

HONG KONG / JUDGMENT

RE KB (ASIA) LTD

COURT

Court of First Instance

DECIDED

30 June 2014

CASE / FILE NUMBER

HCMP307/2013

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bjbj HCMP 307/2013 IN THE HIGH COURT OF THE HONG KONG SPECIAL ADMINISTRATIVE
REGION COURT OF FIRST INSTANCE MISCELLANEOUS PROCEEDINGS NO 307 OF 2013

IN THE MATTER of Section 166 of the Companies Ordinance, Cap 32 and IN THE MATTER of KB
(ASIA) LIMITED

Before: Hon Harris J in Court Date of Hearing: 27 May 2014 Date of Decision: 30 June 2014

DECISION

Introduction

On 18 December 2012 a petition was presented by Inspur (HK) Electronics Limited (Inspur) to wind up the Company on the grounds of insolvency. The Petitioner had obtained a judgment for US\$1,730,092 on 18 February 2010 and had come to terms for payment of this sum and interest in February 2011. The settlement was not honoured and Inspur relied on the outstanding debt of US\$1,781,465.22 to establish insolvency. As matters developed there was no dispute that the Company was massively insolvent and unable to pay Inspur. The Company sought time to present a scheme of arrangement for consideration by its creditors. I adjourned the winding-up petition. The company is a private company. It was involved in trading, principally, electronic products. The company is family owned and the family business has a long history. The company's audited financial statements show that in the financial year ending 31 March 2009, it had a turnover of \$252,940,994. The turnover increased by approximately another \$50 million in 2010. Then the financial fortunes of the company changed dramatically. The financial statement for the year ending 31 March 2013, which has recently been audited, shows that by the end of 2012 the company had a turnover of \$16,269,195. In practice, the company had ceased taking new orders

by February of 2012 and for the remainder of that financial year was involved in dealing with outstanding orders. In 2012, the company made an operating loss of \$98,489,497. The balance sheet for the year ending 31 March 2012 records that the company has very limited assets. Plant and equipment are valued at \$63,139 and trade and other receivables have diminished to \$760,270. This is a very significant reduction in the trade receivables shown in the financial statement for earlier years. Change in the balance sheet has come about largely, I understand, as a result of a significant proportion of receivables having been written off. On 14 February 2013 the Company applied by originating summons under section 166 of the Companies Ordinance, Cap. 32, for leave to convene a meeting of creditors to consider a scheme. When the matter first came before me on 26 March 2013 I declined to make such an order because it seemed to me that the explanatory statement was obviously inadequate and needed further work. I, therefore, adjourned the originating summons. It was restored on 5 July 2013. On that date I made an order convening a meeting, but made it clear, as is recorded in my judgment of that date, that I had concerns about the scheme. The relevant concerns were as follows: There was no convincing explanation of why the shareholder of the Company, Mr. Khemlani, would be prepared to inject, as the scheme provided, US\$1,000,000 into a company which was massively insolvent and had not active business. An injection of US\$1,000,000 would result in a return to unsecured creditors of 8%. This was inclined to encourage cynicism about why the Company had written off significant accounts receivables in its own books, which are the subject of a floating charge granted by debenture dated 25 September 2012 to a company owned by its shareholder called Rak Industries Limited (). The implication being that Mr. Khemlani was confident that the Company could secure repayment of some of the accounts receivables. There was no explanation of why a claim valued at approximately HK\$28,000,000 in relation to a letter of credit referred to in note 2 on page 17 of the explanatory statement against HSBC could not be profitably pursued by a liquidator. The note remains the same in the final version of the explanatory statement. The explanation is limited to a statement that HSBC had said that if litigation was commenced HSBC would withdraw all facilities to the Company. This consideration is, of course, now irrelevant. It might be relevant if it was understood as a threat to withdraw facilities to Mr. Khemlani and his other business interests. In 2012 and 2013 the Company paid its banks all debts due to them which totaled HK\$52,026,799. One scheme meeting took place on 25 September 2013 at which unsecured creditors were called upon to vote on the Scheme. Rak voted at that meeting. According to the Chairman's report 81.9% in value of unsecured creditors who attended in person or by proxy and voted, voted in favour of the Scheme. A majority in number of those attending in person or proxy also voted in favour of the Scheme. On the face of the matter, therefore, a statutory majority was obtained. The hearing of the Petition was delayed because of the death of Mr. Sunder Khemlani in November 2013 whilst on a business trip in Tanzania. Inspur objects to the court sanctioning the Scheme on four broad grounds:

- (1) There were no properly constituted classes of creditors for the purpose of the Scheme Creditors Meeting;
- (2) There was no fair and bona fide representation at the Scheme Creditors Meeting;

- (3) An honest and intelligent person would not approve the Scheme;
- (4) The Scheme Creditors were not given sufficient explanation of the Scheme and its effects to enable them to make a reasonable judgment as to how to vote at the meeting. Before turning to consider its reasons for objecting I will summarise the relevant legal principles. Legal Principles For the purpose of determining whether there were properly constituted classes of creditors in the Scheme Creditors' Meeting, the Court of Final Appeal has laid down the following general principles in *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* (2001) 4 HKCFAR 358 (at 27): It is the responsibility of the company putting forward the Scheme to decide whether to summon a single meeting or more than one meeting. If the meeting or meetings are improperly constituted, objection should be taken on the application for sanction and the company bears the risk that the application will be dismissed. Persons whose rights are so dissimilar that they cannot sensibly consult together with a view to their common interest must be given separate meetings. Persons whose rights are sufficiently similar that they can consult together with a view to their common interest should be summoned to a single meeting. 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. The fact that individuals may hold divergent views based on their private interests not derived from their legal rights against the company is not a ground for calling separate meetings. The question is whether the rights which are to be released or varied under the Scheme or the new rights which the Scheme gives in their place are so different that the Scheme must be treated as a compromise or arrangement with more than one class. The Court has no jurisdiction to sanction a Scheme which does not have the approval of the requisite majority of creditors voting at meetings properly constituted in accordance with these principles. Even if it has jurisdiction to sanction a Scheme, however, the Court is not bound to do so. The Court will decline to sanction a Scheme unless it is satisfied, not only that the meetings were properly constituted and that the proposals were approved by the requisite majorities, but that the result of each meeting fairly reflected the views of the creditors concerned. To this end it may discount or disregard altogether the votes of those who, though entitled to vote at a meeting as a member of the class concerned, have such personal or special interests in supporting the proposals that their views cannot be regarded as fairly representative of the class in question. As Lewison J explains in *Re The British Aviation Insurance Co Ltd* [2006] BCC 14 at 82, which was decided after *UDL Argos*, in deciding whether the classes of creditors were correctly identified, the starting point is to identify the appropriate comparator. Where a company is insolvent (as is the present case) or insolvent liquidation is the only alternative to the scheme, then insolvent liquidation is the comparator. The Court's function under Section 166 has been defined as summary and quasi-inquisitorial. The Court should not be pre-disposed to question statements made under oath by the Company. However, if there are matters that cast serious doubt on the opinion of the majority, the Court must give such matters their due weight. The Company is not entitled to the full protections of an adversarial hearing. When a serious allegation of collateral motive is made, it must be backed by proper evidence. Mr. Gormley argued that

where it is suggested that votes of a supporting creditor should be discounted it is not sufficient simply to demonstrate that the creditor is related to the Company. He referred me to the judgment of Kwan J (as she then was) in *Re App (Hong Kong) Ltd*. This is correct as far as it goes, but in my view the court can properly be invited to draw the inference from the relationships between a company and a creditor that a creditor has sufficient personal or special interest in supporting a proposal that its views cannot fairly be regarded as representative of the class in question; so much in my view is clear from the judgment of Lord Millett in *UDL*. Whether or not it is proper for the court to do so is fact sensitive, but it does not seem to me that it is essential to adduce direct evidence of a creditor having regard to collateral considerations.

Grounds of Opposition

The first ground of opposition is that Rak should not have voted as an unsecured creditor because it has security in the form of a floating charge over the Company's receivables. This was disputed by Mr. Gormley who appeared for the Company, who argued that the evidence filed by the Company indicated that Rak had waived its security. It does not seem to me that this is a fair reading of the evidence. Mrs. Khemlani, who is a director of both the Company and Rak, says this in the final two sentences of paragraph 10 of her affirmation in support of the Scheme: The secured creditor may agree the appraised value of its security interest with the Chairman and participate in the Scheme Creditors Meeting and vote for the unsecured portion of its admitted claim. In RAK's case, since the appraised value of the charged assets, trade and other receivables of the Company, is nil as clearly explained, the shortfall (i.e. whole amount due by the Company to RAK) should be regarded as unsecured liabilities. In his report to the court the Chairman of the meeting, Glen Ho of Deloitte Touche Tomatsu, records the following exchanges between him and various creditors:

5. Mr. Zou Bo asked whether Rak Industries Limited would waive the First Floating Charge as disclosed in Note 1 at page 23 of the English version of the Explanatory Statement. The Chairman stated that the background of the First Floating Charge and the nature of claim filed by Rak Industries Limited against the Company were disclosed at page 19 of the English version of the Explanatory Statement. The Chairman also stated that being the Chairman of the Scheme meeting, he was not in a position to answer the question on behalf of Rak Industries Limited.
6. Mr. Zou Bo asked whether Rak Industries Limited was of the same class of other scheme creditors as the shareholder(s) and/or director(s) of Rak Industries Limited were the family members of Mr. Sunder Khemlani, a director of KB (Asia) Limited. The Chairman stated that all the related companies including Rak Industries Limited were disclosed in section 5 of the Explanatory Statement and according to the Scheme Document, Rak Industries Limited was under the same class with other scheme creditors as they were all unsecured creditors with similarity of rights.

7. Mr. Liaw Desmond Tai Niap, a proxy of Reed Smith Richards Butler, asked whether the claim amount of Rak Industries Limited was admitted for voting purposes. The Chairman stated that Rak Industries Limited was admitted for voting purposes and that it had the right to vote as it was one of the scheme creditors.
8. Mr. Zou Bo asked whether the scheme creditors would be entitled to share the future profits of the Company if the Company were profitable in the future. The Chairman stated that pursuant to the terms of the Scheme of Arrangement, the scheme creditors were only entitled to receive a sum of approximately HK\$7.8 million (equivalent of US\$1 million) if the scheme becomes effective and the remaining liabilities due by the Company to its scheme creditors would be discharged. As I read these passages Mr. Ho is stating that he did not know whether the floating charge had been waived or otherwise discharged. If he did know he should have answered the question accurately. I do not accept, as Mr. Gormley suggested, that because at the end of paragraph 10 of his Report, Mr. Ho says the appraised value of the debt due to Rak is zero and Rak should be regarded as an unsecured liabilities, it follows that the floating charge must have been released. On the contrary the language used tends to suggest that Mr. Ho approached the treatment of Rak's debt in accordance with clause 3.7 of the Scheme which provided that a secured creditor could be admitted as Scheme Creditor by either foregoing his security or by agreeing an appraised value for it and voting any shortfall. The language Mr. Ho used suggests that he dealt with Rak's debt in accordance with the latter mechanism, which in turn indicates that the security had not been released, or possibly, that it had been, but he had not been told. However, as Mrs. Khemlani in her evidence makes no reference to the security being released, as I would have expected if it had been, it seems to me that the only inference that can sensibly be drawn is that it had not been. I am fortified in this conclusion by the fact that at no time during the hearing did Mr. Gormley receive instructions, and his clients were in court, that the security had been released. Mr. Ho seems to have thought that clause 3.7(a) of the Scheme allowed him to value the security at zero and to admit Rak as an unsecured creditor for the whole of its debt. On its face clause 3.7(a) does allow him to do so if the Scheme is sanctioned. However, this is not the relevant test for the purposes of determining whether or not the class voting has been properly constituted. The test is whether or not the court considers that Rak's legal rights and those of the unsecured creditors were so dissimilar that they could not sensibly be allowed to consult together over the merits of the Scheme. In my view they could not. The critical difference between Rak and the unsecured creditors is that if, as I shall assume on the basis of the evidence before, Rak did have a floating charge over the accounts receivables it did not have to concern itself with whether or not the accounts receivables proved to be recoverable in the future because if they did it would benefit. I do not consider Inspur's concern that accounts receivables may prove recoverable in the future fanciful. In my view the classes were not properly constituted and for this reason the Scheme fails. The second objection is that there was no fair and bona fide representation at the Scheme Creditor's meeting. There is no dispute that the Company formed part of a family business which included other companies. Rak, for example, is owned by Mr. Khemlani's sons. Mr.

Khemlani's interests in other creditors are explained on page 27 of the Explanatory Statement, which was drafted at a time when he was still alive. It tells us: Mr. Sunder Khemlani is one of the two directors of the Company, which is wholly owned by KB Group Limited. Mr. Sunder Khemlani is the sole shareholder of KB Group Limited. Mr. Sunder Khemlani is a Scheme Creditor himself with a claim of HK\$7,805,954 (after he settled the bank loan of the Company on its behalf: see above). He is also the ultimate beneficiary owner of KB Group Limited, KB (HK) Limited and KB (Far East) Limited, which are also Scheme Creditors with claims of HK\$708,356, HK\$2,933,543 and HK\$65,600 respectively. The natures of these liabilities are provided in Appendix 6. Ms. Jyoti Khemlani is another director of the Company. Ms. Jyoti Khemlani (wife of Sunder Khemlani), Mr. Anand Khemlani and Mr. Rajiv Khemlani (sons of Sunder Khemlani and Jyoti Khemlani) are shareholders of Rak Industries Limited, which is also a Scheme Creditor with claim of HK\$38,462,147 after they settled the bank loan of the Company on its behalf (see above). Ms. Jyoti Khemlani and Mr. Anand Khemlani are directors of Rak Industries Limited. Page 20 of the Explanatory Statement sets out reasons why Mr. Khemlani wished to keep the Company alive and was prepared to inject US\$1,000,000 into it: The Company operated a trading business that was 60 years old and had been founded by his Father. The Company and its directors have considerable good will and many of its suppliers and customers remain supportive of it. This is due to the building up of relationships over a lengthy period. The Khemlani Family would prefer creditors to receive something rather than nothing. I accept for present purposes that Mr. Khemlani would have preferred creditors to recover something, however, it is clear, as indeed I would expect, from a fair reading of the relevant paragraphs that the main incentive for making a payment to creditors was the commercial value that he believed existed in the Company's name and to continue what he describes as the family business. This invites the suggestion made by Inspur that in these circumstances the family creditors, in particular Mr. Khemlani himself, have a purpose in supporting the Scheme other than maximising their recovery as creditors. In this regard they do have a special interest which differs from the interest of the ordinary independent and objective creditor: *Re British Aviation*. In my view the Explanatory Statement does demonstrate that, what I shall call, the family creditors do have a special interest to promote in determining how to vote and that accordingly their vote should be discounted. If their votes are ignored a statutory majority has not been achieved. The third ground of opposition is that no honest and intelligent person would support the Scheme. This is an established ground for the court refusing to sanction a scheme. It amounts to saying that it is irrational for a creditor to support it. I disagree. Recovering the accounts receivables, many of which seem to have been outstanding for years, or recovery from HSBC, would be an expensive and time consuming and there is no certainty that it would be successful. There is no guarantee that if anything is recovered it will exceed the amount offered by Mr. Khemlani. Although I can understand Inspur's objections to the Scheme and its decision to oppose it, it does not seem to me that it can fairly be said that a decision to support it is irrational. Given the generally low level of recoveries in liquidations of companies which have no substantial assets other than prospective claims against third parties it seems to me that there are likely to be few

cases in which it can fairly be said that a creditor's decision to accept an immediate modest payment rather than wait in the hope of a larger recovery as a result of the liquidation process is irrational. The fourth ground of opposition is that the Scheme did not provide enough information. I disagree. It seems to me that the Scheme Document provided sufficient information for an honest and intelligent creditor having regard to relevant considerations to make a decision whether or not to support the Scheme. The gravamen of Inspur's objections is that the Scheme is not put forward honestly and it advances principally two reasons for this: first, that accounts receivables have too readily been written off and, secondly, that a claim against HSBC has not been pursued. It seems to me that the Scheme tells creditors enough about these matters to determine whether or not it is better for the Company to be put into liquidation with a view to a liquidator investigating these matters or to take the sum currently offered.

Conclusion

I am not satisfied that the class of voters was properly constituted, which is enough to justify dismissing the Petition. It also seems to me that the creditors related to Mr. Khemlani have an interest in supporting the Scheme that differs from the ordinary unsecured creditor and that the court should, if I were wrong about the first matter, take this into account in determining whether the 75% threshold has been achieved. In my opinion their votes should be discounted and it follows a statutory majority has not been achieved. So far as costs are concerned I order that the costs of the Inspur are paid by the Company and be treated as part of the costs which Mr. Khemlani has undertaken to pay. (Jonathan Harris) Judge of the Court of First Instance High Court Mr Anthony Michael Gormley, instructed by Lo, Wong & Tsui, for the applicant Mr Anson Wong SC and Mr Martin Ho, instructed by Hastings & Co, for the opposing creditors, Inspur (HK) Electronics Limited HK\$86,824,448.83 total debt was voted without any abstentions. Lam J in Re PCCW Ltd CACV 85/2009 at 114- 116 Lewison J in Re Linton Park Plc [2008] BCC 17 at

[2005] 1 HKLRD 272 at 31; see also Lord Millett in UDL supra at 372J to 373B and Chadwick LJ in Re BTR Plc [2000] 1 BCLC 740 at 747G to 748B. Supra 69 quoting Re BTR Plc [2000] 1 BCLC 740 PAGE - A B C D E F G H I J K L M N O P Q R S T U V A B C D E F G H I J K L M N O P Q R S T U V A B C D E F G H I J K L M N O P Q R S T U V h n 6 \ h n 6 \ g d n 6 \ g d == / g d n 6 \ g d n 6 \ g d n 6 \ h _ Y ; g d | % \ g d == / h e ! M h _ Y ; h | % \ h == / h 3 U h 3 U h 3 U h 3 U h _ Y ; g d 3 U h == / h 8 L L h == / h == / h == / h == / g d > = g d == / h _ Y ; h I \$ W g d I \$ W g d I \$ W h I \$ W h _ Y ; x t m b h I \$ W g d I \$ W z m \ O B h == / h == / h t G g d ~ K u g Z I < [Content_Types].xml I w } , \$ y i } _ r e l s / r e l s t h e m e / t h e m e / t h e m e M a n a g e r . x m l K Y , s Q } # t h e m e / t h e m e / t h e m e 1 . x m l w t o c ' v) I ` n 3 V q % ' # q x } r : \ T Z a G I u 3 L + M 2 e \ O \* \$ \* c ? ) 6 - r I q b J # x , A G m T [ X F 6 4 E ) ` # R > Q D = (K & = a l - 4 v f a 0 % M 0 t h e m e / t h e m e / _ r e l s / t h e m e M a n a g e r . x m l . r e l s 5 6 ? \$ Q K (M & \$ R (. 1 [Content_Types].xml PK _ r e l s / r e l s P K t h e m e / t h e m e / t h e m e M a n a g e r . x m l P K t h e m e / t h e m e / t h e m e 1 . x m l P K t h e m e / t h e m e / _ r e l s / t h e m e M a n a g e r . x m l . r e l s P K < ? x m l v e r s i o n = " 1 . 0 " e n c o d i n g = " U T F - 8 " s t a n d a l o n e = " y e s " ? > < a : c l r M a p x m l n s : a = " h t t p : / / s c h e m a s . o p e n x m l f o r m a t s . o r g / d r a w i n g m l / 2 0 0 6 / m a i n " b g 1 = " l t 1 " t x 1 = " d k 1 " b g 2 = " l t 2 " t x 2 = " d k 2 " a c c e n t 1 = " a c c e n t 1 " a c c e n t 2 = " a c c e n t 2 " a c c e n t 3 = " a c c e n t 3 " a c c e n t 4 = " a c c e n t 4 "

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