

# Fraudulent Trading - Directors' Personal Liability and the Duty of Good Faith in Negotiations

By Andrew Chiew Ean Vooi & Nicola Tang Zhan Ying



1. The Federal Court had the opportunity to consider novel questions of law concerning fraudulent trading under S 540, Companies Act 2016 (“CA 2016”) in **Lai Fee & Anor v Wong Yu Vee & Ors** [2023] 4 CLJ<sup>1</sup>.

The Federal Court was invited to consider 3 questions –

**Question 1:** Where a vendor agrees to the immediate transfer of an asset to a company relying on the representation of the company that the balance purchase price will be paid in the future and the company subsequently fails to pay the balance purchase price when it falls due, are the directors of the company, ipso facto liable to the vendor under S 540 of the CA 2016?

**Question 2:** Where a company has been adjudged in a previous suit to be liable for failure to pay the balance purchase price under a sale and purchase, and a director of the company is subsequently sued under S 540 of the CA 2016 arising from the said debt: -

(i) is such a director barred by issue of estoppel and/or res judicata from asserting defences which had been unsuccessfully raised by the company in the previous suit?

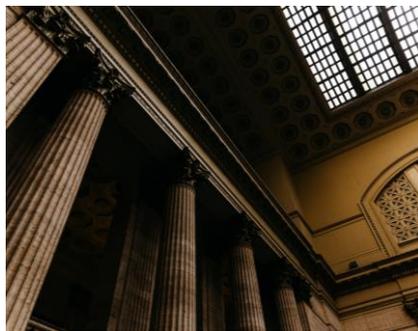
(ii) may such a director raise as a defence that the company had a legitimate commercial reason not to

pay the balance purchase price notwithstanding the judgment in the previous suit?

**Question 3:** Is the position by Lord Kerr in paragraph of the grounds in the English Supreme Court case **Takhar v Gracefield Developments Ltd and Others** [2019] UKSC 13, namely, “... *that the law does not expect people to arrange their affairs on the basis that other people may commit fraud*” representative of the position of Malaysian law?

## Facts

2. The appellants (plaintiffs) were partners of a partnership business, Fave Enterprise (“**Fave**”) that owned timber logging rights. The respondents (defendants) negotiated with the appellants to acquire the timber logging rights from Fave. It was agreed the appellants would enter a sale and purchase agreement (“**SPA**”) with Centennial Asia Sdn Bhd (“**Centennial**”). The respondents are directors of Centennial<sup>2</sup>. The appellants agreed to transfer their interest in Fave to Centennial for the purchase price of RM7 million (“**Purchase Price**”), which would be paid in 3 tranches.



3. Upon execution of the SPA, the appellants relinquished and transferred their interest in Fave. Although Centennial was the named buyer under the SPA, the respondents caused Fave to be registered under their personal names. The respondents caused another company, Westhill Equity Sdn Bhd ("**Westhill**") to pay the initial 2 tranches of the Purchase Price to the appellants. Centennial defaulted in paying the final balance Purchase Price of RM2.5 million ("**Balance Purchase Price**").

4. Centennial's default resulted in the appellants commencing an action against Centennial in the High Court for specific performance of the SPA and for an order that Centennial pay the Balance Purchase Price ("**Centennial Suit**"). Centennial

raised a defence and counterclaimed for misrepresentation. The High Court allowed the appellants' claim and dismissed Centennial's counterclaim. Centennial, an impecunious company, failed to settle the judgment.

5. The appellants brought a separate action in the High Court against the respondents, being directors of Centennial, for fraudulent trading and sought to declare them personally liable for the Balance Purchase Price ("**Fraudulent Trading Action**"). The respondents denied liability. The respondents in their defence claimed misrepresentation by the appellants.

6. The High Court after full trial dismissed the Fraudulent Trading Action<sup>3</sup>. The Court of Appeal affirmed the decision on appeal<sup>4</sup>.

7. The Federal Court granted leave to appeal on Questions 1, 2, and 3.

#### **Question 1: Fraudulent trading**

8. The Federal Court found the following

facts were not in dispute (*Grounds, para [30]*) -

8.1 The respondents incorporated Centennial for the sole purpose of acquiring Fave for its timber logging rights.

8.2 The respondents became directors of Centennial not long after they became aware that Fave had been awarded the timber logging rights and the negotiations regarding the sale of Fave began.

8.3 The respondents had full control, power, and were actively involved in the management of Centennial.

8.4 Centennial was a dormant company. It did not have -

- (i) any business dealings or history of business prior to the SPA;
- (ii) any funds, assets of value and/or any bank accounts as at the date of the SPA;
- (iii) a business address; and,
- (iv) auditors;

8.5 Centennial shares the same registered address and company secretary with Westhill;

8.6 Westhill is the majority shareholder of Centennial;

8.7 The respondents are directors and majority shareholders of Westhill;

8.8 Westhill does not have a business address; and

8.9 Neither Centennial nor Westhill filed their audited financial statements.

<sup>1</sup> [The Federal Court's Grounds of Judgment \("Grounds"\) may be viewed here.](#)

<sup>2</sup> It was also not in dispute the 3rd respondent is a shareholder of Centennial.

<sup>3</sup> [The High Court's Grounds of Judgment may be viewed here.](#)

<sup>4</sup> [The Court of Appeal's Grounds of Judgment may be viewed here.](#)

9. On the law, the Federal Court held -

9.1 A company is carrying on a business "with intent to defraud creditors" if, -

(i) the company continues to carry on business to incur debts at a time when to the knowledge of the directors, there is no reasonable prospect of the creditors ever receiving payment of those debts<sup>5</sup>.

(ii) there is an intent<sup>6</sup> to deprive creditors, of an economic advantage or inflict upon them some economic loss<sup>7</sup> - *Grounds, para [24](ii)*.

9.2 The words "if ... it appears" denotes a lower threshold to trigger the operation of S 540(1), CA 2016 - *Grounds, para [24](iv)*.

9.3 The burden of proof to establish fraudulent trading on the balance of probabilities<sup>8</sup> rests on the appellants - *Grounds, para [24](v)*.

9.4 An act constitutes fraud when it is established that an unjustifiable risk was taken, resulting in harm or prejudice to another. It is not necessary to demonstrate that, at the moment the debts were accrued, it was known that creditors would not receive payment. What matters is at the time the debts were incurred, there was no reasonable expectation that the necessary funds

would be available to meet the debt when it fell due, or in the near future<sup>9</sup> - *Grounds, para [24](viii)*. The Federal Court found this criterion to be partly subjective and partly objective.

9.5 Ascertaining whether there was any intention to defraud is a matter of fact to be inferred from the surrounding circumstances and subsequent actions of the defendants<sup>10</sup> - *Grounds, para [24](ix)*.

9.6 To be a knowing party, actual knowledge of the company's fraudulent transaction is required. However, there was no requirement to establish the person had assumed a managerial or controlling role in the company's operations to be deemed complicit<sup>11</sup> - *Grounds, para [24](ix)*.

9.7 A single act in the course of carrying on the company's business with intent to defraud only one creditor is sufficient to amount to fraudulent trading; it is not necessary to establish a scheme to defraud<sup>12</sup> - *Grounds, para [24](xi)*.

9.8 Whether a person has conducted a company's business with intent to defraud its creditors is a question of mixed fact and law - *Grounds, para [25]*.

10. The Federal Court then held -

10.1 Firstly, the respondents used Centennial as the vehicle to execute the SPA notwithstanding they had actual knowledge that Centennial was a dormant company with no assets, business activities, or trading and income. Although the respondents incorporated Centennial for the sole purpose of acquiring Fave, they did not inject any capital into Centennial to meet its contractual obligation under the SPA, i.e., to pay the appellants the Purchase Price. When the Purchase Price became due, the respondents had no reasonable expectation that Centennial would have the funds to settle the debt - *Grounds, para [31]*.

10.2 Secondly, the appellants agreed to the immediate transfer of their interest in Fave to the respondents on the representation that Centennial would pay them the Purchase Price. The respondents, however, used Westhill to pay the first 2 tranches of Purchase Price. Westhill was not a party to the SPA and there is no provision in the SPA referring to this arrangement. - *Grounds, para [32]*.

10.3 Lastly, another unusual aspect was the transfer of Fave to the respondents instead of to Centennial, even though Centennial was the named buyer under the SPA. There was no provision under



<sup>5</sup> *R v Grantham* [1984] BCLC 270

<sup>6</sup> The person must be taken to intend the natural or foreseen consequences of his/her act (In Re Gerald Chemicals Ltd. (In Liquidation) [No. 001027 of 1977] [1978] Ch 262 at 267)

<sup>7</sup> *Coleman v The Queen* [1987] 5 ACLC 766

<sup>8</sup> *Sinnaiyah & Sons Sdn Bhd v Damai Setia Sdn Bhd* [2015] 7 CLJ 574 (FC)

<sup>9</sup> *Regina v Sinclair* [1968] 1 WLR 1246

<sup>10</sup> *Rahj Kamal bin Abdullah v PP* [1998] 1 SLR 447; *LMW Electronics Pte Ltd v. Ang Chuang Juay & Ors* [2010] 4 CLJ 849

<sup>11</sup> *Tan Hung Yeoh v Public Prosecutor* [1999] 2 SLR(R) 262 HC

<sup>12</sup> *JCT Ltd v Muniandy Nadasan & Ors* and another appeal [2016] 6 MLJ 635 (CA) at para [42], applied in *Dato' Prem Krishna Sahgal v Muniandy Nadasan & Ors* [2017] 10 CLJ 385 (FC) at para [91]. See also *Re Gerald Cooper supra*; *Morphitis v Bernasconi & Ors* [2003] BCLC 53



the SPA which allowed Centennial to appoint a nominee(s) to take up the shares in Fave. The SPA also mandated the immediate transfer of Fave ownership upon execution, while the full Purchase Price remained outstanding. The respondents therefore became the new owners of Fave, enjoying all the SPA's benefits, while Centennial retained exclusive responsibility for the unpaid Purchase Price.

11. It is important to note Vernon Ong, FCJ.'s findings at paras [34] and [35] of the Grounds where his Lordship held –

"[34] ...The procurement of Centennial and Westhill in the defendants' scheme was intended to create corporate layers to obfuscate themselves from the transaction. Both Centennial and Westhill are dormant companies. There was no prospect of Centennial paying the balance purchase price. Westhill was not a party to the SPA; no contractual liability could attach to it because it was not privy to the SPA, and neither did Westhill derive any benefit under the SPA. We also noted the fact that in Suit 128, the defendants had given evidence on behalf of Centennial; that their defence and counterclaim premised on misrepresentation was dismissed.

*[35] As such, we have no hesitation in concluding that what was done was dishonest according to the ordinary standards of reasonable and honest people. The fact that Centennial and Westhill were utilised as layers to insulate the defendants leads to an inference that the defendants must have known that their act was by those standards dishonest. The subsequent conduct of the defendants in raising the defence of misrepresentation in the s 540 Suit when that very same defence and counterclaim was dismissed in Suit 128 gives rise to yet another inference as to the intention of the defendants to defraud the plaintiffs. The fact of the defendants' participation in the SPA transaction both at the negotiation stage (pre-SPA), execution stage and post-SPA is not disputed; they were the real controlling arm behind both Centennial and Westhill. In all the circumstances, the fact that this was a single transaction does not negate the inferences arising from the settled facts."*

#### **Question 2: Res Judicata**

12. The respondents, who were also witnesses in Centennial Suit, relied on the misrepresentation defence pleaded

in the Centennial Suit. The defence was rejected by the High Court and Centennial did not appeal. The appellants argued res judicata applies. The High Court and Court of Appeal rejected the argument.

13. The Federal Court did not agree. As the same issue has been determined by the High Court in the Centennial Suit, the Federal Court held res judicata applies and the respondents, who are privies of Centennial as directors are estopped from relitigating the same allegation of misrepresentation.

14. The Federal Court, in coming to its decision, approved Mohd Arief Emran Arifin, JC. (as he then was) explains why decision in **Muhammad Nur Hafiz bin Roslan v Mohamed Izani bin Mohamed Jakel & Ors** [2021] MLJU 2311. The Court in **Muhammad Nur Hafiz** followed Wilson Chan, J.'s decision in **Lo Kai Shui v HSBC International Trustee Ltd & Ors** [2021] 5 HKC 337 where it was held the doctrine of res judicata applies to privies who were not parties to the earlier proceedings. At para [27], Mohd Arief Emran, JC. explains why the doctrine applies –

"[27] I adopt the summary of the legal position as stated by Wilson Chan J in the above-quoted case, which is reproduced as follows: -

- "(1) Whether a claim falls foul of the Henderson doctrine of abuse requires the application of a broad, merits-based test and close scrutiny of the facts;
- (2) It is no answer to say that the causes of action in the two claims are different, if they arise out of substantially the same facts;
- (3) Nor is it a bar to a finding of abuse that the parties in the two actions are different. In particular:

(a) A party may be bound by the Henderson doctrine because he is deemed by virtue of privity of interest as having been the litigant in a prior action; and,

(b) A witness in a prior action may also raise Henderson abuse as a defence when a claim is brought against him in respect of substantially the same issues;

(4) Although the application of the doctrine is necessarily fact-sensitive, factors that have been identified in the case law as supporting a finding of abuse include:

(a) Where a party could have been joined as a defendant to the earlier action, especially if the claims arise from the same underlying facts;

(b) Where the plaintiff knows of the opposing interest of and/or has evidence against a witness in a prior action but fails to join him to the same, only to raise a fresh claim later in respect of the same issues; and,

(5) A claim can also amount to an abuse where it constitutes a collateral attack against a final decision.”

### Question 3: Implied Good Faith – In Negotiations and Contract Formation

15. Question 3 concerns whether Lord Kerr, SCJ.’s judgment in the English Supreme Court case of **Takhar v Gracefield Developments Ltd and Others**<sup>13</sup>, “... that the law does not expect people to arrange their affairs on the basis that other people may commit fraud” is representative of the position of Malaysian law.

16. The Court of Appeal<sup>14</sup> –

16.1 held the appellants were “aware

and consciously knew about Centennial’s financing standing before they enter into the Agreement”;

16.2 affirmed the High Court’s finding that the appellants did not enquire or raise issues concerning Centennial’s assets, financials, bank account, or record of business activities before signing the SPA; and,

16.3 held the appellants “entered into the Agreement (SPA) voluntarily with conscious mind relating to Centennial position” and “reasons related to Centennial’s assets, financial standing, bank account and business records are only excuses and afterthought.”

17. The Federal Court was of the view this issue is rooted in the notion of good faith in contract. The position in Malaysia is that except where statutorily imposed and in cases of relational contracts (such as insurance contracts, family settlements, partnership agreements, and employment agreements), there is no implied obligation of good faith when engaging in contractual relations unless expressly provided for under the contract.

18. In analysing the common law

jurisprudence developed in –

(a) England (**Yam Seng Pte Ltd v International Trade Corp Ltd** [2013] EWHC 111 (QB) – where the Court doubted whether English Law would recognise a requirement of good faith as a duty implied by law<sup>15</sup>) – see Grounds, paras [46]-[51]; and

(b) Canada (**Bhasin v Hrynew** [2014] SCC 71 - which clarified the principle of good faith in contract law and introduced the duty of honest performance<sup>16</sup>) – see Grounds, paras [52]-[55],

the Federal Court was careful to point out those cases relate to the notion of good faith in contractual performance. Whereas in the case of **Lai Fee**, the wrongful act complained of relates to the duty of good faith and the respondents’ fraudulent conduct leading to the creation of a contract – Grounds, para [56].

19. In this case, the Federal Court inferred the appellants’ consent to enter into the SPA was induced by fraudulent actions on the part of the respondents. The fraud was perpetrated by the



<sup>13</sup> [2019] UKSC 13

<sup>14</sup> At paras [31], [32] and [35] of the Court of Appeal’s Grounds of Judgment. See also paras [20] and [21] of the High Court’s Grounds of Judgment

<sup>15</sup> See also cases decided post Yam Seng - **Pakistan International Airline Corporation (Respondent) v. Times Travel (UK) Ltd (Appellant)** [2021] UKSC 40; **Candey v. Bosheh & Anor** [2022] EWCA Civ 1103; **Mark Faulkner & Others v. Vollin Holdings Ltd & Others** [2022] EWCA Civ 1371

<sup>16</sup> See also cases decided post Bhasin – **C.M. Callow Inc v. Zollinger** [2020] SCC 45; **Wastech Services Ltd v. Greater Vancouver Sewerage and Drainage District** [2021] SCC 7

respondents with the purpose of persuading the appellants to enter into the SPA with Centennial. Further, the appellants were also induced to immediately relinquish their interest in Fave to the respondents upon the execution of the SPA. The respondents, who immediately benefited from the SPA, sought to shield themselves from any responsibilities or obligations under the SPA by involving Centennial and Westhill. In contrast, the appellants acted honestly and in good faith, with the expectation that the Purchase Price would be settled in accordance with the SPA. In these circumstances, the Federal Court found the appellants ought not be criticised for their actions, or lack thereof.

20. On that premise, the Federal Court found the position in **Takhar** represents the legal position in Malaysia. Particularly, the principle that the law does not expect people to arrange their affairs on the basis that others may commit fraud is not inconsistent with the principle of free consent under Contracts Act 1950. Free consent plays a crucial role in the pre-contract negotiation process and underscores the obligation of good faith in contract formation, specifically, the duty to act honestly. This is because “the Contracts Act starts on the assumption that all contracts are valid. It is only if it can be proved that the consent was procured by coercion, fraud, misrepresentation, or undue influence, then the contract becomes voidable at the option of the innocent party” – *Grounds, para [61]*.

21. In **CIMB Bank Bhd v Maybank Trustees Bhd and other appeals** [2014] 3 MLJ 169, the Federal Court ruled that a party who committed fraudulent misappropriation of trust monies could not benefit from its own fraud and that that party cannot rely on the exemption clause under the contract



as a defence. In the written grounds, Ariffin Zakaria, CJ. referred to the following remarks of Lord Bingham in **HIH Casualty and General Insurance Ltd v. Chase Manhattan Bank** [2003] 1 All ER (Comm) 349 at para [15] –

*“... fraud is a thing apart. This is not a mere slogan. It reflects an old legal rule that fraud unravels all: fraus omnia corrumpit. It also reflects the practical basis of commercial intercourse. Once fraud is proved, ‘it vitiates judgments, contracts and all transactions whatsoever’: Lazarus Estates Ltd v Beasley [1956] 1 QB 702 at p 712, per Lord Justice Denning. **Parties entering into a commercial contract will no doubt recognise and accept the risk of errors and omissions in the preceding negotiations, even negligent errors and omissions. But each party will assume the honesty and good faith of the other; absent such an assumption they would not deal.**”*

22. In light of the Federal Court’s differentiation that **Lai Fee** concerns the duty of good faith in the creation of a contract, the fundamental rule that there is no overarching implied duty of

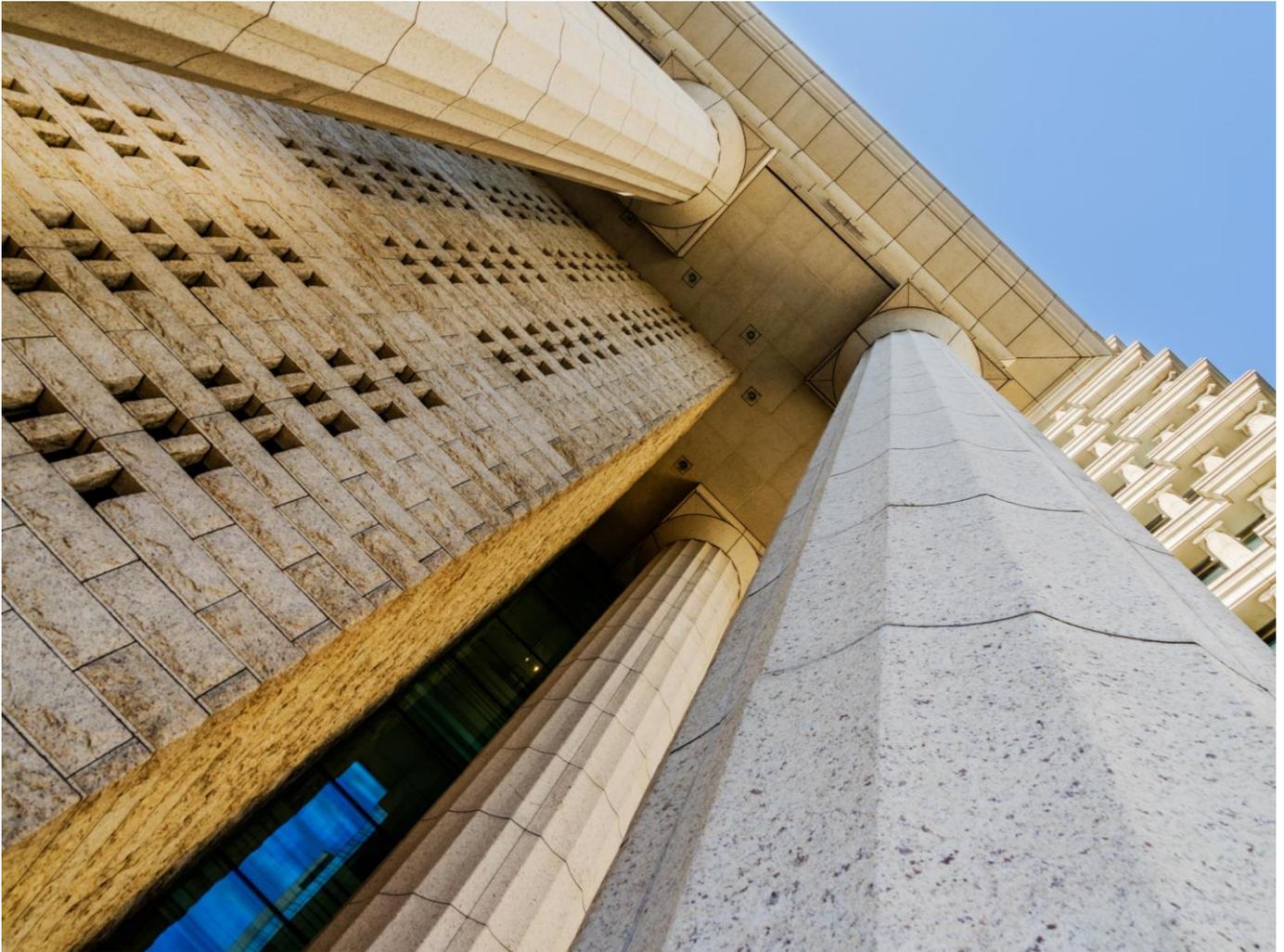
good faith in commercial contracts remains intact in Malaysia. However, there is no escaping the reality that this landmark decision holds the potential to pave the way for the incorporation of good faith into contract performance in future Malaysian court proceedings. This is particularly significant given the Federal Court’s recognition of the need for the law to align with the practical reality that honest contracting parties do not anticipate the necessity to “arrange their affairs on the basis that others may commit fraud”.

#### **Decision**

23. The Federal Court answered the questions as follows –

**Question 1:** Where a vendor agrees to the immediate transfer of an asset to a company relying on the representation of the company that the balance purchase price will be paid in the future and the company subsequently fails to pay the balance purchase price when it falls due, are the directors of the company, ipso facto liable to the vendor under S 540 of the CA 2016?

Answer: Affirmative



**Question 2:** Where a company has been adjudged in a previous suit to be liable for failure to pay the balance purchase price under a sale and purchase and a director of the company is subsequently sued under S 540 of the CA 2016 arising from the said debt:

(i) is such a director barred by issue of estoppel and/or res judicata from asserting defences which had been unsuccessfully raised by the company in the previous suit?

Answer: Affirmative

(ii) may such a director raise as a defence that the company had a legitimate commercial reason not to pay the balance purchase price notwithstanding the judgment in the previous suit?

Answer: Negative

**Question 3:** Is the position by Lord Kerr in paragraph of the grounds in the English Supreme Court case **Takhar v Gracefield Developments Ltd and Others** [2019] UKSC 13, namely, "... that the law does not expect people to arrange their affairs on the basis that other people may commit fraud" representative of the position of Malaysian law?

Answer: Affirmative

24. Decisions of the High Court and Court of Appeal were set aside. Judgment was entered against the respondents.

If you have any queries, please contact Senior Associate, Nicola Tang Zhan Ying

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