

THE UPDATE



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Special Issue 1 of 2012

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Abbreviations

Jur	:	Jurisdiction
MY	:	Malaysia
SG	:	Singapore

INTRODUCTORY NOTE

This Special Issue 1 of 2012 is necessitated by two important decisions delivered recently, one by the apex court in Malaysia and the other by its equivalent in Singapore.

In *Sumatec Engineering and Construction Sdn Bhd v Malaysian Refining Company Sdn Bhd*, the Federal Court of Malaysia extended the exception to restrain payment in an on-demand bank guarantee or performance bond to “unconscionability”, apart from the sole “fraud” exception. By doing so, Malaysia has joined other commonwealth countries to counter any injustice and minimize inequitable result that may arise from a call or payment on an on-demand bank guarantee or performance bond. This decision will certainly stir an interest in the construction industry as well as the banking sector.

The Singapore Court of Appeal in *The Royal Bank of Scotland NV v TT International Ltd* laid down numerous principles concerning proper implementation of a scheme of arrangement and compromise under s.210 of the Singapore Companies Act (Cap 50, 1994 Rev Ed) (the equivalent of s.176 of the Malaysian Companies Act 1965). The pinnacle court also possibly for the first time provided a working guide on how to apply the “dissimilarity principle” in classifying different classes of scheme creditors. This case is therefore a must-read for advisors and consultants of corporate rescue schemes of distressed companies.

We also feature the highly anticipated corruption case of the former Menteri Besar of Selangor, Khir Toyo.

Happy Reading!

LANDMARK RULING ON INJUNCTING CALL UPON ON-DEMAND BG & PERFORMANCE BOND

Finally, our courts recognized 'unconscionability' as an exception to restrain payment in an on-demand guarantee or performance bond, apart from the long established 'fraud' exception. This long-awaited determination at the highest court of the land came about in *Sumatec Engineering and Construction Sdn Bhd v Malaysian Refining Company Sdn Bhd*.

In the case, Sumatec was appointed by MRC as contractor for certain structural steel works for the contract value of about RM47m. The contract required Sumatec to provide a bank guarantee for its due performance for 10% of the contract value, which it did. There was a reduction of the scope of Sumatec's works which caused the value to drop to about RM13m. Sumatec duly completed all works under the reduced scope of contract which was confirmed by the issuance of a provisional acceptance certificate in November 2009. Sumatec had then raised with MRC two claims for unpaid amounts of RM4.3m whilst MRC in turn introduced back charges claim without any notice of defects or opportunity to Sumatec to rectify such defects in disregard of the contractual terms. Negotiations were actively pursued to resolve the dispute when MRC made a demand to Bank Islam to encash the bank guarantee (BG).

The BG was an on-demand and unconditional guarantee as follows:

"If the CONTRACTOR shall in any respect fail to execute the CONTRACT or commit any breach of its obligations thereunder as certified by MRC, the GUARANTOR shall pay to MRC on first notice and without any proof and conditions the sum of RM4,784,668.80 being 10% of the CONTRACT PRICE."

There are three entrenched principles on unconditional and on-demand bank guarantees and performance bonds. (1) The autonomy principle --- the guarantee constitutes a separate contract from the underlying transaction between the account party and the beneficiary; its privity being only between the beneficiary and the issuing bank. (2) The "cash in hand" principle --- this reflects the importance of promoting commercial efficacy and certainty in the use of letters of credit, guarantees and bonds. (3) The "fraud" exception --- the sole exception to the above two principles arises where the plaintiff can establish fraud in the circumstances of the call or payment. This permits injunctive relief. Thus, MRC could in reliance of the autonomy principle call upon Bank Islam to make payment on the BG at any time and without any proof of any breaches arising from the underlying contract it had with Sumatec.

Prior to *Sumatec*, the sole exception to the autonomy principle was fraud and it must be clearly established fraud and the evidence must be clearⁱⁱ, although, as observed by the Federal Court, in Canada, it has diluted to the less stringent test of a "strong prima facie case" of fraudⁱⁱⁱ. It would appear that the courts in neighbouring Singapore have recognized "unconscionability" as a distinct ground to restrain a beneficiary from calling or demanding moneys under the performance bond^{iv}. The Federal Court also took note of the judicial trend in other Commonwealth countries which are more willing to look beyond the fraud exception and consider unconscionability as a separate ground to allow a restraining order on the beneficiary. It then cited with approval our own High Court decision in *Focal Asia Sdn Bhd & Anor v Raja Datuk Nong Chik & Anor*^v which recognized unconscionability as a separate exception and laid down the test of "seriously arguable that the only realistic inference is fraud". The Federal Court further extended this "seriously arguable and realistic inference" test to the extended exception of unconscionability. Notably, *Focal Asia* was also recently approved by the Court of Appeal in *Kejuruteraan Bintai Kindenko Sdn Bhd v Nam Fatt Construction Sdn Bhd & Anor*^{vi}. The Federal Court in *Sumatec* went on to affirm the numerous principles enunciated in *Nam Fatt*. Among others, the determination of unconscionability is fact specific which means that courts must consider a claim of unconscionability on a case to case basis and consider the totality of the circumstances. All the facts and circumstances surrounding the demands made on the performance bond must be so lacking in good faith and amount to unconscionable conduct that it warrants court intervention by way of injunction to avoid injustice.

In conclusion, "unconscionability conduct" on the part of a beneficiary of a bank guarantee or performance bond is a distinct ground, apart from "fraud", that entitles the court to restrain the beneficiary from calling on or demanding and receiving monies under the bank guarantee or performance bond. Unfortunately,

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unlike *Nam Fatt* where there was a positive finding of unconscionability which warranted an injunction, the several incidences of the alleged unconscionable conduct on the part of MRC (beneficiary) were insufficient to prove unconscionability to maintain the injunction granted by the High Court. Thus, whilst a breakthrough was achieved on the law on this subject of on-demand and unconditional bank guarantee and performance bond, the appellant failed in its appeal on the facts.

ⁱ[2012] 2 AMR 673, [2012] 3 CLJ 401

ⁱⁱ*Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 All ER 976, *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 CLJ 283

ⁱⁱⁱ*CDN Research Development Ltd v Bank of Nova Scotia* (1980) 18 CPC 62

^{iv}*Bocotra Construction Pte Ltd & Ors v AG (No.2)* [1995] 2 SLR 733 read with *GHL Pte Ltd v Unitrack Building Construction Pte Ltd & Anor* [1999] 1 SLR 374

^v[2011] 2 AMR 515

^{vi}[2011] 2 AMCR 461

Company Law

A HOW-TO GUIDE OF SCHEME OF ARRANGEMENT

Companies in financial distressed state may consider to carry out a scheme of arrangement or compromise with their creditors or members pursuant to s.176 of the Companies Act 1965 (the Act). This provision enables a company to propose a scheme to compromise its creditors' claims or to reorganize the share capital of the company. It is useful because it allows a company to overcome the impossibility or impracticability of obtaining the consent of every creditor or member (as the case may be) and it prevents a minority of creditors or members from frustrating a beneficial schemeⁱ. This is achieved by allowing a majority in number representing 75% in value of the creditors (present and voting) at a scheme creditors' meeting (or meetings, if there is more than one class of creditors) to approve the proposed scheme (the requisite majority) --- s.176(2) of the Act. At the same time, the requirement to convene a separate meeting for each class of creditors with different rights and interests protects the minority from the possibly oppressive conduct of the majority. From the viewpoint of creditors, a scheme of arrangement or compromise may be more beneficial than the alternative of the debtor company in liquidation. Creditors will be able to salvage and recover portion of the debts instead of suffering a total wipe-off of their debts.

The recent decision of the Court of Appeal of Singapore in *The Royal Bank of Scotland NV v TT International Ltd*ⁱⁱ laid down several principles of law which serve as a useful guide for any future undertaking of a scheme of arrangement. The Singapore provision --- s.210 of the Companies Act (Cap 50, 1994 Rev Ed) --- is substantially similar to s.176 of the Act. However, before we discuss the decision, a quick overview of the process by which an arrangement scheme becomes binding on the company and its creditors pursuant to such provisions will be helpful to our readers and we can do no better than to adopt the short outline in *Re Hawk Insurance Co Ltd*ⁱⁱⁱ. First, there must be an application to the court under s.176(1) of the Act for an order that a meeting(s) be summoned. Decision will have to be made as to whether or not to summon more than one meeting; and if so, who should be summoned to which meeting. Second, the proposed scheme is put to vote at the meeting(s); and is approved (or not) by the requisite majority. Thirdly, if approved, there must be a further application to the court under s.176(3) of the Act to obtain the court's sanction to the proposed scheme. The court in *TT International* case took the opportunity to set out numerous principles relevant to the mechanics in each stage.

The 1st Stage --- Leave to Convene Meeting(s)

The proper classification of creditors is vital. The general principle is that persons whose rights are so dissimilar that they cannot sensibly consult together with a view to their common interest must hold separate meetings. The law in this area has been extensively reviewed by the Hong Kong Court of Final Appeal and set out in *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin*^{iv}. However, the Singapore apex court departed from its counterpart in Hong Kong on whether the issue of creditors' classification should be left to the sanction hearing at the 3rd Stage. The Singapore preferred to follow the Practice Statement in England^v

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which required the court, in considering whether or not to order meeting(s) of creditors, to consider whether more than one meeting of creditors was required and if so, what was the appropriate composition of those meetings. On the other hand, *UDL Argos* left the issue of creditors' classification to the sanction hearing at 3rd Stage^{vi}.

Where there is no realistic prospect of a scheme receiving the requisite approval, the court should not act in vain in granting the application to convene meeting(s).

If a meeting is ordered to be convened, notices summoning the meeting(s) must be sent to the creditors and must be accompanied by an explanatory statement (ES) as required by s.177 of the Act. The ES must be perfectly fair and, as far as possible, give all the information reasonably necessary to enable the recipients to determine how to vote^{vii}.

Between the 1st Stage and the 2nd Stage --- Proof of Debt Adjudication Process

The creditors will then submit their proofs of debts together with any supporting documents, before a 'cut-off date', to the chairman of the meeting(s) for his adjudication. The chairman usually acts as the proposed scheme manager. He has to perform the quasi-judicial task of adjudicating upon disputes as to the voting rights of anyone claiming to be a creditor. He has to carry out his role objectively and in an independent manner without regard to the likely way in which the creditor holding the debt may vote^{viii}. He must never favour the interest of his appointers over that of the other legitimate creditors^{ix}. If he wishes to extend the 'cut-off date' for submission of proofs, he has to obtain prior court sanction and all creditors must be informed.

The 2nd Stage --- Court-Convened Meeting

It has been regarded as a usual practice in Singapore for the chairman to post a list of the creditors and the corresponding amounts of their admitted claims at the meeting venue prior to the court-convened meeting. There must not be deliberate concealment of material information until the meeting so as to influence its outcome. After the creditors have cast their votes, the chairman will immediately tabulate the results and announce them by the end of the meeting.

The 3rd Stage --- Court Sanction

The requirement of the court's approval of the scheme (as prescribed under s.176(3) of the Act) is to ensure the integrity of the voting outcome and the objective fairness of the proposed scheme. The court will consider the merits and fairness of the scheme^x.

The court must be satisfied of three matters before it sanctions a scheme: (i) the statutory provisions have been complied with, such as the resolution has been passed by the requisite majority at a court-convened meeting properly held; (ii) those who attended the meeting were fairly representative of the class of creditors and that the statutory majority did not coerce the minority in order to promote the interests adverse to those of the class whom the statutory majority purported to represent; and (iii) the scheme is one which a man of business or intelligent and honest man, being a member of the class concerned and acting in respect of his interest, would reasonably approve^{xi}.

Once the court is satisfied, it will grant an order to approve the scheme and upon lodgment at the Registrar of Companies, the scheme becomes binding on all parties (including the dissenting creditors) pursuant to s.176(5) of the Act.

Conflict of Interest

The proposed scheme manager in *TT International* case was the nominee for the individual voluntary arrangements (IVAs) filed by the chairman of the Company and his wife, an executive director. This put the proposed scheme manager in an unacceptable position of unavoidable conflict of interest. The court thus ordered him to elect either to continue as scheme manager or as nominee for the two key personnel of the company in their proposed IVAs only.

Right to examine proofs of debt submitted by other creditors

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The complaint was that the creditors had inadequate information to assess whether the proposed scheme manager's decision in admitting and rejecting the proofs of debts were proper to ensure the integrity of the voting process. Generally, a creditor has no legal right to have access to the proofs of debts of other creditors except where his voting rights have been or are likely to be affected. He has to produce *prima facie* evidence of impropriety in the admission or rejection of such proofs of debts to be entitled to access. The requesting scheme creditor should make the request to the proposed scheme manager and if it is rejected, he should apply to court for an order that the proofs and supporting documentation be disclosed to him.

Notification of chairman's decision to admit or reject proofs of debts

A scheme creditor had to be notified of the proposed scheme manager's decisions to admit or reject its own and other creditors' proofs of debt before the votes were cast at the creditors' meeting. The proposed scheme manager should have provided all the scheme creditors present with the full list of scheme creditors entitled to vote and the corresponding quanta of their claims that were admitted for the purpose of voting. If a proposed scheme manager cannot comply with the above prior to the scheme creditors' meeting, he should seek from the court leave to defer the meeting until after the adjudication is completed.

Appeal against the chairman's decisions to admit or reject proofs of debts

A scheme creditor was entitled to appeal to the court the proposed scheme manager's decisions to admit or reject its own and other creditors' proofs of debts. However, such appeals to court should only be taken after the votes have been counted and it could be seen whether the vote in question would affect the result, preferably concurrently during the sanction stage. In hearing an appeal, the court should be slow in overriding the professional judgment of the chairman, unless it was affected by bad faith, a mistake as to facts, an erroneous approach to the law or an error of principle and the court's role was not to engage in its own valuation of a claim^{xii}.

In the present case, the whole of St George Bank's claim was admitted. It exceeded the amount of loan actually drawn down, such excess was dressed up as a contingent claim. The court held that it was wrong to allow St George Bank to vote based on contingent claims (founded on the undrawn credit facilities) which the bank could later unilaterally ensure would never crystallize (by withdrawing those credit facilities). Likewise, it was unfair to allow a lessor to vote based on contingent claim (founded on the future lease payments) which it could unilaterally ensure would never crystallize (by terminating the lease).

Classification of scheme creditors

The principle on classification of scheme creditors for voting purposes is trite. Those creditors whose rights are so dissimilar to each other's that they cannot sensibly consult together with a view to their common interest must vote in different classes^{xiii}. The pinnacle court went on to provide a working guide on how to apply this "dissimilarity principle". If a creditor's position will improve or decline to such a different extent *vis-à-vis* other creditors simply because of the terms of the scheme, assessed against the most likely scenario in the absence of scheme approval (the appropriate comparator), then it should be placed in a different voting class from the other creditors.

The appropriate comparator is not necessarily an insolvent liquidation although in most cases it is, as in this case. It is not easy to understand this working guide. Perhaps an illustration of how the court applied it to the facts of the case will be helpful. The issue in the case was whether the contingent claims should be classified separately from other unsecured creditors. The appropriate comparator was an insolvent liquidation. Without the scheme, in an insolvent liquidation, the contingent creditors would be distributed a portion of the company's assets (on a *pari passu* basis) based on the "just estimate" of their contingent claims. With the scheme, they would be able to claim under the terms of the scheme if their claims crystallized within 5 years which, on the facts, did not appear unlikely. In other words, the contingent creditors' legal rights as against the company (and relative to the other creditors) were the same under the scheme as they were in an insolvent liquidation (the appropriate comparator scenario).

Thus, the scheme did not alter the relative rights of the contingent and non-contingent creditors so that the contingent creditors would be better or worse off than they would be (relative to the non-contingent creditors) if a winding up occurred. If, to the contrary, the relative rights (among creditors) of the contingent creditors were better (or worse, as the case maybe) according to the scheme than in a winding up situation,

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the contingent creditors would have an additional interest to vote for (or against, as the case maybe) the scheme. This additional non-private interest derived from their rights under the scheme would make it impossible for them to consult the non-contingent creditors with a view to their common interest. Put it in another way --- conduct a comparison between the relative rights of creditors (among each other) under the scheme and their relative rights (among each other) in the alternative scenario (the appropriate comparator).

Interestingly, the court remarked that the fact that the rights of the contingent creditors would not arise until certain event happens does not by itself make the contingent creditors to be separately classed. Such approach^{xiv} was in the view of the court merely restating the contingent nature of the said creditors' claims and was wrong.

On the facts of the case, the claims of certain substantial shareholders should have been classified separately since their claims would have been subordinated in a liquidation scenario pursuant to s.250(1)(g) of the Act whereas they were not so (and thus, more advantageously dealt with) under the scheme. Their rights were thus so dissimilar from those of general class of unsecured creditors (due to this additional non-private interest to vote for the scheme). The claims of the chairman and his wife should have been classified separately as well because they were granted rights of first refusal to some bonds and shares under the scheme which improved their position relative to other scheme creditors *vis-à-vis* a liquidation scenario.

Discounting Votes of Related Party Creditors

It is the norm that the votes of related party creditors should have been discounted because of their special interests to support the proposed scheme by virtue of their relationship to the company. The votes of wholly owned subsidiaries should have been discounted to zero and effectively classified separately from the general class of unsecured creditors since they were entirely controlled by their parent company.

Conclusion

The scheme did not have the approval of the requisite majority of creditors voting at meetings properly constituted. The High Court thus had no jurisdiction to sanction the scheme. Further meetings were called for the same scheme to be put to a re-vote, subject to the directions as given.

ⁱ *Oriental Insurance Co Ltd v Reliance National Asia Re Pte Ltd* [2008] 3 SLR(R) 121

ⁱⁱ [2012] 2 SLR 213

ⁱⁱⁱ [2001] 2 BCLC 480

^{iv} [2001] 3 HKLRD 634

^v [20002] 1 WLR 1345

^{vi} para [60], *TT International Ltd*.

^{vii} *In re Dorman, Long and Company, Limited* [1934] CH 635 at 657

^{viii} *Bailey & Groves, Corporate Insolvency: Law & Practice* (LexisNexis, 3rd Ed, 2007) at p 260 para 9.45

^{ix} *Fustar Chemicals Ltd (Hong Kong) v Liquidator of Fustar Chemicals Pte Ltd* [2009] 4 SLR (R) 458

^x *Re Telewest Communications plc* [2004] BCC 342

^{xi} *Oriental Insurance Co Ltd, supra*

^{xii} *Bacnet Pty Ltd v Lift Capital Partners Pty Ltd (in liquidation)* [2010] FCAFC 36

^{xiii} *UDL Argos, supra*.

^{xiv} *Econ Corp Ltd Re* [2004] 1 SLR 273

Criminal Law

A CORRUPT MENTERI BESAR

In *Pendakwa Raya v Dato' Seri Mohd Khir bin Toyo*ⁱ, the accused who was a former Menteri Besar of Selangor was charged with the offence of obtaining, as a public servant, a valuable thing with inadequate consideration, from a person related with the businesses involving his official duties as a public servant, under s.165 of the Penal Code. The accused had purchased a property in Shah Alam at RM3.5 million from PW-2

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who had purchased it from PW-1 at the price of RM6.5 million. PW-2's company had its application for some state government related projects approved by the accused.

PW-1 (the vendor) testified that the accused and his wife went to see the property and enquired the price. When told that it was RM7 million, they said it was expensive and left. About two months later, PW-2 agreed to buy the property at RM6.5 million. The issue was whether the accused had knowledge that the purchase price paid by PW-2 was RM6.5 million. The trial judge held that the circumstances were such (ie. the close relationship between the accused and PW-2) as to give rise to an irresistible inference that the accused would have asked PW-2 about the actual price PW-2 had paid for the property.

PW-2 testified that the accused asked him to buy the property and his understanding was that the accused was interested in the property and the accused might subsequently purchase the property from him. It was during the discussion on renovation from the manner the accused and his wife directed PW-3 to renovate the property in accordance with the Balinese concept that PW-2 knew the accused intended to buy the property.

The accused had offered to buy the property at RM3.5m which was not agreed by PW-2 who counter-proposed RM5m-RM5.5m. PW-2 testified that he had to finally agree with RM3.5m as his company had many dealings with the accused. The accused contended that the issue of inadequate consideration should not arise as the price of RM3.5m was the market price as valued by a valuer. However, the trial judge held that the defence of market price would only raise a reasonable doubt if the accused did not visit the property and was not aware of the price demanded by PW-1.

The accused was found guilty. He was sentenced to 12 months' imprisonment.

[2012] 3 AMR 66

THE UPDATE is a quarterly law bulletin of TAY & HELEN WONG Law Practice which aims to highlight to the firm's clientele, business partners and friends contemporaneous development in law (particularly in principal areas of the firm's law practice) which might have an impact on their business dealings, operations or trade. The bulletin focuses primarily on case law development in the jurisdiction of Malaysia.

The Publisher of the UPDATE is TAY & HELEN WONG LAW PRACTICE of Suite 703 Block F Phileo Damansara I No. 9 Jalan 16/11 46350 Petaling Jaya Selangor Darul Ehsan Malaysia Tel (603) 79601863 Fax (603) 79601873 email: lawpractice@thw.com.my website: www.thw.com.my

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