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
3. The offence of fraudulent trading
4. Highlights from the landmark ‘Price Club’ Case

Different modes of liquidation

Different modes of liquidation

- Members' voluntary winding up
- Creditors' voluntary winding up
- Court winding up

Insolvency vs Financial Distress

Insolvency:

- No definition per se of “insolvency” in terms of Maltese law,
- Article 214(2)(a)1 of the Companies Act establishes the concept of ‘ inability to pay debts’ as a cause for dissolution and consequential winding up of a company:

  214(2)(a) *‘ a company may be dissolved and wound up by the court in the following cases – […] (ii) the company is unable to pay its debts’ .*

- There are two alternative insolvency tests to determine inability to pay debts”: (i) the cash flow test; and (ii) the balance sheet test.

Insolvency vs Financial Distress

- **Financial distress:**

Maltese courts tend to make reference to expressions such as ‘ financial distress’ , ‘ financial difficulties’ , ‘ approaching insolvency’ , and ‘ precarious somewhat interchangeably and not on the basis of a precise definition of the state of affairs represented by such expressions.

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 Act 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.**

- But it requires the directors to convene a general meeting to **allow the shareholders to review the company's position and determine the steps forward, including the possibility of liquidation and the corporate recovery procedure.**

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 liability**.

- In specific instances, certain behavior during insolvency or the time leading up to insolvency can constitute a **criminal offence**.

…….What kind of behavior?

Restrictions - Personal liability

…….What kind of behavior?

The Companies Act does not expressly prohibit directors from allowing the company to **continue to trade** when the company has reached a state of insolvency or financial distress….

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

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

Personal liability – offences

- Status of the company when certain behaviour was conducted – dissolved? Insolvent? In the process of winding up?
- To whom the offence is directed – solely directors? Shadow directors? Officers of the company?
- Who can bring the action – creditors? the liquidator?
- What is the determining factor – intent to defraud?

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(2)

"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**" *–(…'For the purposes of this article, "director" includes a person in accordance with whose directions or instructions the directors of the company are accustomed to act)*

(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 – "knew or ought to have known…"

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.

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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**.

(i) 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.

(i) Parties to the fraud

- **English jurisprudence:**

Bowood Constructions Limited vs Greta Bugeja et (FHCC, 2017);

In this case, a company had judicial proceedings instituted against it, along with other persons, for fraudulent trading, however the company pleaded that the provision applies to physical persons only.

The Court, however, stipulated that even a company can be held liable under this provision; even stating that a financial consultant or an auditor too could be held liable.

(ii) 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.**

(iii) 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.

(iii) 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, s**uch behaviour would qualify as commercial fraud.

- **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 o**f 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*

(iii) 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 accoun**t and a respondent may have some difficulty extricating himself or herself from liability if the subjective view was not reasonable.'*

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

Fraudulent Preferences

Fraudulent Preference

- Transactions carried out within six months preceding a company' s deemed date of dissolution may be annulled if they constitute a **transaction at an undervalue or a fraudulent preference** - Article 303 of the Companies Act.

- A company is considered to have entered into a transaction at an undervalue if:

(i) the company makes a gift or otherwise enters into a transaction on terms under which the company receives no consideration; or

(ii) the company enters into a transaction for a consideration the value of which is significantly less than the value of the consideration provided by the company.

- A company is considered to have given preference to a person if:

(i) that person is one of the company' s creditors or a surety or guarantor for any of the company' s debts or other liabilities; and

(ii) the company does anything or suffers anything to be done which, in either case, has the effect of putting that person into a position which, in the event of the company going into insolvent winding up, will be better than the position he would have been had that act or omission not occurred.

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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.

Key facts:

- When PCO was wound up, it had enormous debt - more than Lm8,000,000 - and very few realisable assets. The advances of Lm1,146,754 that PCO had made to PCH were used principally by PCH to pay interest and part of the capital loan it had taken from HSBC Bank Malta plc and from shareholders.

- As a consequence of the insolvency and consequential winding up of PCO, the majority of the rent that the 3 Prop Cos should have received from PCO could not be paid, and as a result, these companies could not pay their debts and/or pass funds to PCH so that it could pay its debts.

- Moreover, PCO no longer had funds to lend to PCH so that the latter could honour its obligations. Besides the fact that PCH had no cash-flow to pay its debts as they fell due, PCH also had a substantial deficiency in its balance sheet, with liabilities exceeding assets.

- **For these reasons, PCH could not pay its debts, including the debt of Lm1,146,754 owed to PCO.**

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 direc**tor 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 **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.**

- 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 **directors liable for fraudulent trading and not merely for wrongful trading**.

- 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**, when considered as a whole, constituted fraud and not merely negligence and mismanagement.**

Thank you

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