INDEFEASIBILITY OF TITLE: DUE DILIGENCE BY FINANCIAL INSTITUTIONS

by Rakkshanaa Samasundaram & Lim Sheh Ting

Malaysia adopts the Torrens system of land registration, which is important to provide certainty and security in land ownership. A key feature of this system is the principle of indefeasibility of title , which ensures that a registered proprietor's title is conclusive and protected against prior unregistered interests except in cases of fraud or other vitiating circumstances statutorily specified. This principle is codified in Section 340 of the National Land Code 1965 ("**NLC**"), ensuring clarity and certainty in land dealings. The Torrens system operates on the premise that the land register maintained by the land office is the ultimate proof of ownership, reducing the risk of disputes.

For financial institutions, the principle of indefeasibility is essential for securing land-based financing, as it allows them to rely on the accuracy of the land register without having to investigate the entire transactional history of a property.

However, an important question arises: to what extent must financial institutions conduct due diligence beyond the land register?

This issue was central in *Malayan Banking Bhd v Mohd Affandi bin Ahmad & Anor* [2024] 6 MLJ 220, where the Federal Court discussed the extent of a financial institution's duty to conduct due diligence before accepting land as security. This article examines the case in detail, analysing the reasoning of the courts at each level and discussing the broader implications for financial institutions.

Background Facts

The case revolved around a dispute over two lots of land i.e. Lot 97 and Lot 716, originally purchased by Ahmad bin Buang ("**the deceased**") from a property developer ("**D1**"). However, despite the full payment by the deceased, the land remained registered under D1's name.

Subsequently, D1 transferred the land to another developer ("**D2**"), which then charged the land to Malayan Banking Bhd ("**MBB**") as security for a term loan.

The administrators of the deceased's estate commenced legal proceedings against D1, D2 and MBB to obtain a court order to nullify the transfer and declare the charge in favour of MBB void. The crux of the administrators' arguments was that

D1 held the land in trust and had no right to transfer it to D2. Hence, since D1 had no right to sell the land, D2's title was defective, and as a result, the charge created in favour of MBB should also be declared void.

Decision of the High Court

After a full trial, the High Court ruled in favour of the administrators of the deceased's estate, concluding that D1 had no legal right to transfer the land to D2. The court found that the deceased had fully paid for the land and had taken possession of it, making D1 a bare trustee under Section 340(4)(b) of the NLC. Since D1 had no ownership rights, it could not lawfully transfer the land to D2.

The High Court also found that the transaction between D1 and D2 was '*dubious and suspicious*'. The High Court relied on *Au Meng Nam v Ung Yak Chew & Ors* [2007] 5 MLJ 136 and held that D2 failed to prove that it had paid valuable consideration for the land. This lack of consideration led to the conclusion that D2's title was defeasible under Section 340(3) of the NLC.

Dissatisfied with the High Court's decision, D2 and MBB appealed to the Court of Appeal.

Decision of the Court of Appeal

The Court of Appeal unanimously dismissed the appeal and affirmed the High Court's decision. The main issues determined by the Court of Appeal were, *inter alia*:

1. Whether D2 was a subsequent purchaser entitled to the protection of deferred indefeasibility?
2. Whether MBB, as a chargee, derived its rights from D2 as an immediate purchaser and whether it was a bona fide purchaser for value?

The Court of Appeal held that D2 was an immediate rather than a subsequent purchaser, as the deceased had acquired a right in rem after fully paying for the land decades earlier. Thus D2's title was not protected under deferred indefeasibility.

Since D2's title was defective, the Court of Appeal ruled that MBB, as a chargee, could not claim rights under deferred indefeasibility. The Court of Appeal also held that MBB could not rely solely on a title search to assume that the transaction between D1 and D2 was valid. MBB's failure to conduct sufficient due diligence disqualified it from being a bona fide purchaser for value protected by the proviso under Section 340(3) of the NLC. The Court of Appeal concluded that MBB should have proven that it was "impossible" to detect any unlawfulness in the transaction, even with proper checks.

Consequently, the Court of Appeal ruled that MBB was not a bona fide purchaser for value and could not rely on deferred indefeasibility under Section 340(3) of the NLC. Citing *Au Meng Nam & Anor v Ung Yak Chew & Ors* [2007] 5 MLJ 136, the Court reaffirmed that a subsequent purchaser must go beyond the land register and examine the transaction to prove good faith.

1 *United States Copyright Office. (2023, September 5). Re: Second Request for Reconsideration for Refusal to Register Théâtre D'opéra Spatial (SR # 1-11743923581; Correspondence ID: 1-5T5320R).*

Decision of the Federal Court

The Federal Court allowed MBB's appeal, overturning the decisions of the High Court and the Court of Appeal. In doing so, the Federal Court reaffirmed the fundamental principles of indefeasibility of title under the Torrens system, emphasising that the land register is conclusive proof of ownership unless fraud or other exceptions under Section 340 of the NLC are established.

I. The Land Register as Conclusive Evidence of Title

The Federal Court reaffirmed that the Torrens system ensures certainty and security in land ownership, granting indefeasibility of title once a proprietor is registered, except in limited circumstances such as fraud, mistake, or a statutory exception.

The Federal Court disagreed with the Court of Appeal's decision that financial institutions must go beyond the land register when assessing land as security. The Federal Court found that requiring MBB to prove it was "impossible" to detect any illegality in the transaction, even after examining the relevant documents, would impose an impractical burden on financial institutions.

II. MBB Was a Bona Fide Purchaser for Value

Further, the Federal Court emphasised that imposing an obligation on banks to verify prior dealings would disrupt commercial transactions and undermine confidence in the land registration system. Here, the Federal Court relied on its decision in *Adorna Properties Sdn Bhd v Boonsom Boonyanit* [2001] 1 MLJ 241 where indefeasibility of title protects innocent purchasers, including financial institutions, who acquire interests in land in good faith. The only exception to indefeasibility arises in cases where fraud, misrepresentation, or forgery is proven, none of which applied to MBB in this case.

In this case, MBB was a bona fide purchaser for value, meaning its security should be protected. At the time MBB accepted the charge, D2 was the registered proprietor, and MBB had no reason to suspect any irregularities in the prior transactions. A land search showed no encumbrances, and there was no evidence that MBB knew of any defects in D2's title. The Court concluded that MBB had acted in good faith and was entitled to indefeasibility protection under Section 340(3) of the NLC.

The Federal Court distinguished the Court of Appeal's decision in Au Meng Nam & Anor v Ung Yak Chew & Ors [2007] 5 MLJ 136, as that case involved an immediate purchaser, whereas in the present appeal, MBB was a subsequent purchaser. Since Section 340(3) of the NLC applies only to subsequent purchasers, Au Meng Nam (supra) was not relevant to the issue of deferred indefeasibility in this case. Additionally, the determination of bona fide status in Au Meng Nam (supra) was based on its specific facts, where the purchaser acted hastily and failed to conduct basic due diligence, such as verifying the sellers' identity and conducting land searches.

The Court of Appeal's decision in Au Meng Nam (supra) should not be treated as a general principle that negligence or carelessness automatically negates good faith under Section 340(3) of the NLC. Adopting such a broad interpretation would undermine the Torrens system's purpose, which is to ensure the certainty and reliability of the land register in reflecting valid land transactions.

III. The Application of Deferred Indefeasibility

In clarifying the law on indefeasibility, the Federal Court reaffirmed the principle of deferred indefeasibility, which protects subsequent purchasers in good faith who acquire property from a party with a defective title. The Court distinguished between immediate purchasers i.e. who acquire land directly from a fraudulent seller, and subsequent purchasers i.e. who acquire land from a prior registered owner without knowledge of any irregularities. Since MBB acquired its charge from D2, which was the registered owner at the time, MBB was classified as a subsequent purchaser, making it entitled to deferred indefeasibility under Section 340(3) of the NLC.

The Court of Appeal had wrongly treated MBB as if it were an immediate purchaser, thereby subjecting it to the same vulnerabilities as D2. However, the Federal Court made it clear that financial institutions that acquire interests from a registered proprietor in good faith are protected, provided there is no actual fraud on their part.

Implications for Financial Institutions

The Federal Court's decision provides clarity on due diligence requirements and protects financial institutions from unforeseen legal risks in land-based financing.

I. Banks Can Rely on the Land Register and Are Protected from Retrospective Challenges

One of the most important aspects of the Federal Court's decision is the reaffirmation that the land register is conclusive proof of ownership, allowing financial institutions to rely on title searches without needing to investigate prior transactions. The Federal Court made it clear that financial institutions are not expected to trace the history of a property beyond the land register unless fraud is apparent.

If the Court of Appeal's ruling stood, banks would need to conduct exhaustive investigations into past transactions, significantly delaying loan approvals and making land-based financing less efficient. This uncertainty could have discouraged financial institutions from accepting land as collateral, restricting access to property financing, business loans, and real estate development funding.

Further, by restoring the principle of deferred indefeasibility, the Federal Court confirmed that banks that acquire security interests in land from a registered proprietor in good faith are protected, even if a prior owner's title is later found to be defective.

II. The Importance of Due Diligence

Further, the Federal Court's decision reinforces the need for banks to exercise reasonable due diligence in cases where there are red flags indicating potential fraud. While the Federal Court's decision clarifies that financial institutions are protected if they act in good faith, a charge still may be set aside if a bank neglects to investigate obvious signs of irregularity. For example, this means that banks must remain vigilant, particularly in cases where:

1. Multiple transactions involving the same property occur within a short time frame.
2. The purchase price is suspiciously low, suggesting a fraudulent transaction.
3. There are existing caveats or encumbrances on the land, which could indicate prior disputes over ownership.
4. The transaction involves individuals or entities linked to past fraudulent dealings.

Conclusion

The Federal Court's decision in *Malayan Banking Bhd* (supra) strengthens the integrity of the Torrens system, ensuring that real estate transactions remain reliable and efficient by allowing banks to rely on the land register without needing to investigate prior transactions. This reinforces certainty and efficiency in land-based financing while ensuring real estate transactions remain secure.

However, the ruling also underscores the importance of due diligence, requiring banks to remain vigilant to signs of fraud and act in good faith when accepting land as security. By striking a balance between commercial certainty and fraud prevention, the ruling provides greater clarity for the stakeholders in real estate industry, safeguarding against unnecessary legal risks while preserving the stability and efficiency of property transactions in Malaysia.

Rakkshanaa Samasundaram | *Associate*
Litigation
rakkshanaa@rdslawpartners.com

Lim Sheh Ting | *Partner*
Litigation
shehting@rdslawpartners.com