
Restructuring & Insolvency

Singapore Court of Appeal Settles Controversy on When a Grant of Security to Cover Existing Indebtedness May Amount to a Transaction at an Undervalue

Introduction

Upon the insolvency of an individual or company, the Court has the power to set aside transactions at an undervalue entered into by the insolvent party when or as a consequence of which it becomes insolvent. Such transactions include transactions for no consideration, and transactions where the consideration received by the insolvent party was substantially less valuable than what it provided. The policy behind this is to protect the insolvent party's general body of creditors from a diminution of assets available to them which confers an unfair or improper advantage on any person.

In *Rothstar Group Ltd v Leow Quek Shiong* [2022] SGCA 25, the Singapore Court of Appeal conclusively ruled on two longstanding questions relating to the law of undervalued transactions. The first is whether the grant of fresh security by an insolvent party for its existing indebtedness can ever amount to an undervalued transaction. The Court held that it cannot. The second is whether there is a difference if the grant of fresh security by an insolvent party is for the existing indebtedness of a third party. The Court held that there is – in this situation, the grant of security could amount to an undervalued transaction.

The Court also clarified that in undertaking a comparison of value between the consideration provided and the consideration received when determining whether a transaction is at an undervalue, the exercise must be undertaken from the perspective of the insolvent party. This has important practical implications where, for example, an insolvent party provides security for a company in which he is a substantial shareholder. The transaction may still be at an undervalue, as the insolvent party may not have personally received the benefit of the transaction or the value of the consideration received by the insolvent party cannot be quantified in monetary terms.

The transaction in question was a legal mortgage entered into by a company and its shareholder as security for moneys owed by an associated company. When the company and shareholder entered into insolvency, the Liquidator and the Private Trustees in Bankruptcy ("PTIBs") sought to have the legal mortgage set aside for being a transaction at an undervalue. The Court of Appeal allowed the applications and discharged the legal mortgage with prospective effect.

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The Liquidator and the PTIBs were represented by Lee Eng Beng SC, Sim Kwan Kiat, Chua Beng Chye, Raelene Pereira, Torsten Cheong, Wong Ye Yang, Yeoh Su Yi, and Fong Han Peow of Rajah & Tann Singapore LLP.

Brief Facts

Mr Ng Say Pek ("**Mr Ng**") was the sole shareholder and a director of a company, Pictorial Development Pte Ltd ("**Pictorial**"). Mr Ng was also a shareholder and director of another company, Agritrade International (Pte) Ltd ("**AIPL**").

AIPL had entered into an agreement for a loan to be provided by the appellant, Rothstar Group Limited ("**Rothstar**"). To secure AIPL's obligations under this agreement, Mr Ng and Pictorial granted an equitable mortgage over a property owned by Mr Ng and Pictorial (the "**Property**"). The equitable mortgage was later terminated in consideration of Mr Ng and Pictorial agreeing to grant Rothstar a Legal Mortgage over the Property. Mr Ng and Pictorial then executed this Legal Mortgage as security for all sums due and payable by them and/or AIPL to Rothstar. AIPL ultimately failed to repay the Loan.

A bankruptcy order was made against Mr Ng, and PTIBs were appointed. Similarly, Pictorial was wound up and a Liquidator was appointed. The PTIBs and the Liquidator applied for the Legal Mortgage to be set aside on the ground that it was a transaction at an undervalue, among others. Relying on the English case of *Re MC Bacon Ltd* [1990] BCLC 324 ("**MC Bacon**"), Rothstar argued that the grant of a security cannot constitute an undervalued transaction.

The High Court Judge found in favour of the PTIBs and the Liquidator, finding the Legal Mortgage to be a transaction at an undervalue. Rothstar appealed against the Judge's decision.

Holding of the Court of Appeal

The Court of Appeal agreed that the Legal Mortgage was a transaction at an undervalue and ordered that the legal mortgage be discharged with prospective effect.

Transactions at an undervalue

The Court's decision was based on the provisions for avoidance of transactions found in section 98 of the Bankruptcy Act ("**BA**") (extended to companies via the Companies Act). While these provisions have been repealed, equivalent provisions have been enacted in the Insolvency, Restructuring and Dissolution Act ("**IRDA**"). The applicable principles thus remain largely unchanged, and the Court's decision here should apply to cases falling under the IRDA regime.

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The relevant provision was section 98(3)(c) of the BA, which defines a transaction at an undervalue as one "for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the [counterparty]".

Grant of security for existing debt

The Court endorsed the principle in *MC Bacon*. The principle is that where an insolvent party grants security for its indebtedness, the grant of security will not amount to an undervalued transaction. This is because the grant of security for the insolvent party's own indebtedness does not deplete or diminish the insolvent party's assets.

The Court also rejected Rothstar's argument that the principle should apply where the insolvent party grants security for a third party's indebtedness. In such a situation, the grant of security would reduce the net assets of the insolvent party as it would impose a new liability which the insolvent party did not previously have.

In this context, the Court held that the comparison of value between the consideration provided and the consideration received should be governed by the following principles:

- (a) The value comparison exercise has to be undertaken from the perspective of the insolvent grantor. Even though the consideration need not be directly received by the grantor, the value of that consideration is relevant only in so far as it accrues to the grantor. Further, the grantor's mere perception of value will not suffice.
- (b) The value of the consideration has to be assessed "in money or money's worth", thus requiring the value of the consideration to be quantifiable in monetary terms.

Application to the facts

On the facts, the Court found that the Legal Mortgage was a transaction at an undervalue under section 98(3)(c) of the BA.

- (a) By entering into the Legal Mortgage, Mr Ng and Pictorial had provided consideration of significant value (the Legal Mortgage securing AIPL's debt and the new primary obligation to repay the loan to Rothstar). However, there was no value received by Mr Ng and Pictorial in money or money's worth.
- (b) Further, the Court found that Mr Ng and Pictorial were insolvent at the time of, or became insolvent as a result of, granting the Legal Mortgage.

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As a result, the Court found the appropriate order to be the discharge of the Legal Mortgage with prospective effect.

Concluding Words

It is not unusual for commercial parties to provide security for loans taken out by persons other than themselves. A common example is where a shareholder provides security for a loan taken out by his company, as was the case in *Rothstar*. While this is acceptable commercial practice, the Court of Appeal's decision in *Rothstar* clarifies that there is a real risk of non-recovery for lenders who lend against such security where the shareholder is or may become insolvent. The mere fact that the insolvent party is a shareholder of the borrower will not be enough to insulate the security from avoidance.

This clarification is ultimately to be welcomed because it recognises that a grantor of security for a third party's indebtedness will have its own creditors who require protection. By the same token, it ensures that a person cannot put his assets out of the reach of his creditors by simply granting security for the indebtedness of a party in which he has some interest.

For further queries, please feel free to contact our team below.

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Contacts



Lee Eng Beng S.C.
Senior Partner
Restructuring & Insolvency
Chairperson, Rajah & Tann Asia

T +65 6232 0402

eng.beng.lee@rajahtann.com



Sim Kwan Kiat
Head, Restructuring &
Insolvency

T +65 6232 0436

kwan.kiat.sim@rajahtann.com



Chua Beng Chye
Deputy Head, Restructuring &
Insolvency

T +65 6232 0419

beng.chye.chua@rajahtann.com



Raelene Pereira
Partner, Restructuring &
Insolvency

T +65 6232 0401

raelene.pereira@rajahtann.com



Torsten Cheong
Senior Associate, Appeals &
Issues

T +65 6232 0555

torsten.cheong@rajahtann.com

Please feel free to also contact Knowledge and Risk Management at eOASIS@rajahtann.com

Our Regional Contacts

RAJAH & TANN | *Singapore*

Rajah & Tann Singapore LLP

T +65 6535 3600
sg.rajahtannasia.com

CHRISTOPHER & LEE ONG | *Malaysia*

Christopher & Lee Ong

T +60 3 2273 1919
F +60 3 2273 8310
www.christopherleeong.com

R&T SOK & HENG | *Cambodia*

R&T Sok & Heng Law Office

T +855 23 963 112 / 113
F +855 23 963 116
kh.rajahtannasia.com

RAJAH & TANN | *Myanmar*

Rajah & Tann Myanmar Company Limited

T +95 1 9345 343 / +95 1 9345 346
F +95 1 9345 348
mm.rajahtannasia.com

RAJAH & TANN 立杰上海

SHANGHAI REPRESENTATIVE OFFICE | *China*

**Rajah & Tann Singapore LLP
Shanghai Representative Office**

T +86 21 6120 8818
F +86 21 6120 8820
cn.rajahtannasia.com

GATMAYTAN YAP PATACSIL

GUTIERREZ & PROTACIO (C&G LAW) | *Philippines*

Gatmaytan Yap Patacsil Gutierrez & Protacio (C&G Law)

T +632 8894 0377 to 79 / +632 8894 4931 to 32
F +632 8552 1977 to 78
www.cagatlaw.com

ASSEGAF HAMZAH & PARTNERS | *Indonesia*

Assegaf Hamzah & Partners

Jakarta Office

T +62 21 2555 7800
F +62 21 2555 7899

Surabaya Office

T +62 31 5116 4550
F +62 31 5116 4560
www.ahp.co.id

RAJAH & TANN | *Thailand*

R&T Asia (Thailand) Limited

T +66 2 656 1991
F +66 2 656 0833
th.rajahtannasia.com

RAJAH & TANN LCT LAWYERS | *Vietnam*

Rajah & Tann LCT Lawyers

Ho Chi Minh City Office

T +84 28 3821 2382 / +84 28 3821 2673
F +84 28 3520 8206

RAJAH & TANN | *Lao PDR*

Rajah & Tann (Laos) Co., Ltd.

T +856 21 454 239
F +856 21 285 261
la.rajahtannasia.com

Hanoi Office

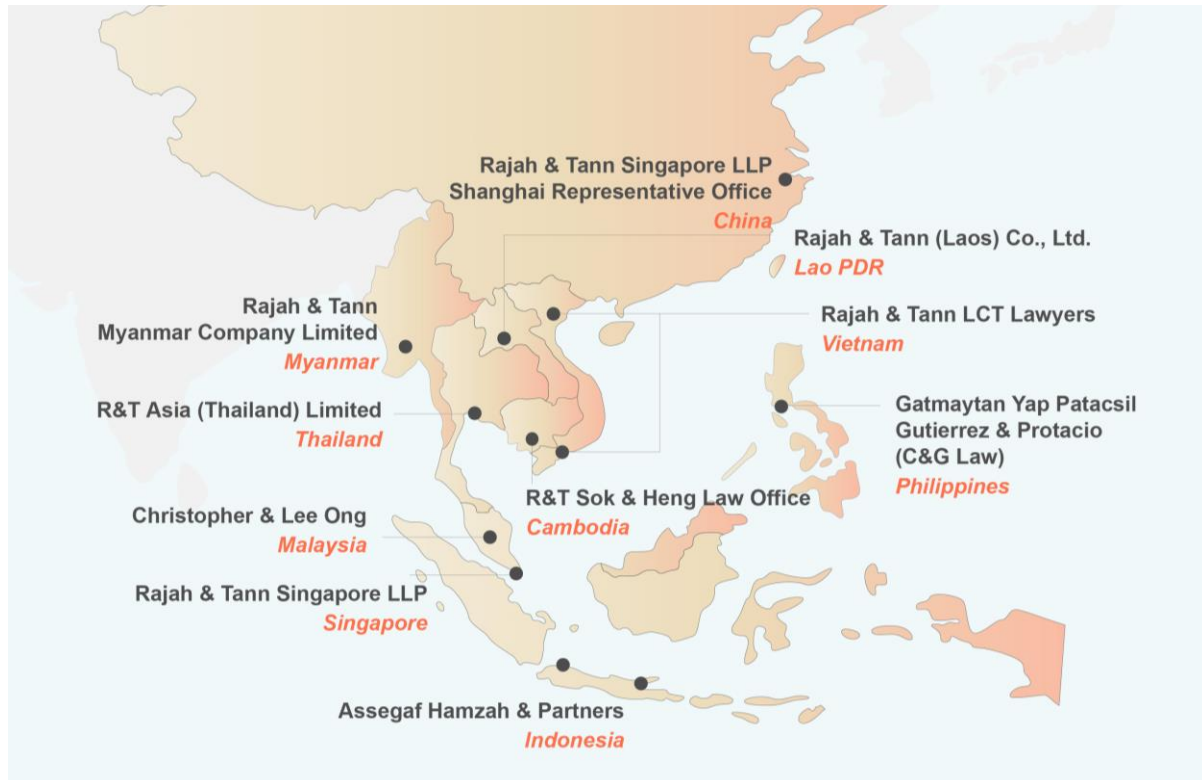
T +84 24 3267 6127
F +84 24 3267 6128
www.rajahtannlct.com

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