Award in company law fundamentals

Lecture Title: *Price Club* judgement

Diploma in Law (Malta)

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Fraudulent Trading – Article 315

- "If in the course of the winding up of a company, whether by the court or voluntarily, it appears that any business of the company has been carried on **with intent to defraud** creditors of the company or creditors of any other person or for any fraudulent purpose, the court on the application of **the official receiver, or the liquidator or any creditor or contributory of the company**, may, if it thinks proper so to do, declare that **any persons** who were knowingly parties to the carrying on of the business in the manner aforesaid be personally responsible, **without any limitation of liability for all or any of the debts or other liabilities of the company** as the court may direct."

Fraudulent Trading – Article 315

"Where the business of a company is carried on with such intent or for such purposes as is mentioned in [sub-article (1)], every person who was knowingly a party in the carrying on of the business in the manner aforesaid, shall be guilty of an offence and liable on conviction to a fine (multa) of not more than two hundred and thirty-two thousand and nine hundred and thirty-seven euro and thirty-four cents (232,937.34) or imprisonment for a term not exceeding five years, or to both such fine and imprisonment."

Main elements (fraudulent trading)

- ✓ In the course of the winding up of the company
- ✓ Business carried out with fraudulent intent
- ✓ Application of the liquidator/official receiver/creditor/contributory
- ✓ Declare those persons knowingly carrying on such business
- ✓ To be held personally and unlimitedly liable for all/any debts and liabilities of the company
- ✓ Multa up to €232,937.34 and, or up to 5 years imprisonment

Silver-lining defence

The English Courts have developed the so-called silver lining or sunshine defence, formulated in the landmark judgement of ***White v. Osmond:*** ,

In my judgment there is nothing wrong in the fact that directors incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fall due. What is manifestly wrong is if directors allow a company to incur credit at a time when the business is being carried on in such circumstances that it is clear that the company will never be able to satisfy its creditors. However, there is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them to get over the bad time

Wrongful Trading – Article 316

1)*"The provisions of this article shall apply where a company has been dissolved and is insolvent and it appears that a person who was a* ***director*** *of the company knew, or ought to have known prior to the dissolution of the company that there was* ***no reasonable prospect that the company would avoid being dissolved due to its insolvency****."*

2)*"The court, on the application of the* ***liquidator*** *of a company to which this article applies, may declare the person who was a director referred to in subarticle (1) liable to make a payment towards the company's assets as the court thinks fit."*

Wrongful Trading – Article 316

3) *"The court shall not grant an application under this article if it is satisfied that the person who was a director knew that there was no reasonable prospect that the company would avoid being dissolved due to its insolvency and* ***accordingly took every step he ought to have taken with a view to minimizing the potential loss to the company's creditors****."*

4) *"For the purposes of subarticles (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take, are those which would be known or ascertained, or reached or taken, by a reasonable diligent person having both –*

a) *the knowledge, skill and experience that may reasonable be expected of a person carrying out the same functions as are carried out by or entrusted to that director in relation to the company; and*

a) *the knowledge, skill and experience that the director has.*

Main elements (wrongful trading)

- ✓ An insolvent dissolution
- ✓ Director knew or ought to have known
- ✓ No reasonable prospect that the company avoids insolvent dissolution
- ✓ Contribution towards the company's assets
- ✓ Brought by the liquidator
- ✓ Defence where despite there being knowledge of no reasonable prospect, such director took every step he ought to have taken with a view to minimizing the potential loss to the company's creditors

COVID -19 legislation – Companies Act (Suspension of filing for dissolution and winding up)

- The provisions of Article 316 have been suspended until 40 days after the an order is made by the Minister lifting such suspension

"the steps a director ought to take with a view to minimising the potential loss to the company's creditors during the suspension established by means of this regulation, shall exclude the filing of an application in court for the dissolution and consequential winding up of the company of which he is a director in terms of article 218 of the Act, or incurring debts in good faith on behalf of the company during its ordinary course of business, unless it is shown that such actions or omissions were deliberately intended to prejudice the pari passu ranking of creditors of the company which existed prior to the act or omission"

The Price Club Case

Dr Andrew Borg Cardona noe vs Victor Zammit et [Court of Appeal] 14 May 2010.

Group structure

A company that operated a chain of supermarkets by the name of Price Club Operators Limited, was burdened with debts and loans sustained by other group companies, where the suppliers were put in a perilous situation due to the created state of affairs, which most of the time were found to be to the benefit of the directors' personal interests.

The structure of the group of companies was as follows:

Facts:

- The Price Club business (as it stood at the time) was acquired by Price Club group in 1998
- The business originally consisted in the operation of 3 supermarkets in Swatar, Marsa and Burmarrad. However, the plan was to increase the supermarkets which was property of a particular family (the Day-to-Day business).
- Eventually, the Price Club also operated in Gozo, Naxxar and Attard and operated a total of 8 supermarkets.
- Ceased operating towards the end of 2001.

Facts: Group structure

- The operations of the Group were carried out as follows: PCH was a Holding Company having 100% interest in PCO, PC Birkirkara Limited, PC Burmarrad Limited, and PC Swatar Limited.

- The latter three Companies each owned a separate supermarket. These three supermarkets were then leased out to PCO and PCO operated them. The rent paid to these three Companies by PCO was to go to pay off the bank loans taken out for the acquisition of the properties and to pay back PCH for the amount it had advanced to them.

- PCO also loaned money to PCH from its profits to pay back the bank loans used to finance the Company.

Facts: Group structure

- The group was structured in a way that PCO would assume all the debts of the Group (this was not prima facie illegal since a corporate group may be formed in a way as to minimise liabilities). However, PCO was undercapitalised – it had huge debts, no realisable assets and no immovable property and very low capital. There was no company in the Group which assumed responsibility for PCO's debts (i.e. guarantees were not granted in favour of creditors).

- The Directors alleged that there was never the intention to defraud creditors with the structure of a holding/operating companies, and that this structure is often used.

Facts: Group structure

- The Court held that although the manner the structure of the group is not in itself illegal, when this structure is examined in light of all other circumstances, the structure was evidence of the directors' dishonest intent, from the outset, to avoid the company's assets being made available to creditors

- Directors argued that creditors had the opportunity to lift the corporate veil so that creditors may attack the property of PCH through the loss of limited liability. The Court held that the lifting of the corporate veil is an extraordinary and costly measure without certainty of success and creditors should not be placed in that position.

Facts: Directors' report

- Art.177 CA obliges directors to compile a directors' report for each accounting period which must show a true and fair review of the company's business. Although towards mid-1999 the directors had become aware of PCO's inability to pay its debts, in the directors' report issued for the period ending 31 September 1999, the directors expressed their confidence that the "**operational performance of the company will improve in the foreseeable future**."

- Mr Justice Mallia also pointed out an occasion when the directors failed to bring mistakes to the auditor's attention.

Facts: Accounting records

- When PCO took over Day-to-Day Supermarket's ("**Day-to-Day**") business in 1998, the sum of Lm 600,000 paid by PCO was not recorded in PCO's accounts. On the contrary, the accounts showed that PCO had loaned that sum to Day-to-Day. Consequently, anyone seeing the accounts would assume that PCO was Day-to-Day's creditor and was entitled to received Lm 600,000. This discrepancy was withheld from the creditors.

- Moreover, PCO's accounts did not present a true and correct picture of the financial position of the company. The financial accounts of the year ending September 2000 showed a loss of Lm 200,000. However, PCO's internal accounts showed a loss of around Lm 1.5 million until March 2011.

Facts: thinly capitalised company

- The court observed that a thinly capitalised company cannot be equated with fraud. **However,** where a subsidiary which has illusory finance obtains credit, the intent to defraud would probably exist. In this case, the company had no realisable assets, huge debts and a low capital decreasing the likelihood of creditors being paid.

Facts: false information to creditors

- The directors were aware that PCO would not be able to start repaying its creditors before 3 years had elapsed. However, rather than disclosing this state of affairs to the creditors, they promised payment within two to three months.

- They also tried to negotiate longer credit terms on the premise that the company was not in financial difficulty but had short-term cash flow problem

Decision:

- The Court concluded that fraudulent intent had been proven and found the directors liable for fraudulent trading.
- The Court of Appeal upheld the decision of the first court that there was an intent to defraud creditors - the company continued to operate with an operating deficit and without a strong capital base and the directors continued to trade in the knowledge that this was to the detriment of creditors.
- ***From the beginning, the directors sought to protect their own interests at the risk of the creditors.***
- The directors were found liable for fraudulent trading in solidum for all the debts of the company.

Conclusion of the Judgement

Ultimately, the Court reached the conclusion that the directors had the intent to enrich themselves at the expense of the creditors at every stage of PCO's trading activity. The Price Club directors did not merely fail to show the required duties of care, skill and diligence expected of them, but they did this with the clear intention of causing undue prejudice to creditors.

The Court chose to conclude that the actions of the directors, which, although considered individually may not be prima facie evidence of fraudulent intent, when considered as a whole, constituted fraud and not merely negligence and mismanagement.

Act LX 2021 – new requirements for the incorporation of a company

- The memorandum of association must now include the email address of the company
- The directors of a private limited liability company must personally sign the memorandum of association indicating his consent to act as a director or must deliver a consent in writing to act as such director. Previously, this requirement was limited to public limited liability companies.

Q&A

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