and
- (c) provides for a dispute resolution mechanism in relation to the rejection of a proof of debt.

## **4. The Principle for Leave to Proceed with Legal Proceedings**

### **(a) Restraining Order / What a Dissatisfied Creditor May Do**

If a creditor takes the view that its interests are better served by commencing its own action against the company, the creditor can choose not to go along with the SOA, and instead bring an action of its own, even where a company has obtained a restraining order, provided it obtains leave of Court to do so.

The main thrust for a restraining order is to give the SOA precedence over the legal and arbitral proceedings as the platform to resolve the debt obligations of a company with its creditors. In other words, the restraining order seeks to preserve the assets of the company and to allow the company to focus its efforts and resources on restructuring and rehabilitating the company.

### **(b) Principle**

The starting principle when entertaining a leave application for proceedings against a restraining order is that such leave will only be granted in 'exceptional circumstances' and the burden will be on the applicant to show the existence of such circumstances. A complete definition of 'special circumstances' is not feasible. The principle must be such that the circumstance or combination of circumstances must be of sufficient weight to overcome the strong imperative to have the claims dealt with under the machinery of the SOA. The fact that the applicant's claim may have a 'real prospect of success' alone cannot constitute 'special circumstances'.

Leave will likely be granted where the commencement or continuation of the legal proceedings does not impede the achievement of the scheme or where it would in fact facilitate and or assist the achievement of the scheme. For instance, where the claim is proprietary in nature and the applicant is not seeking anything other than to reclaim possession or ownership of property said to belong to the applicant creditor, leave will normally be granted. Another instance is where the adjudication of the quantum of

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the creditor's claims is determinative of the question of approval of the scheme, leave may be granted to proceed with legal proceedings if the circumstances of the disputes are such that a summary decision on the claims is not appropriate.

Ultimately, it is the Court which will need to exercise its discretion in balancing the harm to the applicant if leave is not granted, against the harm to the general body of creditors if leave is granted. The Court will take into consideration, among others, the structure and terms of the scheme and how the company seeks to implement the same, the support of the creditors for the scheme, the company's financial position, the *bona fide* of the company in proceeding with the scheme, the stage of the legal proceedings and whether the outcome of the legal proceedings would have a determinative impact on the approval of the scheme.

## Concluding Remarks

This comprehensive decision in *Top Builders* dealt with important aspects of an SOA. In relation to proofs of debt, this decision sets out the procedural rules on proofs of debt which help settle the issues in respect of voting at the creditors' meeting(s) and the entitlement to pay out under the SOA. The decision balances the rights of the creditors in having certainty of their debts on which they can vote and the rights of the debtor to have an expeditious summary process to implement a scheme. In relation to leave to proceed with legal proceedings against the company with a restraining order, creditors have to be mindful that 'exceptional circumstances' or 'special circumstances' will have to be shown for the Court to grant such leave.

If you have any queries on the above, please feel free to contact our team members below who will be happy to assist.

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