Award in company law fundamentals

Lecture Title: Wrongful trading, fraudulent trading and the Price Club case

Diploma in Law (Malta)

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Overview

1. Introduction: Personal liability of directors
2. The offence of wrongful trading and fraudulent trading
3. Highlights from the landmark ‘Price Club’ Case
4. Legislative Update: EU Directive on Insolvency and Restructuring (Pre-Insolvency Act, Commercial Code Amendment Act, Insolvency Practitioners Act)

Additional duties when a company is in financial distress or insolvent

- In addition to the duties incumbent on directors when a company is solvent, which continue to apply when the company is no longer solvent, **an additional duty would apply in circumstances where the company is unable to pay its debts, or is imminently likely to become unable to pay its debts.**

- Article 329A of the Companies Act requires directors to convene a general meeting of the company to review the company's position, **where they become aware of the company's inability, or imminent inability, to pay its debts.**

- Such duty referred to in Article 329A of the Companies Act35 is triggered **prior to the company reaching a state of insolvency in terms of Maltese law.**

Additional duties when a company is in financial distress or insolvent

- Article 329A of the Companies Act **does not extend so far as to require directors to place the company into liquidation.**

- The Companies Act **does not expressly prohibit directors from allowing the company to continue to engage in business activities** when the company has reached a state of insolvency or financial distress.

However, depending on the circumstances of the case at hand, doing so may **potentially expose directors to personal liability**.

Restrictions - Personal liability

- Beyond the positive duties imposed on directors when a company is insolvent or in financial distress, the Companies Act sets out a number of provisions **restricting a director from conducting himself in a particular manner.**
- As a consequence of directors conducting themselves in the manner described in such provisions, directors may be **exposed to personal liabiaility**.
- In specific instances, certain behaviour during insolvency or the time leading up to insolvency can constitute a **criminal offence**.

Personal liability – offences

- Wrongful trading
- Fraudulent trading
- Fraudulent preferences
- Fraud in anticipation of dissolution
- Fraud by officers of companies subsequently wound up
- Fraud while the company is being wound up
- Delinquent directors

Wrongful Trading

Wrongful Trading – Article 316

"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****."*

"The court, on the application of the ***liquidator*** *of a company to which this article applies, may declare the person who was a director […] liable to make a payment towards the company's assets as the court thinks fit."*

Wrongful Trading – Article 316

"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.****"*

Wrongful Trading – Main elements

The following considerations ought to be made for the purpose of determining whether liability for wrongful trading may arise:

(i) whether the person has been a **director (or a "shadow director**");

(ii) whether the company has been dissolved and is in the course of winding up, specifically **insolvent winding up;**

(iii) whether the director **knew or ought to have** concluded that there was **no reasonable prospect that the company could have avoided being dissolved due to its insolvency**;

(iv) whether the director **took every step which he ought to have taken** with a view to minimising the potential loss to the company's creditors.

Degree of knowledge

In assessing **whether the director knew or ought to have known** that there was no reasonable prospect that the company could have avoided being dissolved due to its insolvency, the Maltese courts would consider:

a) ***Objective test:*** *the knowledge, skill and experience that* ***may reasonably 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) ***Subjective test:*** *the knowledge, skill and experience that* ***the director has.***

These two tests must be satisfied cumulatively.

No reasonable prospects of avoiding insolvent liquidation

- This examination will entail consideration of a number of factors, such as:
  - **pressure from creditors,**
  - **illiquidity,**
  - **lack of financial support,**
  - **employment and contract losses, and**
  - **difficulty to collect what is due to the company.**

- Fraud or dishonesty do not need to be proved for wrongful trading.

- **Actions that can lead to liability for wrongful trading** include failing to safeguard the company's assets, entering transactions at less than fair value, paying excessive compensation to company officers, and neglecting to collect debts owed to the company.

Took every step to minimize potential creditor losses

- The director is burdened with the onus of proving that he has in fact taken every step to try to reduce any potential losses to the creditors.
- This is the only defence afforded to directors in proceedings of this nature.

Wrongful trading test

Therefore, a director will **not** be found liable for wrongful trading if:

(i) he shows that he knew that there was no reasonable prospect that the company would avoid being dissolved due to its insolvency; and

(ii) accordingly took every step he ought to have taken with a view to minimising the potential loss to the company's creditors.

Consequences

- If found to be in breach of Article 316 of the Companies Act, a director may be held liable to make a contribution to the company's assets at the discretion of the court.

- The liability to make said contribution to the company's assets may not necessarily equate with making good damages caused to the company, and in turn cannot be applied in favour of a particular class of creditors.

Fraudulent Trading

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 to do so, 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 [...] 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."*

Fraudulent Trading – Main elements

The following considerations ought to be made for the purpose of determining whether liability for fraudulent trading may arise:

(i) the provision may be invoked against any person **knowingly party to the fraud';**

(ii) whether the company has been dissolved and is **in the course of winding up (court or voluntary);**

(iii) The business of the company is carried out with **intent to defraud or for fraudulent purposes**.

Parties to the fraud

- Article 315 applies to 'any persons who were knowingly parties to the carrying on of the business'.

- This goes beyond the reference to directors and shadow directors made in article 316.

- The provision can be invoked against **any person involved in the fraud**, and liability may therefore be imposed not only on directors, but **also on managers, shareholders and on any other person** as long as they are knowingly parties to the fraud. Accordingly the action may be brought against any person complicit in the fraud which has been perpetrated.

Parties to the fraud

- **English jurisprudence:**

*In my judgment, **a creditor is party** to the carrying on of a business with intent to defraud creditors if he accepts money which he knows full well has in fact been procured by carrying on the business with intent to defraud creditors for the very purpose of making the payment.*

Intent to defraud

- In order to state that the business of a company has been conducted with fraudulent intent, proof of **actual dishonesty** must be provided, which translates into proof of the **intention to compromise a creditor.**

- The intention arises from the **conduct**, even **by inference**, having regard to all the circumstances of the case.

Intent to defraud

- **E.g.-** If it is proven that a director asks for an advance when he knows, or was aware of the fact that, there was **a real risk that there was not the possibility that the repayment would be made within the timeframe agreed upon,** therefore such behaviour would qualify as commercial fraud.' stances of the case.

- **English jurisprudence quoting Arlidge & Parry:** *Although it is not easy to describe comprehensively all the different types of activity that will constitute the carrying on of business with intent to defraud creditors, three categories emerge from the authorities:*
  1. *Putting the trader`s **existing creditors at risk of** not being paid;*
  2. *Causing people who are **not his existing creditors to become his creditors** at a time when he is, or is likely to become, insolvent;*
  3. *Doing things which give **rise to causes of action in damages** against him in favour of people who are not his existing creditors*

Intent to defraud

- **Andrew Keay**

*The test for intent to defraud **is subjective and not objective**, in that **the state of mind of the respondent** at the time of the alleged fraudulent trading will be the deciding factor. But, having said that, objective considerations are not irrelevant. The **circumstances surrounding alleged fraudulent trading must be taken into account** and a respondent may have some difficulty extricating himself or herself from liability if the subjective view was not reasonable.'*

Financial position

- At the time of engaging in activities which may potentially satisfy the 'intent to defraud' test, the company **need not be insolvent**, nor in a state of financial distress.

- Therefore, a person may be exposed to liability for fraudulent trading in respect of fraudulent conduct carried out **before the company has reached a state of insolvency, or financial distress.**

- **However the provision can only be invoked once the company has been dissolved and is in the course of winding up. This weakens the efficacy of the provision.**

Consequences

- A director found in breach of the fraudulent trading provision faces two types of sanctions

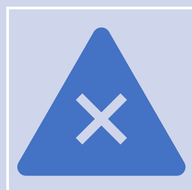
1. The civil offence of fraudulent trading → unlimited liability for all or any of the debts or other liabilities of the company as the court may direct

2. The criminal offence of fraudulent trading → subject to a fine of up to €232,937.34, imprisonment of up to five years, or both

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

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The Price Club Case

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

Group structure

The structure of the Group of companies was as follows:

***A company that operated a chain of supermarkets by the name of Price Club Operators Limited **burdened with debts and loans sustained by other group companies.**

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
- 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.** 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

Continuing to trade

- The way directors **dishonestly disregarded the interest of creditors**: the directors caused the company to continue trading and incur indebtedness even after realising that the amount due to creditors was on the rise.

- **They abused creditors' monies by continuing to trade, asking for more credit and doing so on false pretences.**

Key findings

The structure of the group

- The creation of the structure of the group in itself and taken alone **was not regarded by the courts as unlawful** since a corporate group may be formed in a way to minimize liabilities, however the court remarked that the way in which the group was structured **did indicate an intent on the part of the directors/shareholders to avoid the risk of creditors attacking their personal assets or the material assets of the group.**

- In this case it transpired that the operations of the applicant company were directed by its holding company and that certain obligations and liabilities were assumed by it not so much in its own interest **but in the interest of its holding company and of the directors and shareholders of the holding company**. The court regarded the holding company (and possibly also its shareholders) to have been acting as **a shadow director** and, as such, could have held the holding company liable in terms of the wrongful trading provision in the Companies Act.

Key findings

Under capitalization

- The company had commenced business with an operating deficit and without a sufficient capital base.

- 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.

Key findings

Management of the company

- The directors did not act prudently and honestly in taking on such role as they **did not have the necessary competence and experience.**

- In view of their lack of expertise, the directors were obliged to ensure the company was built on financially stronger foundations and necessary investments were made.

Key findings

The Dissemination of False Information to Creditors

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

- Moreover, the directors held meetings with the creditors to request longer credit periods. At these meetings, although being fully aware that the company was in dire financial straits and that there was no possibility of further financing, the directors always presented the company's financial difficulties as being **a temporary cash flow problem.**

Key findings

Directors' report

- Article 177 obliges directors to compile a directors' report for each accounting period which must show a **true and fair review of the company's business**.

- The court emphasised that, 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 30 September 1999, the directors expressed their confidence that the 'operational performance of the company will improve in the foreseeable future.' **The court viewed this misleading directors' report as a clear indication of the directors' intent to defraud the creditors.**

Key findings

True and fair view of financial position?

- The company's accounts have been "manipulated" in such a way that, while, perhaps, being correct for accounting standards, they **do not give a clear picture of the true situation of the company.**

- The accounts must not only be correct, but must be clear and give the third party that he is entitled to give them faith, a true and fair view of the situation.

- The audited financial statements and the reports of the respondent directors and auditors of PCO gave a misleading, and even fraudulent, picture of the financial situation of PCO.

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

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

- Despite the fact that the requirements of the wrongful trading action are satisfied in the Price Club judgements, it is significant that the court found the **<u>directors liable for fraudulent trading and not merely for wrongful trading</u>**.

- As a result of its judgement, the court chose to step things up a notch and conclude that the actions of the directors, which, although considered individually may not be prima facie evidence of fraudulent intent**<u>, when considered as a whole, constituted fraud and not merely negligence and mismanagement.</u>**

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Pre-insolvency reforms

Legislative updates

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, 2022 - 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.

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 Restructuring Directive. 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:

i. The Company Recovery Procedure (Art. 329B of the Companies Act)

ii. Compromises & Arrangements – Company Reconstruction (Art. 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.

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.**

- 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:
  - They are a member of the registered firm's administrative or management body;
  - They are vested with legal and/or judicial representation of the registered firm; or
  - They are responsible for directing the fulfilment of any engagements taken on by the registered firm.

The Competent Authority

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**. 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.

The Register is now publicly available - https://businessrestructuring.mbr.mt/en/registry-of-insolvency-practitioners

Launch of Self-Assessment Insolvency Tool

On the 15th of November, 2024, the Insolvency and Receivership Service within the Malta Business Registry (the "**MBR**") launched a new online portal with an innovative tool designed to help companies in self-assessing their financial position and determining whether they can continue with their business operations.

The purpose of the insolvency tool is to help businesses monitor and self-assess their operations, with the aim of hopefully avoiding insolvency and resulting in a better chance of companies in financial difficulty recovering or restructuring their debts.

Launch of Self-Assessment Insolvency Tool

To maximise the effectiveness of this early warning tool, companies should implement certain mechanisms that alert directors as early as possible to a potential risk that the company may face financial distress, including:

- Keeping accurate and up-to-date accounting records including management accounts;
- Creating budget and cash flow projections to ensure debts can be paid;
- Monitoring debt collection and the payment of suppliers;
- Creating an adequate system to ensure that tax obligations are met.

In circumstances where the self-assessment tool indicates a potential risk for insolvency or if the directors think that a company is, or is likely to be, unable to pay its debts, the directors should consider seeking appropriate advice.

Thank you

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