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Classification Of Related Party Creditors In Scheme Of Arrangement

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A scheme of arrangement, being one of the corporate rescue mechanisms provided under the Companies Act 2016 (CA 2016), allows a financially distressed company to propose to its creditors a plan to fulfil its debts owing to such creditors over an agreed timeline. It operates by restructuring the debts of the company and varying the creditors' debts, as opposed to immediate liquidation of such company.

The 3-stage process for a scheme of arrangement to become binding on a company and its creditors under section 366 of the CA 2016 are as follows:

(a) Firstly, either the company, creditors, members of the company, liquidator or judicial manager may apply to the Court to convene a creditors' meeting.

(b) Secondly, the proposed scheme is presented at the meeting to be agreed upon by a majority of 75% of total value of creditors present and voting, either in person or by proxy or at the adjourned meeting.

(c) Thirdly, upon obtaining the requisite approval, a further order by the Court is to be obtained to sanction the scheme of arrangement. [1]

This alert analyses the case of MDSA Resources Sdn Bhd v Adrian Sia Koon Leng [2023] MLJU 1565, where the Federal Court upheld the High Court's decision to, *inter alia*, dismiss the appellant's application for sanction of a scheme of arrangement made pursuant to section 366(4) of the CA 2016.

REIMAGINING LEGAL SOLUTIONS

[1] *Mansion Properties Sdn Bhd v Sham Chin Yen & Ors* [2021] 1 CLJ 609; [2020] MLJU 1969 (Federal Court).

Background Facts

The appellant, MDSA Resources Sdn Bhd (MRSB or the appellant), is a company engaged in property development and related activities. It had completed several projects in Melaka including the Hatten Place which was completed in November 2015.

The respondent, Adrian Sia Koon Leng (Adrian or the respondent) is a purchaser of the property developed by MRSB. He is also a creditor of MRSB as he had let the property he bought from MRSB back to MRSB for rental under a scheme known as 'Guaranteed Rental Return Scheme' (GRR).

As a result of the financial problems faced by MRSB in 2019, 298 legal claims were taken out against MRSB. A vast majority of those who had taken legal action against MRSB were property owners who had bought properties from MRSB where these properties were then let back to MRSB under the GRR scheme.

MRSB applied under section 366(1) of the CA 2016 to summon meetings of the creditors of MRSB (Scheme Meetings) for a scheme of arrangement proposed between MRSB and such creditors (Proposed SOA) to be approved by the Court.

Under the Proposed SOA, there was to be a single class of unsecured scheme of creditors comprising of:

(i) The creditors under the GRR scheme, creditors which/whom are owed liquidated agreed damages and trade creditors (collectively Third Party Scheme Creditors).

(ii) The ultimate holding company of MRSB, holding company of MRSB, subsidiaries of MRSB, directors of MRSB and related parties which have common directors with MRSB (collectively Hatten Group Scheme Creditors).

The Third Party Scheme Creditors and the Hatten Group Scheme Creditors are hereinafter collectively referred to as the Scheme Creditors.

In this case, MRSB had filed an application for the Court to sanction the Proposed SOA (Sanction Application) and to extend the restraining order issued pursuant to Section 368 of the CA 2016 to facilitate the Proposed SOA (Application for the Extension of RO). On the other hand, the respondent objected to the Proposed SOA with the main reason that the Proposed SOA lacks particulars.

High Court

On 29 January 2021, the Melaka High Court dismissed MRSB's Sanction Application and its Application for the Extension of RO. The High Court held, *inter alia*, that:

(a) The Proposed SOA was unreasonable and was to the detriment of the Third Party Scheme Creditors.

(b) The waiving and release and discharge of all debts owed by the appellant to the Scheme Creditors were done merely to perpetuate the existence of MRSB to the detriment and at the expense of the Third Party Scheme Creditors in that the Third Party Scheme Creditors would no longer have an avenue against MRSB if the Court were to sanction the scheme.

(c) The Hatten Group Scheme Creditors should not have been categorised together with the Third Party Scheme Creditors during the voting at the Scheme Meeting as the Hatten Group Scheme Creditors were related to MRSB and had a special interest in MRSB. Considering this and the enormous difference in the debt value between the Hatten Group Scheme Creditors and the Third Party Scheme Creditors, the learned judge was of the view that the Hatten Group Scheme Creditors' views in the Scheme Meeting did not fairly represent the entire class of creditors of the Proposed SOA.

(d) There was much uncertainty in the Proposed SOA.

(e) There was insufficient information in the Sanction Application. In particular, there was no information as to when the debts to the Hatten Group Scheme Creditors were incurred and the circumstances under which they were incurred, which is material to determine the credibility of the transaction in light of the Hatten Group Scheme Creditors being the related parties to MRSB.

Court of Appeal

The decision of the High Court was affirmed by the Court of Appeal on amongst others, the following grounds:

(a) The composition of the class of creditors comprising the Third Party Scheme Creditors and the Hatten Group Scheme Creditors in a single class of the scheme creditors was unfair, uneven, and downright lop-sided, and hence could not be regarded as fairly representative of the class in question.

(b) There was a non-disclosure of material information as the appellant/MRSB proffered insufficient explanation to the Third Party Scheme Creditors about the full effect of the Proposed SOA.

(c) The proposed SOA was rigged with uncertainties and was unreasonable, unfair and not equitable. The Third Party Scheme Creditors including the respondent would be left in a bind if the proposals were accepted as they could no longer claim their money in full from the appellant/MRSB.

Federal Court

After MRSB was granted leave to appeal to the Federal Court against the decision of the High Court Judge of Melaka, the Federal Court, in a 2-1 split decision, dismissed the appeal of MRSB.

The Federal Court's majority decision answered two questions of law as follows:

(a) **Question 1:** "*Whether the votes of related-party creditors are to be treated differently from the votes of other creditors in the same class in a scheme of arrangement?*"

In this regard, the Federal Court ruled that a wholly-owned subsidiary or related party of a company that proposed a scheme of arrangement under the CA 2016 should not be placed in a single class of creditors as other creditors due to their special interest in promoting the scheme.

In particular, on the facts of the case, the Federal Court explained that the legal right of the Third Party Scheme Creditors against MRSB is the outstanding rentals of the units of Hatten Suites under the GRR agreements. Such legal right of the Third Party Scheme Creditors is dissimilar from that of the Hatten Group Scheme Creditors which had a special interest in promoting the scheme. There is no community of interest between the Hatten Group Scheme Creditors and the Third Party Scheme Creditors.

(b) **Question 2:** "*If the answer to 1 is yes, whether the votes of related-party creditors in a scheme of arrangement should be discounted or not be counted altogether*."

In relation to the treatment of votes of the related party creditors, the Federal Court held that the votes of related-party creditors must be discounted as they have a special interest in promoting the proposed scheme with the propensity to disregard the interests of the other creditors in the scheme.

On the other hand, in the dissenting minority decision, Justice Zabariah Mohd Yusof FCJ was of the view that:

(a) It cannot be denied that in a scheme of arrangement, not only is there the risk of

empowering the majority to oppress the minority, there is also the risk of enabling a small minority to thwart the wishes of the majority. Both of these concerns on the risks must be balanced. Grouping creditors into different classes gives each class the power to veto a scheme of arrangement and may deprive a bona fide scheme of arrangement of much of its value;

(b) The test is based on similarity or dissimilarity of legal rights against the company, not on similarity or dissimilarity of interests not derived from such legal rights. In this case, the rights of the Hatten Group Scheme Creditors and the other unsecured creditors are similar, namely these creditors would only be paid "*pari passu*" from the surplus funds of the wound-up company; and

(c) In dealing with related parties whose rights are not prima facie dissimilar to those of the ordinary creditors, the approach is to allow the related parties to vote at the same meetings as the other creditors but the Court is given the discretion at the sanction hearing whether to discount or disregard entirely the votes of the related party for the purpose of determining whether the scheme was approved by the requisite majorities.

Conclusion

Following the Federal Court's decision in MDSA Resources Sdn Bhd v Adrian Sia Koon Leng, companies applying for schemes of arrangement pursuant to Section 366 of the CA 2016 must ensure that their related-party creditors are placed in a separate classification from the third-party creditors, as related-party creditors may have a special interest in the business which could potentially be prejudicial to third-party creditors. However, it remains to be seen how the law would develop in regard to the extent of discount or weightage that would be given to related-party creditors in a scheme of arrangement.

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