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SPECIAL ALERT !

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Shifting Tides: The Fate of Arbitration Clauses in Liquidation Proceedings

Swissray Asia Healthcare Co. Ltd v V Medical Services M Sdn Bhd (Civil Appeal No. W-02(NCC)(A)-1479-08/2022) ("**Swissray**")

&

Sian Participation v Halimeda International Ltd [2024] UKPC 16 ("**Sian Participation**")

As creditors in insolvency or liquidation proceedings, can you apply to wind up or bankrupt a debtor if the disputed debts in question are subject to an arbitration agreement? In the past few years,[1] creditors in Malaysia were told that they could not. Instead, debtors were allowed to apply for a fortuna injunction or a stay of the winding-up process in situations where there exists a valid and operative arbitration agreement, irrespective of whether there were substantial grounds for disputing the debt.

With two recent decisions delivered by the Court of Appeal of Malaysia and the Privy Council respectively,

[1] ***NFC Labuan Shipleasing I Ltd v Semua Chemical Shipping Sdn Bhd*** [2017] MLJU 900 was the first reported case in Malaysia to adopt the principles enunciated by the English Court of Appeal in ***Salford Estates (No 2) Ltd v Altomart Ltd (No 2)*** [2014] EWCA Civ 1575 which held that a winding-up petition ought to be stayed if the underlying debt was subject to an arbitration agreement.

the tides have shifted – debtors are now required to demonstrate that a debt is *"bona fide"* disputed, or in other words disputed on "*genuine and substantial grounds*", before a winding-up petition can be stayed for the dispute to be referred to arbitration. Creditors can now breathe a huge sigh of relief. In situations where a debt is not genuinely or substantially disputed, arbitration agreements will no longer act as an impediment to insolvency proceedings.

In this alert, we will first discuss the decisions in ***Swissray*** and ***Sian Participation***, before exploring the potential implications of these two decisions in Malaysia.

Swissray – Court of Appeal of Malaysia

(a) Brief Facts

The appellant and the respondent entered into a distributorship agreement that contained an arbitration clause. In May 2016, the respondent received two medical machines which it ordered from the appellant. When the appellant demanded payment, the respondent denied that any sums were owed to the appellant and disputed the existence or validity of such purchase, since certain terms were unfulfilled by the parties.

The appellant sent notices of demand to the respondent premised on the outstanding sums for the medical machines supplied. After failed attempts at reaching a settlement, the respondent applied for a fortuna injunction to restrain the appellant from presenting a winding-up petition against it on the grounds that there existed a disputed debt without any final award or judgment.

The High Court allowed the respondent's application for a fortuna injunction. Dissatisfied with the High Court's decision, the appellant appealed.

(b) The Court of Appeal's Decision

The key issue for determination was whether the *bona fide* dispute test (which carries a higher threshold) or the

prima facie dispute test (which has a lower threshold) should apply to an application for a fortuna injunction to stay or restrain a winding-up petition where there exists an arbitration agreement. The "*bona fide dispute test*", if applicable, would entitle the courts to examine the genuineness of the dispute.[2]

The Court of Appeal dismissed the High Court's decision and found that a fortuna injunction should only be granted if the debts are genuinely disputed. Importantly, it was held that a party seeking to restrain a winding-up petition must show the existence of a bona fide dispute, and not merely a prima facie dispute, even in the face of an arbitration clause. The rationale for the Court of Appeal's decision includes, among others:

a. While parties are bound to an arbitration agreement as the chosen mechanism for the resolution of their dispute, they must equally be held to the terms of their contract that they have chosen to enter, i.e., make payment for the medical machines purchased from the seller.[3]

b. The existence of an arbitration clause cannot be relied upon as "*some mechanical mantra*"[4] to evade what would otherwise be a legitimate claim for a debt. If the courts are refrained from considering whether the dispute is genuine or *bona fide* and are required to refer parties to arbitration, this effectively suggests that "*judges are to abdicate their responsibility*"[5] and "*throw up their hands in the air in abject surrender*"[6] whenever there exists an arbitration clause. Justice Collin Lawrence Sequerah opined that the courts' hands should not be tied in this manner.[7]

c. It would be an abuse of process if frivolous disputes can be asserted by a debtor, to derail or distract attention from the legitimate presentation

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[2] Swissray, Grounds of Judgment, paragraphs 38 and 57.
[3] Ibid, paragraph 73.
[4] Ibid, paragraph 72.
[5] Ibid, paragraph 57.
[6] Ibid, paragraph 56.
[7] Ibid, paragraph 60.

of a winding-up petition, when in fact there is no genuine dispute on the debt.[8]

In this case, there were repeated admissions of the debt owed by the respondent to the appellant. Upon examining the facts, the Court of Appeal found that no bona fide dispute existed. The appeal was allowed, and the fortuna injunction ordered by the High Court was set aside.

Sian Participation – Privy Council

(a) Brief Facts

The respondent advanced a loan of USD 14 million to the appellant under a facility agreement. The loan was not repaid. As of December 2020, the outstanding debt was over USD 226 million ("**Debt**").

The respondent commenced winding-up proceedings in the British Virgin Islands ("**BVI**") court premised on the Debt. The appellant disputed that the Debt was due on the basis of a cross-claim and/or set-off and applied for the winding-up proceedings to be dismissed or stayed due to the existence of an arbitration agreement in the facility agreement. The appellant argued that the respondent should have established the Debt in arbitration.

The BVI Commercial Court and Court of Appeal found that the Debt was not disputed on substantial and genuine grounds. The winding-up process should not be stayed despite the Debt falling within the scope of the arbitration agreement. In November 2023, the appellant was granted permission to appeal.

(b) Privy Council's Decision

The Privy Council decided that where a debt is disputed and subject to an arbitration agreement, the applicable test in determining whether a winding-up petition should be stayed pending arbitration would turn on whether the

[8] Ibid, paragraphs 68 – 69.

debt is disputed on genuine and substantial grounds. The rationale behind the Privy Council's decision includes, among others:

a. A winding-up petition does not involve the resolution of any dispute pertaining to the existence or amount of a debt, nor does such proceedings require a determination on whether a petitioner is owed money.[9] The winding-up or insolvency proceedings, therefore, do not offend the obligations in an arbitration agreement where parties are required to refer disputes to arbitration.

b. The legislative policies and objective of arbitration – party autonomy, limited curial intervention, and efficiency – would not be infringed if a company is wound up in situations where the debt was not genuinely disputed on substantial grounds. Conversely, if a creditor is compelled to arbitrate in the absence of a genuine or substantial dispute, this would lead to "*delay, trouble and expense for no good purpose*".[10]

The Privy Council held that its decision and the above rationale would also apply to debts subject to an exclusive jurisdiction clause. However, if an arbitration agreement or exclusive jurisdiction clause contains terms that apply to liquidation or winding-up proceedings, different considerations would arise.[11]

Impact of *Swissray* and *Sian Participation* in Malaysia

In light of the decisions in ***Swissray*** and ***Sian Participation***, it appears that arbitration agreements are no longer given preferential treatment in winding-up or insolvency proceedings. The courts will likely scrutinise the genuineness and substantiveness of disputed debts when deciding whether to stay or refrain from winding-up proceedings and refer parties to arbitration.

[9] Sian Participation, Grounds of Judgment, paragraph 88.
[10] Ibid, paragraph 92.
[11] Ibid, paragraph 127.

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These two recent decisions will likely have the following implications for creditors and debtors in winding-up petitions and insolvency proceedings:

a. For debtors, it may no longer be feasible or advisable to insist on invoking an arbitration agreement as a primary defence or response to a winding-up petition. The courts are unlikely to grant a stay of proceedings purely because there is an assertion that the debts in question are disputed. It must be proven that the debts are disputed on genuine and substantive grounds.

b. For creditors, if there exists an arbitration agreement, a winding-up petition or insolvency process would not be stayed purely on the basis that the debts are disputed by the debtor. The winding-up or liquidation process will only be stayed if a debtor can demonstrate the existence of a *bona fide* dispute or if the debts are disputed on "*genuine and substantial grounds*".

Swissray and ***Sian Participation*** are significant because they have departed from the English Court of Appeal's decision in ***Salford Estates***,[12] an approach which the Malaysian courts and other common law jurisdictions (e.g., Singapore) have adopted in recent years. If ***Salford Estates*** remains good law, a winding-up petition will generally be dismissed or stayed if a disputed debt is subject to an arbitration agreement, regardless of whether there are substantial grounds for disputing the debt.

It is anticipated that creditors, especially financial institutions, will welcome the decisions in ***Sian Participation*** and ***Swissray*** as they would be more inclined to agree to the inclusion of an arbitration agreement or clause in their contracts if the liquidation process is not hindered by unsubstantial or ingenuine dispute on the debt.

It will also be interesting to observe how the Malaysian Courts will, in the near future, reconcile the decisions in

[12] ***Salford Estates (No 2) Ltd v Altomart Ltd (No 2)*** [2014] EWCA Civ 1575.

Swissray and ***Sian Participation*** with Section 8[13] of the Arbitration Act 2005 ("**AA 2005**"), a statutory provision unique to the arbitration legislation in Malaysia.[14] The phrase "*No court **shall** intervene … except where so provided in this Act*" embodied in Section 8 effectively confines the powers of the Malaysian courts to matters expressly provided in the AA 2005. Thus, if a winding-up petition is not mandatorily stayed pursuant to Section 10 of the AA 2005 despite the existence of a valid and operative arbitration agreement, where does this leave Section 8 of AA 2005?[15] This is an important issue which the Malaysian courts should address in future cases.

The judgment of the Privy Council in ***Sian Participation*** can be accessed here. The judgment of the Malaysian Court of Appeal in ***Swissray*** has not been reported as of the date of publication of this Alert.

If you have any queries, please contact Associate, **Soh Zhen Ning** (szn@lh-ag.com), Pupil, **Lim Jia Yun Ruth** (jylim@lh-ag.com) or their team Partner, **Crystal Wong Wai Chin** (wwc@lh-ag.com).

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[13] Section 8 of AA 2005 reads: "No court shall intervene in matters governed by this Act, except where so provided in this Act."

[14] In other jurisdictions, such as the UK, the equivalent of Section 8 of AA 2005 does not contain the word "shall" which carries a mandatory requirement that the Malaysian courts cannot act beyond the matters provided in the AA 2005. Section 1(c) of the UK Arbitration Act 1996 states "*… in matters governed by this Part the court should not intervene except as provided by this Part*".

[15] This issue was not addressed in the case of ***Swissray***. As the wording in Section 8 is unique to Malaysia's arbitration law, this issue was not explored by the Privy Council in ***Sian Participation***.

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