



LOAN RECOVERY THROUGH DEBENTURES
THE MALAYSIAN BANKING EXPERIENCE

BY

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ABSTRACT

The debenture is one of the standard securities accepted by banks in its lending activities. The debenture can only be provided by a company registered at the Registrar of Companies. Individuals, partnerships and cooperatives have no power to create debentures. A bank will normally require the corporate borrower to provide a debenture as a collateral apart from landed properties, cash deposit, assignment, pledge of shares or other forms of security. The main benefit of having a debenture is, the recovery process is effectively faster, without having to go through the normal legal process. The banks can appoint a receiver to sell the charged asset including the landed property on a private treaty without going through the judicial sale. The creation of debenture is also accepted in Islamic Banking. Nevertheless, for purposes of Islamic Banking, the content of debenture shall be free from *Riba*, *Gharar*, *Maysir* and *Jahl*.

However, the right of debenture holders (banks) has been vitiated by recent developments such as new case laws, rules and regulations of the country. The court decision in the Kimlin case has taken away the power of the debenture holder to sell landed properties by private treaty. The court decided that the sale of charged lands which belong to defaulting corporate borrowers must strictly follow the requirements as section 257 of the National Land Code 1965. The court decision in the Kimlin case has to some extent defeated the purpose of the bank having a debenture.

Apart from the case, during the 1997 financial crisis, many companies sought and received relief and protection pursuant to section 176 of the Companies Act. Under section 176, the court can issue summary orders to temporarily restrain creditors from proceeding to liquidate the company. Once the court issues such Restraining Orders, the bank, as a debenture holder cannot exercise its right.

The formation of Danaharta by the Government has also to some extent affected the legal remedies of debenture holders. Once the charged asset is disposed to Danaharta, the debenture holders (banks) have no right to claim the shortfall of the loan outstanding from the borrowers. This position in reality gives the negative benefit to the debenture holders. Under the Danaharta Act 1998, Danaharta is empowered to appoint special administrators to take over the asset and management of company without the consent of the lenders. Once a special administrator is appointed all rights of the debenture holders is lost.

The creation of Corporate Debt Restructuring Committee (CDRC) has also to some extent affected the debenture holder's right. Unlike Danaharta, which has legal power to exercise its right, CDRC uses moral suasion of Bank Negara to the lenders to accept any scheme of arrangements introduced by them. The debenture holders once again cannot use its right once they accept the scheme of arrangement of CDRC.

The main objective of this study is basically to ascertain whether the present law and regulations on debentures provide sufficient remedies for the financial institutions to recover its loans. The second objective is to examine whether the content of debenture documents used by the Islamic financial institution is in line with Syariah. The third

objective is to study whether the present practice of loan recovery through enforcement of the right of debenture holder is in line with the Syariah principles.

The dissertation begins with an introduction that incorporates remarks pertaining the new developments, which has affects the right of debenture holder. This chapter also contains the background of the study, the statement of problem, research methodology and scope and limitation of the study.

Chapter two dwells on the topic type of securities taken by the financial institutions other than debenture such as land charges, guaranteed indemnity, letters of pledge, hypothecation, lien, assignment, promissory note and mortgage of ship.

Chapter three explain in debentures on details. It covers the definition of debenture, type of debenture, type of charges under the debenture, documentation of debentures, the rights of debenture holders and the debenture from Syariah perspective.

Chapter four focuses on the recent developments, which have vitiated the right of debenture holders. This includes the implications of the Federal Court decision in Kimlin's the impact of section 176 of the Companies Act 1965, the establishment of Danaharta and the formation of (CDRC). In this chapter, the operation of Danaharta and CDRC will be reviewed and to ascertain whether the practice is in line with the Syariah principles.

Chapter five is the conclusion and recommendation chapter. In this chapter the discussion is on whether the right of debenture of holder is protected with the recent developments. Some findings are made on this issue. Besides some comments, recommendations are given in view of improving the right of debenture holder. Finally, it is hoped that this study can be used as additional reference on the subject of debenture. It is also hoped that the finding of the study can help the authority to do the necessary changes to improve the right of debenture holders.

ملخص البحث

استقبلت مصارف السند أحد من المستوى السندات في اقراض أعمالها. يستطيع شركة الرئيس في رئيس الشركة. ليس عند الأفراد والشركة والقانون الوسع ليكون السند. البنك سيطلب المقترض للشركة ليزود السند كضمان منفصلا من الملكية عقارية ودفع النقد والتحويل والرهن من السهم والآخر طيعا.

الفائدة الرئيس في السند أن يكون استرداد العمل أسرع مؤثرا ليس عنده أن يمر سار القانون طيعا. يمكن على بنك أن يعيش المستسايد لبيع أصول التكلفة. بما فيه ملكية عقارية في معاهده الخاص وليس عليه أن يمر ببيع القضائي. قد استقبل تكوين السند في مصرفة الإسلامية. وعلى الرغم من هذا للغاية في مصرفة الإسلامية لا بد على محتويات السند حرا من الربى والقرار والميسر والجهل.

ولكن قد عند الحق صاحب السند (البنك) بتسمية الأحداث مثل الأحكام القضائية في "KIMLIN" الوسع في صاحب السند أن يبيع ملكية عقارية بمعاهده الخاص. حكمت المحكمة أن واجب على بيع أرض تكليفي التي يملك بصاحب السند معسرة أن يبيع المتطلبات كباب "National Land Code" 257 حكم المحكمة في "KIMLIN" قد إلى حد ما الغاية البنك في ملكية السند.

بالنسبة إليه في أثناء أزمة مالية في ١٩٩٧، طلبت كثير من الشركة الشعور بالاتيح بعد ثراء والأم وحماية بناء على باب 176 Companies Act. تحت هذا الباب تستطيع المحكمة أن يخرج خلاصة الأمر ليقيد دوائن في اتخاذ أن يتهلك الشركة مؤقتا، قليلا ما المحكمة أن يخرج قياد الأمر لا يستطيع البنك كصاحب السند أن سيعمل حقه.

قدأثر تكوين "DANAHARTA" من الحكومة إلى حد ما دواء القانوني صاحب السند أيضا، قليلا ما خرج أصول التكليفي على DANAHARTA ليس عند صاحب السند الحق أن يطلب الباقي في القروض القائمة من الدوائن. في الحقيقة هذا الموقف يعطي فائدة سلبية إلى صاحب السند تحت DANAHARTA ACT 1998 يفوض على DANAHARTA ليعيش أولياء الخاصة أن يأخذ شركة الأصول والتدبير دون رضا الدوائن. قليلا ما عين أولياء الخاصة كل حقوقهم باطلاع.

قد أثر تكوين أهله إعادة هيكلة دين الشركة إلى حد ما الحق صاحب السند أيضا بخلاف " DANAHARTA" الذي عنده وسع القانوني لاستعمال حقه، سيستعمل "CDRC" إقناع قائم على أساس أخلاق عن BANK NEGARA إلى دوائن أن يسلموا أي حظه ترتيبات.

الغاية الرئيس في البحث مبدئ أن تحقق أما القانون والتنظيم الحالي في سندات يعد دواء كفاة في مؤسسات مالية أن يرتد دينه. الغاية التالي أن يمتحن أما المحتويات في وثيقة السند استعمال بمؤسسات مالية إسلامية وافق في الشريعة.

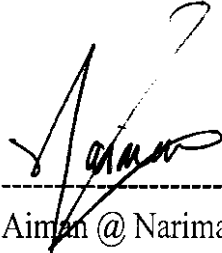
يبدأ هذا البحث بمقدمة التي تحتوي المذكور في تنمية الأحداث التي تؤثر الحق صاحب السند. هذا الفصل يحتوي تاريخ البحث وكشف المسألة ومناهج البحث ومجال وتحديد البحث أيضا. باب الثاني يتناول بأسهاب وتفصيل في الموضوع أنواع السندات أعطى من مؤسسات مالية دون السند مال أرض التكليفي وتفويض الضمان وخصاب الضمان ومرهمي وحق امتياز وتحويا وسند أذني وسفينة عقاري. باب الثالث يوضح بتفصيل سندات وضحيا يحتوي التعريف السند ونوع السند ونوع العروض تحت السند ووثيقة السند والحقوق صاحب السند والسند في طريقة الشريعة.

باب الرابع يوضح في تنمية الأحداث التي قد أفسدت الحق صاحب السند. هذا يحتوي على استدلال في الحكم Federal Court في "KIMLIN" وأثر في باب 176 Companies Act 1965 وتأسيس "DANAHARTA" وتكوين "CDRC" سمرض وأن يمتحن أما التنفيذ وافق على طريقة الشريعة. باب الخامس هو باب الخلاصة والتوصية في هذا الباب المناقشة هي أما حق صاحب السند سمي بتنمية الحداث. خلق بعض قرار المحلفين في هذه المسألة.

بالنسبة إلى بعض تعليق أعطى توصية لتحسين حق صاحب السند. في النهائي لعل استعمال هذا البحث كالمراجع صاحب السند. لعل قرار المحلفين في هذا البحث أن يعلن السلطة ليكون تغيير مباح لتحسين السند.

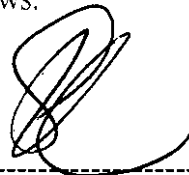
APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Comparative Laws.



Aiman @ Nariman Bte Mohd Sulaiman
Supervisor

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Samsar Kamar Bin. Hj. Abdul Latif
Examiner

This dissertation was submitted to Ahmad Ibrahim Kulliyah of Laws and is accepted as partial fulfilment of the requirements for the degree of Master of Comparative Laws.




Nik Ahmad Kamal Nik Mahmod
Dean, Ahmad Ibrahim Kulliyah of Laws

DECLARATION

I hereby declare that this dissertation is the result of my own investigations except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and bibliography is appended.

Name: Md Noor Bin Mohammad Yusoff

Signature:..........

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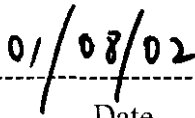
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Islamic Banking Act 1983 (Act 276)

Merchant Shipping Ordinance (No. 70 of 1952).

National Land Code 1965 (Revised 1990)

Pengurusan Danaharta Nasional Berhad 1998 (Act 587)

The Securities Commission Act 1993

LIST OF ABBREVIATIONS

A.C.	Appeal Cases
Ag.	Acting
All E.R.	All England Law Reports
A.M.R.	All Malaya Reporters
Anor	Anor
©	Copyright
Cap.	Chapter
cf	Compare
C.J.	Chief justice
C.L.J.	Current Law Journal
C.P.C.	Criminal Law Journal
D.P.P.	Deputy Public Prosecutor
e.g.	(exempligrana) For example
F.C.J.	Federal Court Judge
F.M.S.	Federal Malay States
Ibid	(ibidem) As cited above
Id	(idem) As cited above at different page
i.e.	That is
J.	Judge
JC	Judicial Commissioner
J.C.A.	Judge of the Court of Appeal
JH	Jurnal Hukum
J.M.C.L.	Journal of Malaysian and Comparative Law
Jr.	Junior
JT	Judgment Today
K.B.	King's Bench
Ky.	Kyshe's Report
L.J.	Lord Justice
L.P.	Lord President
M.C.	Malayan Cases
M.L.J.	Malayan Law journal
n.	Footnote
Ors.	Others
p.	Page
pp.	Pages
P.C.	Privy Council
P.P.	Public Prosecutor
R.	Rex
Reg.	Regina
S.C.J.	Supreme Court Judge
S.L.R.	Singapore Law Reports
s.	Section
ss.	Sections
Supp.	Supplement
Supra	As cited earlier
v.	Versus

Viz.	(videlicet): namely
Vol.	Volume
W.A.L.R.	West Australian Law Report
w.e.f.	With effect from

CHAPTER ONE

PRELIMINARY CHAPTER

1.1 INTRODUCTION

The Asian financial crisis, which started in mid-1997, has adversely affected banking performance in most of the countries in the Far East and South East Asia. Many banks in Japan, Thailand and Indonesia had no alternative but to close their operations. The surviving banks on the other hand, have been left with high non-performing loans. Malaysia also experienced the same phenomenon. The net non-performing loans of the Malaysian banking industry rose from 4.1% in December 1997 to a peak of 14.9% in November 1998¹. The concern at this juncture was whether the bank has sufficient remedies provided by the law to recover their outstanding loans. The bank normally provides loans to corporate borrowers based on the strength of securities offered. The standard securities acceptable to banks are:

- a. Debenture – Registered at Registrar of Company
- b. Torrens Land Charge – Registered at Land Office
- c. Pledges of shares and deposits
- d. Corporate and Individual Guarantee/Indemnity
- e. Mortgage of Ships
- f. Assignment

When a borrower defaults on payment of his loans, the bank will exercise its right to recover the loan through formal and/or informal methods. If a bank has created a

¹ C Rajandaran, *A Debt Restructuring, Recapitalisation Financial and Economic Implication*, in MIER NATIONAL ECONOMIC OUTLOOK 2000 CONFERENCE, Nikko Hotel, Kuala Lumpur, pg 17.

debenture, it may exercise its right as provided under the debenture in which the bank can appoint a Receiver and Manager subsequently to sell the asset of the defaulting borrower/company. However, the right of a debenture holder has been vitiated by the new development in the landmark case of **Kimlin**², protection from section 176 of the Companies Act 1965, formation of Pengurusan Danaharta Nasional Bhd³ and setting up of Corporate Debt Restructuring Committee (CDRC)⁴.

The financial crisis experienced by Malaysia has resulted in many corporate borrowers facing insolvency proceedings due to their inability to repay their debts. These companies are now seeking legal as well as non-legal protection from their creditors through the court and CDRC.

In 1998, a total of 32 companies sought and received relief and protection from section 176 of the Companies Act 1965.⁵ Under this section financially distressed companies can apply to undergo rehabilitation and restructuring on a going concern basis under the supervision of the court. Under this arrangement, the court can issue summary orders to temporarily restrain creditors from proceeding to liquidate the company.

² [1997] 2 MLJ 805; (1997) 3 AMR 2361 (FC).

³ Pengurusan Danaharta is an asset management company set up to acquire and manage non-performing loan (NPLS) of banking institutions.

⁴ CDRC is set up to facilitate voluntary corporate debt restructuring: CDRC is under the supervision of Bank Negara Malaysia.

⁵ C Rajandaran, *A Debt Restructuring, Recapitalisation Financial and Economic Implication*, in MIER NATIONAL ECONOMIC OUTLOOK 2000 CONFERENCE, Nikko Hotel, Kuala Lumpur , pg 16.

During the early part of the financial crisis right up to mid-1998, there were arguments that the section was abused by some debtor companies to buy time and pre-empt court action taken by their creditors.⁶ Furthermore, some companies appeared to have obtained court protection even though the proposed scheme of arrangement was not substantiated by clear and effective restructuring strategies. Once an order is issued, the court effectively puts a fence around the company for a stipulated period of time.⁷ In 1998, section 176 of the Companies Act was amended⁸ to prevent abuse of the provisions granting summary relief from creditor's legal action. The amendment restricts the relief to only ninety days⁹ and requires registration with the Registrar of Companies after filing for summary relief.¹⁰ It also requires companies to immediately start work with creditors on developing the reorganisation plan. This amendment has rendered the proper application of the company law provisions in dealing with reorganisation of companies on a going concern basis. Despite the amendment, it is submitted that section 176 still has certain disadvantages to creditors. The bank will not be able to foreclose its security when the court has issued Restraining Orders.¹¹ Furthermore, the court can also extend the relief period from time to time¹² in addition to the ninety days period stipulated by the section.

⁶ "Ailing Companies Breach Section 176 of the Malaysian Co.s Act: Consultant", *Asia Pulse*, 19 August 1998.

⁷ Section 176 (10) of the Companies Act 1965

⁸ vide Companies (Amendment) Act 1998, Act A1043/98, which came into force on 1st November 1998.

⁹ Subsection (10A) of section 176 Companies Act 1965, inserted by Act A1043/98

¹⁰ Subsection (10E) of the amended section 176 Companies Act 1965

¹¹ Section 176(10) of the Companies Act 1965

¹² ".....or such longer period as the Court may for good reason allow....": Section 176(10A) Companies Act 1965

Apart from section 176, the Federal Court's decision on 24th May 1997 in the case of **Kimlin Housing Development Sdn Bhd v. Bank Bumiputra**¹³ has overturned a decade old practice of sales of charged lands which belong to the defaulting corporate borrowers by 'private treaties' without any reference to the court under section 257 of the National Land Code 1965 (the 'NLC'). Prior to **Kimlin**, the Malaysian common law on the powers of sales of receivers and managers of charged lands which are the properties of corporate borrowers were laid down in the leading case of **United Malaysian Banking Corporation v. Official Receiver and Liquidator of Soon Hup Seng Sdn Bhd**.¹⁴ In this case, the Court allowed the debenture holder to sell the charged property without the necessity of applying to court for an order of sale. This shortcut method of realising cash from the private sale of the company's charged land by appointed receivers has been very popular amongst financial institutions and lenders who are in possession of secured debentures. This is popular because the lengthy process of a judicial sale under the charge provisions of the NLC is not what a lender will bargain for¹⁵.

This long established company practice as laid down in **Soon Hup Seng** had recently been overturned by the Federal Court in the case of **Kimlin**. It is submitted that the **Kimlin** case has certainly affected the right of debenture holders as provided under the Companies Act.

¹³ [1997] 2 MLJ 805; (1997) 3 AMR 2361 (FC).

¹⁴ [1986] 1 MLJ 75 (HC).

¹⁵ SY Kok, *A Review of the Federal Court Case of Kimlin Housing development Sdn. Bhd*, 1997, 3 MLJ, pp cii.

The formation of Danaharta by the Government¹⁶ recently has also to some extent affected the bank's legal remedies to recover its outstanding loans. On the advice of Bank Negara Malaysia, the financial institutions will have to sell some of their non-performing loans to Danaharta. Here, Danaharta will purchase the loan assets from the financial institutions based on the prevailing market value of the collateral of the loans.¹⁷ The market value of the collateral during the financial crisis is certainly much lower than that of the outstanding loans. Should there be any shortfall in the sale and the loan outstanding, the bank is not allowed to recover from the borrowers. This provision certainly put the bank in a disadvantaged position. If the banks directly foreclose the collateral, the bank can recover the loss on disposal from the corporate borrower and guarantors. However, this cannot be done under the sale to Danaharta.

Apart from Danaharta, the government has also established the Corporate Debt Restructuring Committee (CDRC).¹⁸ The purpose of CDRC is to provide a new avenue for large corporate borrowers to restructure their debts without resorting to legal provisions under the Companies Act.¹⁹ The resolution framework adopted by CDRC follows the voluntary corporate restructuring known as the 'London

¹⁶ Vide Pengurusan Danaharta Nasional Berhad Act 1998 ("Danaharta Act"), which came into force on 1 September 1998.

¹⁷ As to the powers of Danaharta with respect to management of assets and liabilities, see in general Part VI (sections 21 to 56) and the Second Schedule of the Danaharta Act

¹⁸ CDRC was established in July 1998. See the Introduction page of the official CDRC website at the following URL- <http://www.bnm.gov.my/CDRC/default.asp?1> (last accessed on 28 June 2002)

¹⁹ "...the CDRC was formed to provide a platform for both borrowers and creditors to workout feasible debt restructuring schemes without having to resort to legal proceedings". : Introduction page of the CDRC website, *ibid.*; see also the Objectives of the CDRC, located at <http://www.bnm.gov.my/CDRC/default.asp?2>, as well as the CDRC Terms of Reference, located at <http://www.bnm.gov.my/CDRC/default.asp?3> (last accessed on 28 June 2002)

Approach'²⁰. By providing a formal platform²¹ for creditors and debtors to participate in a structured workout process involving consensus, compromises, CDRC helps distressed companies to avoid the often protracted and debilitating legal tussles between creditors and debtors. The secretariat of the CDRC is situated at Bank Negara Malaysia.²² In principle, the framework of CDRC is supposed to be on voluntary basis. However, during the implementation of the proposed scheme the banks will have less bargaining power. Most of the terms, which are imposed by CDRC, are more in favour of the borrowers.²³ Based on the past practice, CDRC would use the moral suasion of BNM to force financial institutions to agree to the proposed corporate restructuring.

All these developments have certainly affected the rights of debenture holders. Therefore, it is high time that a study be carried out as to determine whether the debenture holders are given sufficient protection with respect to loan recovery in the banking system.

²⁰ C Rajandaran, *A Debt Restructuring, Recapitalisation Financial and Economic Implication*, in MIER NATIONAL ECONOMIC OUTLOOK 2000 CONFERENCE, Nikko Hotel, Kuala Lumpur , pg 19.

²¹ See the Revised Debt Restructuring Guidelines, issued by the CDRC on 3 August 1999, which may be found on the official CDRC website at following URL- <http://www.bnm.gov.my/CDRC/default.asp?6a> (last accessed on 28 June 2002)

²² Details concerning the CDRC Secretariat may be found in the official CDRC website at following URL- <http://www.bnm.gov.my/CDRC/default.asp?5> (last accessed on 28 June 2002)

²³ Some of these practical issues were highlighted in the feature "Helping Firms to Restructure Debts", New Straits Times, Business Section, 26 April 2000