EVERSHEDS HARRY ELIAS

Asia | Client Update

Whose scheme is it anyway?

The law on schemes of arrangement in Singapore after *SK Engineering Construction Co Ltd v Conchubar Aromatics Ltd and another appeal* [2017] SGCA 51

Introduction

1. Companies seeking to have their schemes of arrangement successfully sanctioned by the Singapore courts would do well to understand and consider the recent landmark decision by the Singapore Court of Appeal in ***SK Engineering Construction Co Ltd v Conchubar Aromatics Ltd and another appeal* [2017] SGCA 51** ("***SK Engineering***"). In that case, Singapore's apex court addressed various novel issues of law regarding the passing of schemes of arrangement under Section 210 of the Companies Act (Cap. 50, Rev. Ed. 2006) ("**Companies Act**"). The issues raised were of such importance that the Chief Justice and four Justices of Appeal were assigned to hear the matter, instead of the usual three judges.

2. Eversheds Harry Elias LLP successfully represented the two scheme companies in *SK Engineering* to obtain the sanction of the High Court, and further defended the appeal brought by the objecting creditor. The team was led by Partners Andy Lem and Justin Chia, and assisted by Associates Akesh Abhilash and Kok Yee Keong.

3. This update seeks to inform readers of 4 issues which may arise in the passing of a scheme of arrangement, and the legal position in Singapore on these issues, as set out below:

    a) when a creditor would be found to be a related creditor of the scheme company;

    b) the applicability of partial discounts on the votes of related creditors who are not wholly-owned subsidiaries of the scheme company;

    c) the court's role in assessing possible vote-splitting by the scheme company; and

    d) when a scheme will not be sanctioned by the courts for lack of clarity or uncertainty.

Summary of *SK Engineering*

4. The scheme companies were (1) Conchubar Aromatics Ltd ("**Conchubar**"), incorporated in the Cayman Islands, and (2) UVM Investment Corporation ("**UVM**"), incorporated in the British Virgin Islands (collectively, the "**Companies**"). They have no underlying businesses and their primary assets were shares (indirectly or directly) in Jurong Aromatics Corporation Pte Ltd ("**JAC**"), a company incorporated in Singapore which was under receivership.

5. The respective schemes of arrangement proposed by the Companies operate in conjunction with the restructuring proposal ("**JEI Proposal**") submitted by Jurong Energy International Pte Ltd ("**JEI**"), a company incorporated in Singapore.

6. The essential terms of the respective schemes of arrangement proposed by the Companies (the "**Schemes**") were as follows:

    a) If the JEI Proposal was accepted by the Receivers and Managers of JAC ("**R&Ms**"), JEI shall purchase the Companies' shares in JAC, and in exchange, the Companies shall receive JEI shares or JEI convertible bonds at the same or greater value as the Companies' shares in JAC. The JEI shares or JEI convertible bonds received by the Companies shall then be distributed *pari passu* to their creditors.

b) However, if the JEI Proposal was not accepted by the R&Ms or one year from the date of the Schemes, whichever is earlier ("**trigger event**"), a failsafe payment will kick in whereby UVM shall pay US$300,000.00 and Conchubar shall pay U$650,000.00 to their respective creditors on a *pari passu* basis in 25% installments every 6 months. The outstanding debt owed to the creditors shall correspondingly be reduced by the amount of failsafe payments made. The failsafe payments were guaranteed by Orient Time Capital Ltd, a company incorporated in British Virgin Islands.

c) Within 30 days of the trigger event, the Companies shall give notice to the creditors as to whether they intend to propose a new scheme. If the Companies intend to propose a new scheme, they shall have liberty to convene the respective creditors' meetings for the voting on the new scheme within 60 days. If successfully approved, the new schemes will supersede the present Schemes.

7. The sole objecting creditor was SK Engineering & Construction Co Ltd ("**SKEC**"), a judgment creditor of the Companies.

8. In the first instance, the Companies successfully obtained the sanction of the Singapore High Court: see *Re Conchubar Aromatics Ltd and another matter* [2017] 3 SLR 748; [2016] SGHC 279 ("**SGHC decision**").

9. SKEC appealed against the decision with 3 main arguments (a [34]): (1) the creditors in favour of the Schemes were related creditors whose votes should be discounted fully, (2) there was material non-disclosure by the Companies that the JEI Proposal was already rejected by the R&Ms before the creditors voted on the Schemes, and (3) the Schemes lacked certainty.

10. The Singapore Court of Appeal was persuaded by the Companies' submissions, and rejected all 3 of SKEC's arguments (see [103]), i.e. it found that the creditors who voted in favour of the Schemes were not related to the Companies, there was no material non-disclosure by the Companies, and the Schemes did not suffer from a lack of clarity or certainty.

11. However, the Singapore Court of Appeal embarked on its own inquiry and found that the Schemes should not have been sanctioned in any event because (1) the material terms of the Scheme were unworkable given that the JEI Proposal as defined in the Schemes were already rejected by the R&Ms at the time of creditors' voting (see [98] - [101]), and (2) the Companies had engaged in vote-splitting in order to circumvent the statutory requirement that a majority *in number* of the creditors must have voted in favour of the Schemes (see [80] - [84]).

Lessons from *SK Engineering*

(1) <u>The test for establishing related creditors</u>

12. Prior to *SK Engineering*, the Singapore Court of Appeal had established that the votes of related creditors shall be discounted because *"the related party may have been motivated by personal or special interests to disregard the interest of the class as such and vote in a self-centred manner*": see *Wah Yuen Electrical Engineering Pte Ltd v Singapore Cables Manufacturers Pte Ltd* [2003] 3 SLR(R) 629; [2003] SGCA 23 at [35]. The special interest to support the proposed scheme arises "*by virtue of [the creditor's] relationship to the company*": see *The Royal Bank of Scotland NV (formerly known as ABN Amro Bank NV) and others v TT International Ltd and another appeal* [2012] 2 SLR 213; [2012] SGCA 9 ("***TT International***") at [155].

13. However, no guideline was previously laid down for determining when a scheme creditor is related to the scheme company.

14. In *SK Engineering*, the Singapore Court of Appeal visited this issue, and held at [41] that "*it is <u>not possible to proffer a definitive statement</u> of what would constitute a related creditor as the objectivity of a creditor can be undermined in a variety of ways. Whether or not a particular creditor is a related creditor of a scheme company <u>ultimately involves a fact-sensitive and fact-intensive analysis</u>.*" Whilst it did not lay down a definitive rule, the Singapore Court of Appeal set out at [41] the following list of non-exhaustive factors that may establish a related creditor:

a) The scheme company controls the creditor or *vice versa*; or they share a common *controlling* shareholder (i.e. more than 50% shareholding).

b) The creditor and scheme company have common shareholder(s) who hold less than 50% but more than *de minimis* stake in both companies.

c) The creditor and scheme company have common director(s), in particular, director(s) who propose or support the scheme.

d) The creditor or scheme company do not have common shareholder(s), but their controlling shareholder(s) are either (i) related by blood, adoption or marriage; or (ii) where the controlling shareholder(s) are corporate entities, these are in turn controlled by individual(s) who are related by blood, adoption or marriage.

e) The creditor is related by blood, adoption or marriage to the controlling shareholder(s) or director(s) of the scheme company.

15. The presence of any factors similar to those listed above allows a court to infer that a creditor is a related creditor, and it is not necessary to adduce *further* direct evidence to establish the same. However, the creditor and the scheme company are at liberty to adduce evidence to establish that their interests are not aligned despite the existence of the above listed factors. One example of such evidence is the use of unchallenged statutory declarations by the creditor and company that they operate independently: see [48] and [54].

(2) Applicability of partial discounts on the votes of related creditors

16. Prior to *SK Engineering*, the Singapore Court of Appeal in *TT International* held at [158] and [165] that the votes of related creditors who are wholly-owned subsidiaries of a scheme company would be discounted to zero, or that they should be classified separately ("**Wholly-owned Discount**"). It also held at [170] that where a creditor is related to the company by virtue of its shares in the company, its vote shall be discounted by the value of these shares as at the ascertainment date ("**Valuation Formula**"), i.e. a *partial* discount.

17. However, the Wholly-owned Discount and Valuation Formula are inadequate to address the variety of scenarios in paragraph 14 above, in which a creditor maybe related to the company.

18. In *SK Engineering*, at the first instance hearing before the Singapore High Court, the court found that some creditors were related to the Companies. It proceeded to apply the principle of partial discount (in the Valuation Formula) to the case at hand, in a "*broad brushed approach*", to determine the appropriate discount, "*informed by the relationships in question and consider previous conduct of the parties*": see SGHC Decision at [16] and [40].

19. Therefore, on appeal, the question posed to the Singapore Court of Appeal was whether a partial discount (in the Valuation Formula) may be extended to other scenarios of creditor-company relationships, and how such partial discount should be applied. However, as the Singapore Court of Appeal had ultimately found that none of the creditors were related to the Companies, this question did not arise on the facts, and the court left it to be addressed in the future: see [65] and [66].

20. Nevertheless, the Singapore Court of Appeal indicated, in *obiter dicta*, that a partial discount is unlikely to be adopted in Singapore:

a) It noted that no jurisdiction other than Singapore (in *TT International*) has applied a partial discount on the votes of related creditors: see [66].

b) It expressed that partial discount is "*inevitably arbitrary and subjective, and not amenable to definitive guidance*" in light of the variety of scenarios in which a creditor may be related to the scheme company: see [67].

c) It suggested that a more principled approach is to wholly discount the votes of the creditor once it is found to be related to the scheme company: see [67]. At the oral hearing, Andrew Phang JA drew the analogy that if ink had spilled into a glass of water, then the entire water content would be tainted; there is no difference whether the spill was a few drops of ink or the entire bottle of ink. The Chief Justice concurred at the oral hearing and suggested that therefore, the true test would rest on whether the court is

> satisfied on the evidence presented that the creditor is related to the company such that it could not have voted in an objective manner.

21. Only time will tell whether the Singapore Court of Appeal will extend partial discounts beyond the Valuation Formula. However, given the above *obiter dicta*, companies and scheme managers would be well advised not to be overly reliant on the prospect of partial discounts on the votes of related creditors in order to pass a scheme of arrangement.

(3) Vote-splitting by scheme company to circumvent headcount test

22. For the first time in local law, the Singapore Court of Appeal expressly recognised that vote-splitting by the scheme company will invalidate the voting process such that the proposed scheme of arrangement will not be sanctioned by the courts.

23. Under Section 210(3AB)(a) of the Companies Act, the shareholders or creditors voting in favour of the scheme must form majority *in number* ("**headcount test**"). However, the provision is silent on whether scheme companies may engage in vote-splitting exercises to boost the number of shareholders or creditors voting for or against a scheme.

24. The Singapore Court of Appeal held at [71] that such vote splitting arrangement would engage the concern identified in *TT International* at [70] as to whether "*those who attended the meeting were fairly representative of the class of creditors or the class of members*". It found support for its position from the judicial decisions in Hong Kong and United Kingdom, namely, *Re PCCW Ltd* [2009] 3 HKC 292 ("***Re PCCW***") and *Re Dee Valley Group Plc* [2017] EWHC 184 (Ch). It further held that the prohibition on vote-splitting exercise applies equally to creditors' and shareholders' schemes of arrangement.

25. What is perhaps more far-reaching is the legal basis for the courts to examine any potential vote-splitting by the scheme company, given that the summary process of obtaining the courts' sanction on a scheme of arrangement is *not* a fact-finding process. On this issue, the Singapore Court of Appeal held at [79] as follows:

> "*We agree with Lam J's comments in* Re PCCW *that in determining whether to sanction a scheme of arrangement, the court does not have to accept at face value what the petitioning parties claim as to the bona fides of their actions. We also agree with his observation that the process of obtaining the court's sanction of a scheme of arrangement is different from ordinary adversarial proceedings. The former process is designed to be summary in nature, and therefore, the court's focus should not be on fact-finding in relation to vote manipulation, but rather, should be on satisfying itself that: (a) the statutory requirements have been satisfied; (b) the statutory majority have voted in a manner that is representative of the interests of the class concerned; and (c) the scheme is one which is reasonable.*"

26. Further, the Singapore Court of Appeal held at [82] that: "*while the proof of debt process under a scheme of arrangement ought to be quick and efficient due to the summary nature of the proceedings, where there are creditors who obtained their debts by assignment, there has to be sufficient information to satisfy the court that the assignments were genuine and also made at arm's length.*"

27. Therefore, while a court is not engaged in a fact-finding process under Section 210 of the Companies Act, it would nevertheless have to question the evidence presented to satisfy itself that the statutory requirements are met.

(4) When a scheme lacks clarity or certainty

28. The Singapore Court of Appeal at [95] rejected SKEC's arguments, and found that the Schemes did *not* suffer from lack of clarity or certainty. Instead, it found that the Schemes were no longer a "*meaningful compromise*" and "*unworkable*" because the JEI Proposal as defined under the Schemes had already been rejected by the R&Ms: see [95] and [99] respectively.

29. What is noteworthy, however, is that the Singapore Court of Appeal at [95] had endorsed the reasoning of the High Court judge at the first instance hearing: "*[t]he principles relied upon by SKEC and the Judge [below] regarding the standard of clarity and certainty required of a*

scheme of arrangement are uncontroversial." This means that the rules set out in the SGHC Decision in determining whether a scheme of arrangement suffers from a lack of clarity or certainty is the prevailing position in Singapore.

30. Prior to the SGHC Decision, the Singapore courts did not have the opportunity to address in detail, schemes that lack clarity or certainty. At the first instance hearing, SKEC had argued that the Schemes should not be sanctioned because (1) they were contingent upon the acceptance of the JEI Proposal by the R&Ms, and (2) they lack certainty because the Schemes allowed the Companies to propose new schemes upon the trigger event so as to circumvent the statutory procedure under Section 210 of the Companies Act: see [42] of SGHC Decision.

31. As there was no local authority on point, the Singapore High Court sought guidance from judicial decisions in Australia and English (namely, *Re Homemaker Retail Management* [2001] NSWSC 1058*, Re NRMA Ltd* [2000] NSWSC 82, and *Re Lombard Medical Technologies Plc* [2014] EWHC 2457 (Ch)), and distilled the following principles (at [47]):

    a) There is no rule that a court must never sanction a scheme simply because it was contingent on the occurrence of some events. Instead, the focus is on whether the scheme of arrangement was sufficiently clear and certain so as to allow creditors to make an informed choice when exercising their votes, which is fact specific.

    b) A scheme that carries within itself machinery for a variation of its terms after it has received the sanction of the court would generally not be sanctioned by the courts.

    c) However, a scheme may provide for different results (including its termination) to emerge from different eventualities, as long as it sets out clearly the kind of results that would follow upon the occurrence of "*certain clearly defined events*".

32. The above guideline by the Singapore High Court, as impliedly endorsed by the Singapore Court of Appeal, would assist companies in formulating dynamic schemes of arrangement within the law.

Concluding Words

33. *SK Engineering* is significant for companies seeking to restructure via a scheme of arrangement under Section 210 of the Companies Act. The following points are noteworthy when formulating a scheme of arrangement:

    a) scheme creditors may be presumed by the court to be related creditors by virtue of certain established factors listed in paragraph 14 above, in which case the creditor and company will have to adduce evidence to prove the contrary, including the use of statutory declarations;

    b) although left as an open question to be addressed in the future, the Singapore courts are likely to *wholly discount* the votes of a related creditor, unless the creditor is related by way of shareholding in the company in which case a partial discount is applied based on the value of the shares;

    c) companies would be well advised *not* to engage in vote-splitting exercise to circumvent the statutory requirement that a majority in number of creditors or shareholders must have voted in favour of the scheme of arrangement; and

    a) a scheme of arrangement is bad for uncertainty if it carries within itself machinery for a variation of its terms after it has received court sanction, whereas a scheme providing for different results based on certain pre-defined eventualities may be acceptable.

For further information, please contact:

Andy LEM
Partner, Civil and Commercial Litigation
+65 6361 9853
AndyLem@Eversheds-HarryElias.com

Justin CHIA
Head, Restructuring and Insolvency
Partner, Civil and Commercial Litigation
+65 6361 9814
JustinChia@Eversheds-HarryElias.com

Akesh ABHILASH
Associate, Civil and Commercial Litigation
+65 6361 9836
AkeshAbhilash@Eversheds-HarryElias.com

KOK Yee Keong
Associate, Restructuring and Insolvency,
Construction and Engineering, and
Civil and Commercial Litigation
+65 6361 9390
YeeKeongKok@Eversheds-HarryElias.com