ROTHSTAR GROUP LTD V LEOW QUEK SHIONG: THE INSOLVENCY IMPLICATIONS OF DIVERTING CONSIDERATION TOWARDS RELATED ENTITIES

JERIEL TEO*

I. INTRODUCTION

In *Rothstar Group Ltd v Leow Quek Shiong,*[1] the Court of Appeal held that a shareholder-director's provision of a legal mortgage to secure the debt of one of his ailing companies was a transaction at an undervalue within the meaning of s 98 of the Bankruptcy Act.[2] The Court of Appeal granted his private trustees in bankruptcy ("**PTIB**") an order that the legal mortgage was to be discharged with prospective effect, stating that the benefits accruing to the ailing company did not create any value for the shareholder-director personally. This raises two related insolvency risks for purchasers or lenders during the relevant clawback period. Firstly, a narrow emphasis on the value received by the grantor personally may lead to deals that are negotiated on a group basis to be unfairly impugned as being at an undervalue. Secondly, if the consideration for a transaction is dissipated by the wrongful conduct of the grantor's directors or officers, the purchaser or lender may become liable for the dissipated funds that were not received by the grantor, notwithstanding that the purchaser or lender may have acted innocently.

II. BACKGROUND TO THE DECISION IN *ROTHSTAR*

Rothstar concerned a debt that was owing by Agritrade International (Pte) Ltd ("Agritrade") to Rothstar Group Ltd ("Rothstar"). Rothstar was a long-standing creditor of Agritrade, who was initially indebted to Rothstar for $5m.[3] This debt was secured by an equitable mortgage granted by Agritrade's shareholder-director, Mr Ng Say Pek ("Ng") and one of Ng's companies, Pictorial

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* LLB Candidate, National University of Singapore, Class of 2024. All errors remain my own.

[1] [2022] SGCA 25 [*Rothstar*].

[2] Cap 20, 2009 Rev Ed [BA], now s 361 of the Insolvency Restructuring and Dissolution Act 2018 [IRDA].

[3] *Rothstar*, *supra* note 1 at para 6.

Development Pte Ltd ("Pictorial"), over Ng's family home at 23 Jalan Tanah Puteh (the "Jalan Tanah Puteh property").[4] Pictorial held 99% of the Jalan Tanah Puteh property, and was wholly-owned by Ng and his wife.[5]

However, Agritrade proved to be unable to pay the debt in time. Rothstar subsequently became concerned about the financial status of Agritrade, and insisted that the equitable mortgage be converted to a legal mortgage, failing which Rothstar would recall the loan, and enforce their rights against the Jalan Tanah Puteh property with immediate effect.[6] Further to this, Rothstar also sought a personal obligation on Ng and Pictorial to pay all monies owing by Ng, Pictorial, and/or Agritrade to Rothstar.[7]

In the events that followed, Agritrade would collapse,[8] Ng would go into bankruptcy,[9] and Pictorial would go into compulsory winding-up.[10] The PTIB of Ng subsequently sought an order from the High Court that the legal mortgage was void for being, *inter alia,* a transaction at an undervalue under s 98 of the BA. The Court of Appeal, affirming the decision of the High Court, allowed the application by the PTIB. This was on the grounds that Ng and Pictorial had received no value in money, or money's worth for the provision of the legal mortgage, and that the benefits that had accrued to Agritrade could not be attributed to Ng or Pictorial for the purposes of the value comparison exercise.[11]

III. THE IMPLICATIONS OF THE *ROTHSTAR* DECISION

A. The legal backdrop to the Rothstar *decision*

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[4] *Ibid.*

[5] *Rothstar*, *supra* note 1 at para 4.

[6] *Rothstar Group Ltd v Chee Yoh Chuang* [2021] SGHC 176 [*Rothstar HC*] at para 48.

[7] *Rothstar*, *supra* note 1 at para 47.

[8] *Rothstar HC*, *supra* note 6 at para 13.

[9] *Ibid* at para 16.

[10] *Ibid* at para 18.

[11] *Rothstar*, *supra* note 1 at para 51.

There are two main transactions at an undervalue provisions in the IRDA, both of which are largely identical. s 224 of the IRDA deals with insolvent companies, and s 361 of the IRDA deals with bankrupts. These provisions allow the relevant insolvency representative to apply to the Court to make an order placing the insolvent company or the bankrupt in the position that they would have been in if not for the undervalue transaction.[12] This thus protects the creditors from a diminution of the insolvent estate during the relevant clawback period.

A transaction may be at an undervalue for two reasons. Firstly, the insolvent company may have received no consideration at all in exchange for the consideration that it had provided.[13] Another reason a transaction may be at an undervalue, is if the value received by the grantor company ("incoming consideration") is *"significantly less"* than the value provided by the grantor company ("outgoing consideration").[14]

In line with the overarching policy behind the avoidance provisions in general, the value comparison exercise focuses on the value actually received by the grantor, and not the value provided by the counterparty.[15] While it used to be thought that the purpose of the undervalue transactions provisions were to uphold the principle of *pari passu* distribution, it has since become relatively uncontroversial that the general policy of the avoidance provisions in general is the protection of the insolvent estate from unjust diminutions.[16] As the Court of Appeal rightly pointed out, a focus on the value received, rather than the value provided, comports with this statutory objective.[17]

In the context of multi-party transactions, where the consideration received may be disbursed to a related entity, or where the consideration is split up amongst multiple related entities, it may be possible for the incoming consideration to be calculated on a collective basis.

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[12] IRDA, *supra* note 2, ss 224(2) and 361(2).

[13] IRDA, *supra* note 2, ss 224(3)(a) and 361(3)(a).

[14] IRDA, *supra* note 2, ss 224(3)(b) and s 361(3)(c) IRDA. Note that s 361 has an additional category for transactions in which the consideration received is marriage.

[15] *Rothstar*, *supra* note 1 at para 25.

[16] *Mercator & Noordstar NV v Velstra Pte Ltd* [2003] 4 SLR(R) 667 at para 27.

[17] *Rothstar*, *supra* note 1 at para 25.

The Court of Appeal had previously considered this possibility in *obiter dicta* in *Velstra Pte Ltd v Dexia Bank NV*.[18] In *Velstra,* the insolvent company, Velstra, made a remittance naming the respondent, Artesia Bank, as the beneficiary, but instead listing the account number of Velstra's shareholders.[19] The Court of Appeal held that there was no transaction between Velstra and Artesia Bank in any real sense. Though Velstra had named Artesia Bank as a beneficiary, the true substance of the transaction was a remittance from Velstra to its shareholders, with Artesia Bank acting as an intermediary or conduit.[20]

Importantly, the Court of Appeal went on to consider whether the remittance could have been a transaction at an undervalue even if the intended beneficiary was Artesia Bank. The Court of Appeal held that there would be no undervalue transaction, because Artesia Bank had released funds equal in amount to the remittance into the accounts of Velstra's shareholders.[21] The Court of Appeal however did not explain in detail why the payment to the shareholders would be a benefit in monetary terms to the company, given that a company and its shareholders are separate legal personalities. Thus, *Velstra* suggests that calculations of the incoming consideration may take into account benefits that do not accrue to the company personally, but instead accrue to their shareholders.

Rothstar appears to caution against taking the *dicta* in *Velstra* too far. While the Court of Appeal recognised that it was possible in principle for the grantor to benefit in monetary terms from a benefit accruing to a related entity, the Court of Appeal firmly stated that a benefit accruing to a related entity would not *ipso facto* result in a benefit accruing to the grantor himself. The value comparison exercise should remain focused on the value received by the grantor, and not "*amorphous*" benefits that arise solely "*by dint of their association*" with other related entities who benefited from the transaction.[22]

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[18] [2005] 1 SLR(R) 154 [*Velstra*].

[19] *Ibid* at para 6.

[20] *Ibid* at para 38.

[21] *Ibid* at paras 8 and 41: the "*full consideration*" identified by the Court of Appeal is a payment into the accounts of the shareholders.

[22] *Rothstar*, *supra* note 1 at para 49.

B. *The* Rothstar *decision creates the risk of artificially undervaluing transactions made to benefit a group of related companies*

While the principle appears to be sound, *Rothstar* generates significant insolvency-related risks for parties transacting with related companies, or their shareholders, during the clawback period. Firstly, a narrow focus on the value received by the grantor may result in otherwise sound transactions being impugned as being at an undervalue. For example, in the context of group companies, transactions may be structured from the perspective of maximizing value for the group on a collective basis, and the true value of the incoming consideration may not be reflected when measuring the benefits to each member of the group on an individual basis. In such situations, a dogged focus on the value received by the grantor, rather than the group as a whole distorts the true nature of the transaction at hand, leading to certain transactions becoming unfairly impugned as being at an undervalue. Thus, counsel would be well advised to ensure that where a transaction provides for consideration to move to any party other than the grantor, there is a well-particularised explanation of how the grantor will personally benefit from such a transaction.

C. *The* Rothstar *decision poses significant risks to innocent purchasers who deal in good faith with insolvent companies*

Secondly, a strict application of this decision potentially prejudices otherwise innocent parties that deal in good faith with the insolvent company, if consideration is split up between the insolvent company and other related companies. This may be illustrated by a hypothetical.

Suppose that Company P wishes to purchase assets from the vendor company, Company I. The director of Company I instructs Company P to instead disburse the consideration to Company X, claiming that it is for reasons of tax-efficiency. Now, suppose further that the director of Company I is a fraudster, and that Company X was no more than a shell company used by the errant director to funnel cash out of Company I. The errant director then absconds with the sales proceeds. Company I then goes insolvent.

If the decision in *Rothstar* is applied strictly, then the sale of assets is a transaction at an undervalue, notwithstanding that Company P is not a party to the fraud and has acted innocently. Company I has received no consideration, because the sales proceeds were all funnelled out by the errant director. If the director absconds and cannot be found, then the liquidators of Company I

will no longer have any possibility of seeking restitution from the errant director. In such situations, the liquidators would be incentivised to seek an order that Company P reimburse Company I to the extent of the undervalue.

Such an order would be prejudicial to Company P, because it would place Company P in the position of subsidizing Company I for the wrongdoing of its errant director. Further to this, if Company P had provided full consideration, then it would be in the position of having to pay twice. Put simply, there is no difference between the former scenario, and the scenario in which Company P disbursed the monies to Company I directly, and the errant director simply siphoned it out of Company I. Though there is equally a depletion of the insolvent estate of Company I, it would be unfair to make Company P liable for wrongdoing that it was not a party to.

D. The risk may be mitigated by the court's discretion to make no order

The risks inherent in such transactions may be mitigated by the Court's discretion to grant no order, even where there is an undervalue transaction. It is uncontroversial that the Court's discretion under s 98(2) BA also extends to not making an order at all, even if there has been an undervalue transaction.[23] Such an exercise of discretion may be justified on the grounds that the purchaser firstly provided full consideration, dealt in good faith, and may be prejudiced by having to pay an additional sum, above and beyond the full consideration they had initially supplied.[24]

The Court may also not be minded to simply reverse the transaction because such orders are often impractical in the context of an insolvent company, which may not have the funds necessary to repay the purchasing company. One example of this took place in *Re MDA Investment Management Ltd*.[25] MDA was a company in dire financial straits. Though it was a financial services business, it had recently lost its membership in the relevant regulatory body and thus could no longer carry on its business. The directors thus arranged for a sale of MDA's assets to a purchaser,

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[23] *Christie, Hamish Alexander v Tan Boon Kian* [2021] 4 SLR 809 at para 80.

[24] *Trustee in Bankruptcy of Gordon Robin Claridge v Claridge* [2011] All ER(D) 27 (Aug).

[25] [2003] EWHC 227 [*MDA*].

Farlake. However, the deal was structured in such a way that over 50% of the consideration paid by Farlake was disbursed to a partnership in which one of the directors was an 80% partner.

Though the High Court found that the transaction was indeed at an undervalue within the meaning of s 238 of the Insolvency Act 1986 (UK),[26] the High Court declined to make an order. As Park J noted:

> the section permits me only to restore the position to what it would have been if [MDA Ltd] had not entered into the transaction at all: it does not permit me to reconstruct the position to what it would have been if [MDA Ltd], as well as not entering the actual transaction, had entered into a different transaction instead.[27]

Because MDA was not able to carry on business for lack of licensing, even a sale of its assets at an undervalue was better than no sale at all. Thus, Park J declined to reverse the transaction.

Though *MDA* should be treated with caution befitting its unique set of facts, it seems to suggest that where the court is unable to reconstruct the position to where it would be had the transaction not been entered, it should exercise its discretion to decline to make an order. In the hypothetical discussed, it would often be impractical to restore the *status quo ante,* because even if Company P restored the purchased assets, Company I would not have the liquidity to refund the purchase. Thus, it is submitted that the right course of action for the Court may be to make no order at all, and leave the liquidators of Company I to the remedies ordinarily available for breaches of directors' duties.

This discretionary approach is perhaps the most preferable solution to this conundrum, largely because they balance the preservation of doctrinal coherence with fairness to creditors who deal in good faith with the company. The discretionary approach is not inconsistent with the general principle of anti-deprivation. The only real "deprivation" to speak of is that the creditors have not enjoyed an unfair windfall at the expense of those that deal with the insolvent company in good

[26] Which is *in pari materia* with ss 361 and 223 of the IRDA.

[27] *MDA*, *supra* note 25 at para 123.

faith, and mitigates the harshness inherent in an approach that values transactions solely from the perspective of the insolvent company.

IV. CONCLUSION

Though the decision in *Rothstar* is largely sound from a doctrinal perspective, the decision generates significant insolvency-related risks for transactions where the consideration does not move directly to the grantor. Though the Court of Appeal left the possibility that benefits that accrue to related entities may also benefit the grantor, the Court of Appeal has issued a strong caution that such knock-on benefits must be clearly particularised and substantiated. Further to this, a strict application of this decision may result in innocent purchasers being held liable for the fraudulent behaviour of errant directors in the grantor company. This risk, however, may be mitigated by the court's discretion to make no order where they see fit, even if there has been an undervalue transaction.