Award in company law fundamentals

Lecture Title: The *Price Club* judgement

Diploma in Law (Malta)

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LIFTING OF THE CORPORATE VEIL

Maltese law favours **the principle of separate juridical personality** of companies. In metaphorical language, a "veil" is said to separate the members from the company.

Yet, notwithstanding the fundamental principle, Maltese law does, by way of exception, occasionally ignore the separate identity of the company and its members and "**lift the corporate veil**".

FRAUDULENT AND WRONGFUL TRADING: WHOSE AT FAULT?

The Companies Act sets out a number of offences, which may arise:

- in the months leading up to the insolvency and winding up; or
- during the actual winding up procedure,

the most important of which are the offences of:

- fraudulent trading
- wrongful trading

Fraudulent Trading – Article 315 of the Companies Act

"(1) 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 of the Companies Act

"(2) 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

Wrongful Trading – Article 316 of the Companies Act

*"(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 of the Companies Act

"(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

b) 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
- ✓ Application made by the liquidator
- ✓ Possible 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

FRAUDULENT TRADING VS. WRONGFUL TRADING

Fraudulent trading

- During winding up (any type)
- Fraudulent intent
- Any person involved
- Personal and unlimited liability
- Application by liquidator / official receiver / creditor / contributory

Wrongful trading

- During insolvent dissolution
- No need to prove fraud
- Directors only
- Contribution to assets
- Application by liquidator

Silver-lining defence

The English Courts have developed the so-called silver lining or sunshine defence, formulated in the landmark judgement of **Re White and Osmond (Parkstone) Ltd*:***

"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****."*

Silver-lining defence (cont'd)

In a subsequent judgment in **Re R v Grantham**, Lord Lane C.J. disapproved of the statement in **Re White and Osmond (Parkstone) Ltd**, stating that if the director knew that there was no short-term prospect of repaying the debt, then it was irrelevant that some day the "clouds will roll away".

"If a man honestly believes when he obtains credit that although funds are not immediately available he will be able to pay them when the debt becomes due or within a short time thereafter, no doubt you would say that is not dishonest and there is no intent to defraud, but ***if he obtains or helps to obtain credit or further credit when he knows there is no good reason for thinking funds will become available to pay the debt when it becomes due or shortly thereafter then****, though it is entirely a matter for you, this question of dishonesty,* ***you might well think that is dishonest and there is an intent to defraud****."*

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The Price Club Case

The Price Club Case

The 'Price Club Case' collectively refers to the following four Court proceedings namely:

1) Dr. Andrew Borg Cardona as liquidator of Priceclub Operators Limited vs. Priceclub (Holdings) Limited and by a Court decree the directors, Biochemicals International Limited and 2000 Holdings Limited were called into the case – *this was a claim brought forward by the liquidator for the dissolution of Price Club (Holdings) Limited*;

2) Dr. Andrew Borg Cardona as liquidator of Price Club Operators Limited vs. Price Club (Holdings) Limited; Price Club (Birkirkara) Limited; Price Club (Burmarrad) Limited; Price Club (Swatar Limited); Biochemicals International Limited and 2000 Holdings Limited – *this was a claim whereby the plaintiff asked the Court to declare that the defendant Companies abused of the privilege of limited liability and consequently lost it making them therefore liable in solidum towards the Plaintiff Company*;

3) Dr. Andrew Borg Cardona as Liquidator of Price Club Operators Limited vs. Victor Zammit et – *by means of this action the plaintiff asked the Court to find defendant Directors guilty of* ***Wrongful Trading***; and

4) Dr. Andrew Borg Cardona as liquidator of Priceclub Operators Limited vs. Victor Zammit et – *this was an action brought by the liquidator on the basis of the* ***Fraudulent Trading*** *provision in the Maltese Companies Act.*

Two appeals were subsequently lodged in respect of 3) and 4), which appeals resulted in a confirmation of the original judgements as handed down by the Court of First Instance.

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:

Key facts:

- The Price Club business (as it stood at the time) was acquired by Price Club group in 1998
- 3 supermarkets, increasing to 8 in a short period of time
- Ceased operating towards the end of 2001
- The operations of the Group were carried out as follows: PCH was a Holding Company having 100% interest in PCO and various property-owning companies (leased out to PCO as operator)
- 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 such 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).

Key findings:

- The structure was evidence of the directors' dishonest intent, from the outset, to avoid the company's assets being made available to creditors
- No realisable assets, huge debts and a low capital - thinly capitalised company
- Directors' report – true and fair view of the business? / true and correct picture of the financial position of the company?
- Just a short term cash flow problem?
- The directors argued that there was never the intention to defraud creditors with the structure of a holding/operating companies, and that this structure is often used.

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.

Conclusions 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.

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Legislative update

On the 23rd December 2022, the following Acts were published:

i. **The Pre-Insolvency Act** ("PIA") – Act XXIV of 2022, Cap. 631 of the laws of Malta

ii. **The Commercial Code (Amendment) Act** - Act XXIII of 2022

iii. **The Insolvency Practitioners Act** ("IPA") – Act XXV of 2022, Cap. 632 of the laws of Malta

The objective of the above pieces of legislation is to partially transpose the relevant provisions of the **EU Directive on Restructuring and Insolvency (Directive (EU) 2019/1023)** with a view to strengthening the existing framework on pre-insolvency regimes and bankruptcy, introducing the role of the insolvency practitioner, and establishing the Insolvency and Receivership Service within the Malta Business Registry.

Whilst the PIA and the IPA came into force on the day on which they were published, the Commercial Code (Amendment) Act is not yet in force and its provisions shall become effective once a commencement notice to this effect is published by virtue of a legal notice.

EU Directive on Restructuring and Insolvency

- The Directive on Restructuring and Insolvency aims to:
  1. give bankrupt entrepreneurs a second chance; and
  2. make it easier for viable companies in financial difficulty to access restructuring measures at an early stage so as to prevent them from becoming insolvent.

- It lays down rules on:
  a) preventive restructuring frameworks available for debtors in financial difficulties when there is a likelihood of insolvency, with a view to preventing insolvency and ensuring the viability of the debtor;
  b) procedures leading to a discharge of debt incurred by insolvent entrepreneurs; and
  c) measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.

- The Directive on Restructuring and Insolvency generally became applicable in EU Member States on the 17th of July 2021, apart from the rules on electronic communication (Article 28) which apply from the 17th of July 2024 and 17th of July 2026, and the **deadline for its transposition was the 17th of July 2022.**

Pre-Insolvency Act (PIA)

- The PIA came into force on the 23rd of December 2022 by virtue of Act XXIV of 2022 with the aim of implementing the provisions of the Directive on Restructuring and Insolvency.
- It introduces **an extra-judicial corporate rescue mechanism** to be availed of by eligible debtors at a pre-insolvency stage where there exists a viable prospect of survival.
- This is in addition to the pre-existing corporate rescue mechanisms that are already found in the Companies Act, namely:
    i. The Company Recovery Procedure (Article 329B of the Companies Act)
    ii. Compromises & Arrangements – Company Reconstruction (Article 327 of the Companies Act)
- The Civil Court (Commercial Section) has been designated as the competent court competent to deal with matters arising under the PIA.

Commercial Code (Amendment) Act, 2022

- The Commercial Code (Amendment) Act, 2022 (the **"Amendment Act**"), was published on the 23rd of December 2022, with the aim of implementing the provisions of the Restructuring Directive and overhauling the bankruptcy regime set out in Part III of the Commercial Code (Cap. 13 of the laws of Malta).
- The provisions of the Amendment Act are not yet in force and shall come into effect once a commencement notice to this effect has been published.
- In terms of the Directive on Restructuring and Insolvency, Member States are bound to ensure that **insolvent entrepreneurs have access to at least one procedure that can lead to a full discharge of debt within a period of 3 years.**
- In terms of the aforementioned Directive, "full discharge of debt" means that the **enforcement against entrepreneurs of their outstanding dischargeable debts is precluded or that outstanding dischargeable debts as such are cancelled, as part of a procedure which could include a realisation of assets or a repayment plan or both.**

Commercial Code (Amendment) Act, 2022

By virtue of the Amendment Act, the scope of the bankruptcy regime previously available to 'traders' has been widened:

Outgoing regime	New regime
'trader'	*'commercial debt'*
Prior to the amendments, the bankruptcy provisions could only be availed of by **a trader** as defined in Article 4 of the Commercial Code.	By virtue of the amendments, the bankruptcy provisions are available to traders, and well as **any person, natural or legal, who becomes liable for commercial debts**, whether as principal debtor or otherwise **who is deemed unable to pay their debts.**

State of bankruptcy

In terms of proposed new **Article 477 of the Commercial Code**, a trader that is unable to pay his commercial debts shall suspend the payment of all his debts, and upon suspension thereof shall be in a state of bankruptcy. Similar to Article 214(5) of the Companies Act, in order to determine whether a trader is unable to pay their debts, the Amendment Act sets out a balance sheet test and a cash flow test.

Art. 477(1) - Balance Sheet Test

Every trader who, **having regard also to his contingent and prospective liabilities**, is unable to pay his commercial debts, shall suspend the payment of all his debts, and shall, upon the suspension thereof, be in a state of bankruptcy.

Art. 477(2) - Cash Flow Test

Without prejudice to the provisions of sub-article (1), **if a commercial debt due by the trader has remained unsatisfied in whole or in part after 24 weeks from the enforcement of an executive title against the trader**, the trader **shall suspend the payment of all his debts and be deemed to be in a state of bankruptcy.**

Filing for bankruptcy

Any trader unable to pay commercial debts is to suspend the payment of all debts.
The suspension operates to place the trader in a state of bankruptcy, triggering the obligation to file for bankruptcy without undue delay

Creditor/s of the bankrupt trader may request the Court to declare bankruptcy. This is to be made against a security of 10% of the debt owing to the creditor or €1,000 whichever is greater

Within 30 days from the filing / demanding of the declaration of bankruptcy, the Registrar is to call upon the relevant parties to disprove the trader's state of bankruptcy and make submissions on the appointment of the bankruptcy trustee ("**BT**")

Following the said submissions, the Court will either declare bankruptcy by judgement or dismiss the application as it deems fit.

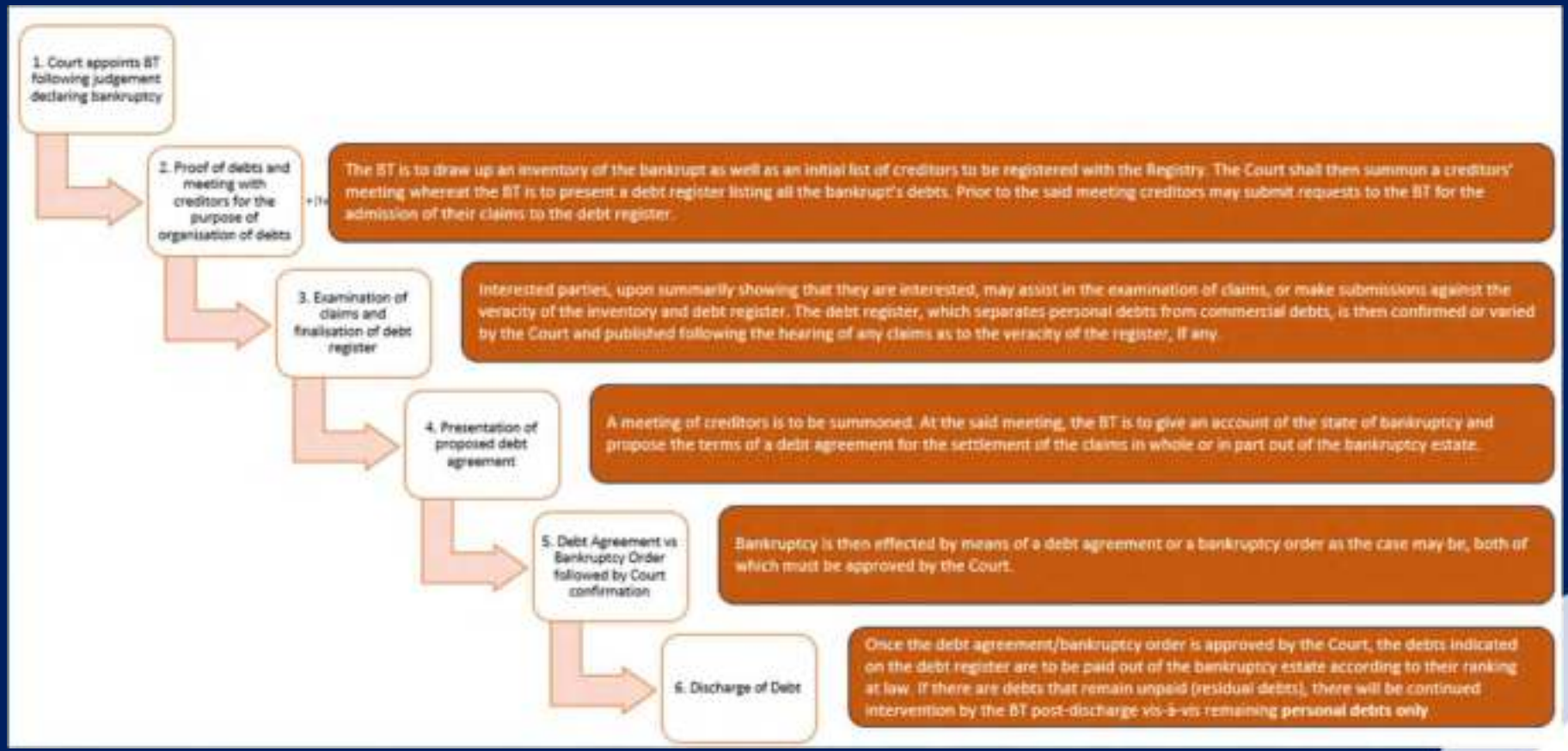
Any transfer of assets, payment of debts, or act of trade made by a trader in a state of bankruptcy, between the date of the suspension and the date of the judgment declaring bankruptcy, shall, unless the Court rules that the debtor is not in a state of bankruptcy, be null and void.

The Bankruptcy Trustee

The curator has been replaced by the Bankruptcy Trustee who is to be appointed by the Court, and is to be duly authorised in terms of the PIA.

- Receives moneys intended for the bankrupt
- Augments the bankruptcy estate
- Continues the business of the bankrupt where this is authorised by the Court
- Organises creditors of the bankrupt into classes for the purpose of voting on any proposed agreement
- Administers the bankruptcy estate held on trust
- Draws up an inventory comprising the report on the BE to be filed in the Registry
- Assesses whether bankruptcy is fraudulent
- Makes compromises and refers disputes for arbitration, subject to creditor and court approval
- Evaluates debts of the bankrupt to prepare the debt register

The bankruptcy process



The Insolvency Practitioners Act (IPA)

- The IPA came into force on the 23rd of December 2022
- It creates and regulates the new profession of **Insolvency Practitioners (IP).**
- It also establishes the **Insolvency and Receivership Service** within the Malta Business Registry, the competent authority for the implementation of the IPA and charged with regulating the activities of insolvency practitioners.

The role of the Insolvency Practitioner (IP)

No person shall exercise the functions of an IP in terms of the IPA or hold himself out as being available to act as an IP unless he is duly authorised by the competent authority. Any person **duly authorised** by the **competent authority** to act as **IP** shall be authorised to:

- Act as an **Insolvency Practitioner** under the PIA
- Act as a **Bankruptcy Trustee** under the Commercial Code
- Act as a **liquidator, special controller, provisional administrator**, or **special manager** in terms of the Companies Act
- Carry out **any other function requiring the competence of an IP,** in terms of law or any directive of the competent authority

It is possible for the competent authority to **limit the functions** of **an authorised IP** such that they will be authorised under a specific category/ies.

Eligibility for Authorisation

Be authorised to exercise the profession of **advocate**, **accountant** or **auditor**, whether in **Malta or in another recognised jurisdiction**, **OR** hold **any other qualification** deemed **sufficient by the competent authority**

Has satisfied the competent authority that he possesses **sufficient competence in the fields of expertise pertinent to the performance of the functions of an IP**, as may, from time to time, be further defined in directives issued by the competent authority

Has satisfied the competent authority that he is **fit and proper** to carry out the functions of an IP **AND** has **not had any previous authorisation granted under this the IPA withdrawn due to misconduct**

Has satisfied such other **additional criteria or requirements** as may, from time to time, be further provided for **in any regulations or directives made under the IPA**

Disqualification Criteria

- Previous authorisation withdrawn for misconduct;
- Interdicted, incapacitated, or an undischarged bankrupt;
- Convicted of crimes affecting public trust or theft or fraud or knowingly receiving property obtained by theft or fraud;
- Non-emancipated minors; or
- Subject to a disqualification order under Article 320 of the Companies Act.

Fines

Any person who carries out the functions of an IP without being authorised to do so under the IPA or holds himself out to a third party as being a person who is authorised to act as an IP when he is not so authorised, shall, on conviction, be liable for each offence to a fine (multa) not exceeding €25,000 or to imprisonment of not less than two years and not more than five years, or to both such fine and imprisonment.

Registered Firms

- The IPA also creates the notion of registered firm. **Legal persons may be authorised by the competent authority**, regardless of their legal form, **which would enable the registered firm so authorised and any connected undertaking** to **carry out the functions of an IP.**

- In terms of the IPA, a connected undertaking means '*an undertaking which is effectively managed or promoted as one practice with the registered firm or as a related undertaking of the registered firm*'

- To qualify for authorisation, the registered firm must have at least one **principal**, a natural person authorised to act as an IP in terms of Article 4 of the IPA. A person is deemed to be a principal of a registered firm where such person is:
  - a member of the registered firm's administrative or management body;
  - vested with legal and/or judicial representation of the registered firm; or
  - responsible for directing the fulfilment of any engagements taken on by the registered firm.

The Insolvency and Receivership Service

The competent authority in terms of the IPA is the Insolvency and Receivership Service within the Malta Business Registry

Register of IPs

One of the competent authority's functions is to establish and maintain a **public register** to be known as the **Register of IPs**, which to date, is **not yet available**. The Register is to **separately identify the following**:

1. IPs;
2. Registered Firms;
3. Categorisation of the functions of each IP, and the extent of the authorisation of each IP and registered firm;
4. IPs and registered firms whose authorisation has been suspended, revoked, or withdrawn; and
5. IPs and registered firms who are deemed to be in default of their obligations in terms of the IPA or any regulations or directives made under it.

The Register shall include the following details:

- With respect to **IPs,** their name, surname, office address and email;
- With respect to **registered firms**, its name, designation, office address, email and a list of IPs employed or connected therewith.

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