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LEGAL UPDATE

May 2019

Court of Appeal adopts "sufficient nexus" test for third party releases in Schemes of Arrangement

Synopsis

In the case of ***Pathfinder Strategic Credit LP and another v Empire Capital Resources Pte Ltd and another appeal*** [2019] SGCA 29, the Court of Appeal upheld the High Court's finding in ***In the Matter of Empire Capital Resources Pte Ltd*** [2018] SGHC 36 that the Court has power to allow a scheme meeting to be convened to consider a proposed scheme brought by a guarantor of 2 series of notes issued by different companies (the "**Notes Issuers**"), and to seek, as part of the scheme, third party releases for the Note Issuers, although it declined to exercise the power to do so on the facts of this case. The Court also held, provisionally, that the 2 sets of Noteholders could be classed together for the purposes of the scheme meeting.

Facts

Berau Capital Resources Pte Ltd ("**BCR**") was the issuer of US$ 450,000,000 12.5% guaranteed senior notes due 8 July 2015 (the "**2015 Notes**"). PT Berau Coal Energy Tbk ("**BCE**") was the issuer of US$500,000,000 7.25% guaranteed senior secured notes due 13 March 2017 (the "**2017 Notes**", together with the 2015 Notes collectively referred to as the "**Notes**"). Empire Capital Resources Pte Ltd ("**Empire**") was one of several guarantors of the 2015 Notes and the 2017 Notes. All 3 companies are within a group of companies known as the "**Berau Group**".

Empire, as a guarantor of both series of Notes, made a single application to convene a scheme meeting under section 210(1) of the Companies Act (Cap. 50) (the "**Act**"), such as to restructure the debts under both sets of Notes with the Noteholders voting as a single class. Under the scheme, the Notes Issuers and all the other guarantors were to be released from liabilities under the Notes. A group of institutional noteholders (the "**Minority Creditors**") said to hold more than 25% of the total outstanding principal sum of the 2015 Notes (but only 14% of the combined outstanding of the 2015 and 2017 Notes) objected to the application. The Minority Creditors objected to the application on (among others) the following bases:

(a) the proposed scheme sought to improperly release the Note Issuers, as the release of the Note Issuers was not necessary to the compromise with the Applicant (the "**Jurisdiction Issue**");

(b) that the classes of creditors had been improperly constituted - the holders of the 2015 Notes and 2017 Notes should be placed into separate classes because, among other things, the 2 sets of Notes accrued different rates of interest which resulted in different amounts being available in the respective Notes' debt service and interest reserve accounts. As such, in a liquidation scenario, the recoveries differed between the holders of the 2015 Notes and the 2017 Notes, but under the proposed scheme each set of Noteholders would recover the same proportion of their debt (the "**Classification Issue**"); and

(c) insufficient financial disclosure had been given to allow an assessment as to the returns from the proposed scheme and the commercial viability of its implementation (the "**Disclosure Issue**").

In the High Court, the Honourable Justice Aedit Abdullah granted leave to convene the scheme meeting, but held that, on the facts of the case, the holders of the 2015 Notes and 2017 Notes ought to vote in separate classes as they had rights exercisable against different entities and that the considerations that come into play in weighing whether any release was to be given, and what should be the price of such release, would seem to be the sort that could attract different results, such that there would be little common interest.

Cross appeals were filed by the parties, with the Minority Creditors appealing against the High Court's decision granting leave to the Applicant to convene a scheme meeting, and Empire appealing against the order that the holders of the 2015 Notes and 2017 Notes vote in separate classes.

The Decision

On the Jurisdiction Issue, the Court of Appeal adopted the test set out in the Australian case of ***Re Opes Prime Stockbroking Ltd*** [2009] FCA 813 and held that in order for the Court to allow a third party release, the applicant had to establish that there was a sufficient nexus or connection between the release of the third party liability and the relationship between the company and the scheme creditors. In adopting this test, the Court of Appeal rejected the argument that such a release had to be "necessary" to the compromise with the scheme applicant.

The Court of Appeal also declined to draw a distinction between "primary" (i.e. principal debtor) and "secondary" (i.e. guarantor) obligations in determining the question of jurisdiction under section 210(1) of the Act.

On the facts of this case, the Court of Appeal found that the release of the debt owed by the other obligors under the Notes was evidently closely related to the creditor-debtor relationship between these Noteholders and Empire as they all arose out of the same Notes and were effectively the same liability since the discharge of one extinguishes the right to pursue the other. As such, it was not relevant to the Court's jurisdiction whether the scheme applicant was an issuer or a guarantor.

The Court of Appeal went on to state that even if the test of necessity were to be adopted, as the Minority Creditors proposed, the test would have been satisfied on the present facts. In coming to this conclusion, the Court of Appeal held that any jurisdictional test would have to be applied in a commercially sensible manner particularly where a group restructuring is concerned, such that in this context, even if it was a guarantor and not the primary obligor who was the scheme applicant, the release of the primary obligor's debt to the scheme creditors would still be regarded as necessary since otherwise liability and enforcement risks would merely be shifted between the members of the group and the overall restructuring objective would be entirely unmet. The Court of Appeal further noted that it would be unrealistic to expect a guarantor within the same corporate group to settle its contingent liability through a scheme without a release of the primary debtors' liability, and in that context, the third party releases must be viewed as necessary to give effect to the proposed scheme.

On the Disclosure Issue, the Court of Appeal held that different disclosure obligations applied at the leave stage and sanction stage – a less onerous standard of disclosure is required of the applicant company at the leave stage than at the sanction stage.

At the leave stage, disclosure was required that would enable the Court to determine such matters as classification of creditors, the proposal's realistic prospects of success and any allegation of abuse of process.

The overarching focus at the leave stage is on the question of fairness in the conduct of the creditors' meeting, and the sufficiency of financial disclosure is pivotal to this as it underpins the integrity of the scheme regime and provides a real safeguard to this exercise in creditor democracy. As such, where the fairness of the creditors' meeting is patently compromised, it is legitimate for the Court to refuse leave even if the proposed scheme is thought likely to obtain the requisite votes and there is no finding of abuse of process.

On the facts of the present case, the Court of Appeal found that the Applicant's disclosure was inadequate to the extent that it was impossible for the Court to be satisfied that any creditors' meeting could be fairly conducted.

On this basis, the Court of Appeal allowed the Minority Objectors' appeal.

While the above finding was sufficient to dispose of the appeals, the Court of Appeal went on to state its provisional views on (among other things) the Classification Issue.

On the Classification Issue, the Court of Appeal reiterated the test laid down in the case of ***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 ("***TT 1***"): *"if the scheme favours or prejudices a group of creditors (against other creditors) differently from how they would be favoured or prejudiced in [the situation of a comparator]…then that group of creditors should be classed separately".* The Court of Appeal then set out three broad steps to creditor classification in applying the approach in ***TT 1***:

(a) First, identify the comparator.

(b) Second, assess whether the *relative* positions of the creditors under the proposed scheme *mirror* their *relative* positions in the comparator, and not the *present situation*.

(c) Third, if there is a difference between the creditors' relative positions identified in the second step, assess whether the extent of the difference is such as to render the creditors' rights *"so dissimilar that they cannot sensibly consult together with a view to their common interest"* (**Wah Yuen Electrical Engineering Pte Ltd v Singapore Cables Manufacturers Pte Ltd** [2003] 3 SLR(R) 629).

Applying the above framework to the facts of this case, the Court of Appeal found that, assuming that insolvent liquidation was the most likely alternative to a sanctioned scheme of arrangement, the differences between the relative positions of the holders of the 2015 Notes and the 2017 Notes under the proposed scheme (uniformity in the rights of all Noteholders) and in an insolvent liquidation (a difference of 3%) did not appear material, and that the holders of both Notes would be able to sensibly consult together with a view to their common interest.

The Court of Appeal considered that the other differences identified by the Minority Creditors did not appear material as they appeared to have no material financial impact on the Noteholders – in particular, given that the relevant inquiry is to compare the proposed scheme with the comparator, here insolvent liquidation, and not to compare it with the *present situation*, the difference in interest rates under the 2015 Notes and 2017 Notes was irrelevant as it would have no relevance in a state of insolvent liquidation.

Conclusion

The Court of Appeal's decision is a welcome development for companies seeking to restructure its debts by way of a scheme of arrangement in Singapore.

In adopting the Australian test – that third party releases are allowable so long as there was a sufficient nexus or connection between the release of the third party liability and the relationship between the scheme company and the scheme creditors, the Court of Appeal decided that the categories of third party releases were not rigidly limited. There was no reason why a guarantor could not seek a third party release of the principal debtor's debt. In doing this the Court of Appeal demonstrated that the Singapore Courts are alive to the commercial realities of complex group restructurings.

The Court of Appeal's guidance on the level of disclosure necessary at the leave stage is an important development for all potential applicants to bear in mind.

The Court of Appeal's provisional finding that holders of the 2015 Notes and 2017 Notes may vote as a single class also reinforces the Court's inclination to exercise caution to avoid the "impractical mushrooming of classes that could potentially result in the creation of unjustified minority vetoes"(***TT 1***).

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