SECTION 176 OF COMPANIES ACT 1965 - SOME ISSUES AND IMPLICATIONS

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INTRODUCTION

In the era of harsh economic recession, many financially over-stretched companies have run into difficulties and crisis. Inevitably, they have suffered the trauma of large corporate debts and are saddled with escalating debts or obligations which they find increasingly difficult to service. Statistics indicated that bankruptcy cases in Sabah rose by about 10% in the first six months of 1998[1]. By the same token, corporate and individual bankruptcies in Singapore increased by 20% over the same period in 1997 due to the Asian Economic downturn[2]. These highly- geared corporations have little choice but to formulate survival options including strategies for corporate rescues and reconstructions. One option which has increasingly been served as a lifeline to Malaysian companies is a restructuring process based on a scheme of arrangement pursuant to Section 176 of the Malaysian Companies Act 1965. According to reliable sources, there are about eighty financially-troubled companies which have applied for Section 176 to undertake reconstruction and more could be considering the same move[3]. This article will examine some of the issues and implications pursuant to Section 176 of the Malaysian Companies Act, 1965.

THE APPLICATIONS UNDER SECTION 176

Section 176 provides a simple way for distressed companies to reconstruct and restructure their insolvent affairs without the necessity of going through the normal process of winding-up. When the section was first enacted, it was intended to allow a company heavily burdened by debts but possibly still viable, to persuade its creditors that it would be in their interest to accept a scheme (as a means to compromise their debts) to arrive at a win-win conclusion.

Two main aspects of Section 176 are involved i.e. sub-section 1 and sub-section 10. Sub-section 10 is more contraversial as the ailing company will get the protection of the court by way of a restraining order against any proceedings being taken by creditors. In other words with the restraining order, creditors cannot take legal actions against the company except with leave of court. To illustrate, a restraining order granted under Section 176(10) will restrain banks from realising their security

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on which the credit facilities were granted or from recalling the credit facilities. The norm is that the ailing company often acts first by going to court under Section 176(10) to request for a restraining order so that it can buy time to get a scheme of arrangement in place.

On the other hand, Section 176(1) is used when the company has a scheme in place but seeks the court' s permission by stating that it wants to take the scheme to the creditors. A meeting of creditors is then ordered under Section 176(1) so that the company can put forward the scheme to seek the approval of three-quarters in value of the creditors (at least 75% of the amount owed). Upon obtaining the requisite majority of creditors, the company would apply to the court again for the approval of the scheme. Once the court approves the scheme, the company has to lodge a copy of the scheme with the Registrar of Companies. As soon as the order is lodged, all creditors of the company would be bound to observe the terms of the schemes. Appendix A will explain the different avenues of obtaining protection from creditors under Section 176[4].

It is observed that most of the cases currently go for orders under both Section 176(1) and (10) i.e. the companies go to court asking for the meeting of creditors to be held and at the same time obtain protection under sub-section 10 until the creditors meeting is actually held[5]. Under normal circumstances, a restraining order may be granted by the Court for a period of 3 to 9 months. In essence, it gives the ailing company the opportunity to come up with a scheme of arrangement without having to worry about the creditors chasing after them.

ADVANTAGES AND DISADVANTAGES OF SECTION 176

Section 176 procedures have proved to be beneficial to a corporation with a number of advantages[6]. They are as follows :-

- They allow very large and complex rescue and reorganisation to be performed by the ailing company;
- They avoid the proliferation of appointments for receiverships where many unsecured or secured lenders may be involved;
- They avoid the stigma of receivership or liquidation which is more likely to reduce the value of assets;
- They protect the assets of the company from creditors - to avoid the unseemly "Smash and Grab" rush by various creditors;
- They allow tax losses to be preserved for the distressed company; and

- They provide shareholders the brightest hope for some recovery of their investment in the troubled company.

However, like all things, Section 176 procedures also have shortcomings. Some of these as follows :-

- For the creditors to agree to the scheme of arrangement, the company must have a viable proposition, and, more importantly it should have a good management team. The information provided to the creditors at times may be too scanty or subjective for creditors to make informed decisions;

- There must be adequate funds or credit facilities available to the ailing company. Without adequate working capital, it is possible that the health of the company may not be "resuscitated" after the restraining period;

- The same people individuals who took the company to its current predicament are the ones who will largely decide on the scheme of arrangement;

- The procedures may prove expensive for some companies. In this respect, the newly-formed option such as Corporate Debt Restructuring Committee may provide another informal alternative of solving the same problem;

- Other creditors, for example the debenture holders, may like to appoint receivers as they are more comfortable with " their own man" ; and

- Companies more often than not come up with a hopelessly inadequate proposal or scheme to seek the cushion of Section 176 protection.

SOME ISSUES & IMPLICATIONS OF SECTION 176

What are the issues and implications associated with Section 176 for the investors, creditors and the public at large? Some of the issues are highlighted below :-

(1) Although Section 176 is not a new provision under the Companies Act, the umbrella of protection granted by the court to the ailing company has recently been extended to the financial institutions which have acted as guarantors for bonds issued by the troubled companies. It was reported that the protection had been granted by the court to nine companies worth around RM1 billion and this has far-reaching implications not only for the young local corporate debt market but also for all the fund managers holding these bonds in their portfolio[7]. In addition, Rating Agency Malaysia Berhad (RAM) has downgraded these corporate debt instruments and Private Debt Securities (PDS) to either a "D" or a stand alone "NP" rating[8]. These papers have become non-investment grade overnight due to the court's ruling to include guarantor banks under the blanket protection of Section 176. Once the investment papers become non-

investment grade papers, they are no longer good investments. A case in point is the insurance companies - they cannot hold any papers graded below "A3", yet they cannot unload the papers in the open market as there are no buyers.

The impact of court protection has somewhat shakened the market players. It was reported that many quarters, including one of the issuers which had filed for Section 176, were making attempts to exclude the bank guarantors of PDS from the court protection[9]. Market observers are asking for the rationale behind extending the protection under Section 176 to bank guarantors. The court protection given to such guarantors has defeated the purpose of bank guarantee because when banks step in to provide the guarantee, they charge a fee of about 1.5% of the total value of the bond issued to investors, for undertaking the risk of default.

(2) As stated earlier, once the company gets a restraining order under Section 176(10), the restraint prevents the creditors from proceeding with their actions. Existing actions, if any, against the company will be frozen at the point when restraining the order is given. A point of debate is whether the restraining order applies to judicial proceedings or non-judicial proceedings. If a creditor files action in court then it is a judicial proceeding, but what of the case of a debenture holder who is given the right under the debenture to appoint a receiver? The creditors of the company normally include secured and unsecured creditors and this may give rise to certain problems as they have different classes of rights. A debenture holder may be given the right to sell various assets under the charge without having to go to the court. The question is whether this situation is covered by judicial proceedings. It would appear that this has not yet been tested in Malaysia[10]. In other words a situation may arise where a scheme of arrangement does not cover "somebody" out who has a contractual right which can be enforced privately, without going to court.

(3) A group of professional bodies called the Company Law Forum has been pushing for judicial management to be incorporated into the Companies Act 1965. It was felt that under the current economic scenario, judicial management appeared to be more "favourable" because of its objectivity in approach and implementation. This means that there will be provisions which would allow the company, its directors or its creditors to apply to the court for an order that a viable company be placed under judicial management if it is unable to pay its obligations. A critical difference is that unlike Section 176, the court appoints a judicial manager to help

the company in the recovery process. As the judicial manager is supposed to be independent, it supersedes the management of the company and looks at the interest of both debtors and creditors. It is felt that the adopting of judicial management would add credibility to the whole process.

(4) With the setting up of the Corporate Debt Restructuring Committee (CDRC) by the Government as an informal way of attempting to solve the problems of non-performing loans, there is also the question whether more companies should resort first to this "friendlier arrangement" to reschedule their debts instead of going to court to ward off creditors. The CDRC, which is modeled after the London approach, allows a company with outstanding debts of over RM50 million from more than one financial institution to work out informal arrangements acceptable to both debtors & creditors without resorting to legal procedures. It is interesting to note that both the legal method (Section 176) and informal approach (CDRC) are not in conflict or competition as both attempt to turnaround viable businesses. In fact, some corporate leaders have suggested that CDRC should be the first line of action, failing which an application under Section 176(10) may be made. This would be achieved by agreement among borrowers, bankers and if required, the borrower's shareholders; and

(5) Last but not least is the question over the restraining order granted to troubled companies under Section 176(10) by the court. This usually stretches over a period of 3 to 9 months. The restraining order may be extended upon the expiry of the time period at the discretion of the court. The next question is for how long and extensive should the restraining period be extended? Some quarters think that the restructuring period is often misused by the distressed companies to delay or frustrate the winding-up proceedings by the creditors. In that case, the principal aims of the restraining order are no longer to secure the survival of the ailing companies or to achieve a compromise or an arrangement between the company and its creditors with a view to benefit all parties. It is simply a case of bad management using Section 176 as a tool against the interest of all the creditors.

RECENT AMENDMENTS TO SECTION 176

In view of the possible loopholes in the application for a restraining order under Section 176 (10), some amendments were made by the Registrar of Companies after consultation with the professional bodies. The amendments seek to ensure that creditors are aware of an application made under subsection

(10). In addition, the amendments also aim to ascertain that restraining orders are only granted under specific conditions to avoid any abuse. In this connection, Section 176 is amended by inserting the following subsections i.e. (10A), (10B), (10C), (10D) and (10E) after Section 176 (10).

"(10A) The Court may grant a restraining order under subsection (10) to a company for a period of not more than ninety days or such longer period as the Court may for good reason allow if and only if :-

(a) it is satisfied that there is a proposal for a scheme of compromise or arrangement between the company and its creditors or any class of creditors representing at least one-half in value of all the creditors;

(b) the restraining order is necessary to enable the company and its creditors to formalise that scheme of compromise or arrangement for the approval of the creditors or members pursuant to subsection(1);

(c) a statement in the prescribed form as to the affairs of the company made up to a date not more than three days before the application is lodged together with the application; and

(d) it approves the person nominated by a majority of the creditors in the application by the company under subsection (10) to act as a director or if that person is not already a director, notwithstanding the provisions of this Act or the memorandum and articles of the company, appoints the person to act as a director.

(10B) The person approved or appointed by the Court to act as a director of the company under subsection (10A) shall have a right of access at all reasonable times to the accounting and other records (including registers) of the company, and is entitled to require from any officer of the company such information and explanation as he may require for the purposes of his duty.

(10C) Any disposition of the property of the company, including things in action and any acquisition of property by the company, other than those made in the ordinary course of business, made after the grant of the restraining order by the Court shall, unless the Court otherwise orders, be void.

(10D) Where a company disposes or acquires any property, other than in the ordinary course of its business, without leave of the Court, every officer of the company who is in default shall be guilty of an offence against this Act.

Penalty : Imprisonment for five years or one million ringgit or both.

(10E) Where an order is made under subsection (10), every company in relation to which the order is made shall, within seven days :-

(a) lodge an office copy of the order with the Registrar, and

(b) publish a notice of the order in a daily newspaper circulating generally throughout Malaysia,

and every company which makes default in complying with this subsection and every officer of the company who is in default shall be guilty of an offence against this Act.

Penalty : One hundred thousand ringgit."

CONCLUSION

Looking at the way things are shaping up, it appears that Malaysia has found its way out of recession. With a debt-laden corporate sector, it is likely that many highly-leveraged companies will continue to resort to Section 176(10) for court protection. Indeed, some of Section 176 applications had been used to prevent cash-strapped companies from being brought to their knees. Section 176 also has other implications on the capital market. It was reported by RAM that as at end of August 1998, there were 287 public ratings amounting to RM46.24 billion. Of this amount, close to 40 per cent or RM17.07 billion were bank-guaranteed bonds and PDS. This will have some ramifications for the holders of bonds and PDS. Notwithstanding the above, with the recent amendments of Section 176, it is hoped that all the loopholes which were subject to abuse by companies are now closed. This is a step in the right direction and only time will testify to the effort to fortify the legislative framework[11].

REFERENCES

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2. *Investor Digest Mid August 1998 page 27*
3. *"Relevance of Debt Restructuring in Times of Need" Cheah Foo Seong, MAICSA Perspective*
4. *The Star Newspaper Wednesday 26, 1998 page 4 / Business*
5. *The Star Newspaper Wednesday 26, 1998 page 4 / Business*
6. *The Star Monday July 27, 1998 Page 19 / Business*
7. *The Edge, August 3 - August 9, 1998 Page 1*
8. *Note : An "NP" rating reflects high investment risks and doubtful capacity for timely payment in the short term while a 'D' rating means payment of interest or repayment of principal is in arrears. Already in default*
9. *The Edge, August 3 - August 9, 1998 Page 1*
10. *The Star Newspaper Thursday August 28, 1998 Page 4 / Business*
11. *Note : The new amendments will be effective from November 1, 1998.*

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