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Law for Directors & Managers

Lecture 10

Dissolution and Winding up
-
Part 2

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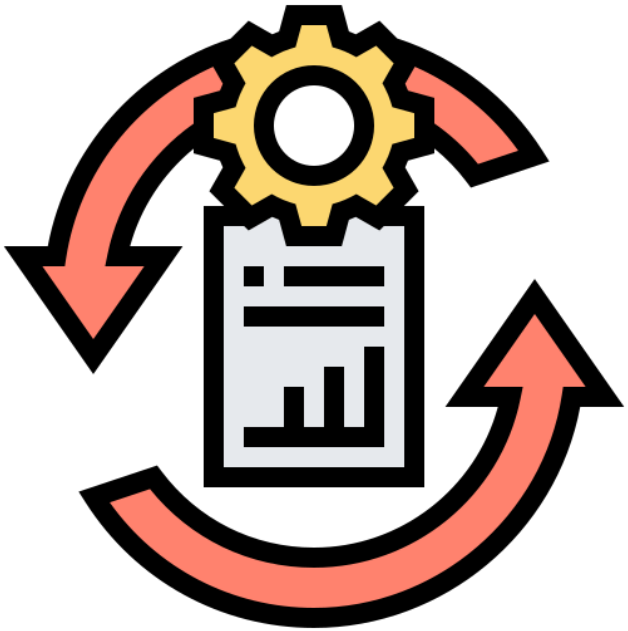
ADVOCATES

The Company Recovery Procedure
-
Article 329A



The Company Recovery Procedure - Article 329A

Article 329A deals with the obligation of the BoD to convene a general meeting in such case where the company is unable to pay its debts or is imminently unable to pay its debts.

The Company Recovery Procedure - Article 329A

Where the directors of a company become aware that the company is unable to pay its debts or is imminently likely to become unable to pay its debts, they shall forthwith, not later than **30 days** from when the fact became known to them, duly convene a general meeting of the company by means of a notice to that effect for a date not later than **40 days** from the date of the notice for the purpose of reviewing the company's position and of determining what steps should be taken to deal with the situation, including:

a. consideration as to whether the company should be dissolved or, where applicable,
b. whether the company should make a company recovery application in terms of article 329B.

Applicability and conditions of the Company Recovery Procedure – Art.329B

The Company Recovery Procedure applies to:

- Companies which are unable to pay its debts
- Companies which are imminently likely to become unable to pay its debts

The following may file for the company recovery procedure:

1. The company, following an extraordinary resolution;
2. Directors, following a decision of the board;
3. Creditors of the company representing more than half in value of the company's creditors; or
4. A class of creditors (more than have of the value of the creditors in that class)

Application

Application requesting the Court to place the company under the company recovery procedure and to appoint a special controller to take over, manage and administer the business of the company for a period to be specified by the Court

Application

The application shall, as far as possible, give the full facts, circumstances and reasons which led to the company's inability or likely imminent inability to pay its debts, together with a statement by the applicants as to how the **financial and economic situation of the company can be improved in the interests of its creditors, employees and of the company itself as a viable going concern**.

Application by the Company

When the application is made by **the company itself**, the following documents would need to be annexed to the Application:

1. A statement of the company's assets and liabilities; and

2. A list of the names and addresses of the creditors of the company with an indication of the amount due to each creditor and whether the debt is secured/unsecured

Application by the Creditors

When the application is made by **the creditors**, it shall be accompanied by appropriate supporting documentation and statements.

Powers of the Court in relation to the Application

On hearing an Application the Court shall examine all circumstances and options available to the company and shall consequently determine whether to dismiss the application or issue a company recovery order (the "Order") acceding to the request and placing the company under the company recovery procedure.

Powers of the Court in relation to the Application

The Court shall grant an Order only where it is satisfied that:

1. The company is, or is imminently likely to become, unable to pay its debts; and

2. the making of the Order would be likely to achieve either the survival of the company as a viable going concern in part or in whole or the sanctioning of a compromise or arrangement between the company and any of its creditors or members.

The Court is to decide whether to dismiss or to uphold an Application within 40 working days from its filing.

Effects of Order for Company Recovery Procedure

Upon the submission of an application and unless itis dismissed, or during the period during which the company recovery procedure is in force:

i. any pending or new winding-up application shall be stayed;

ii. no resolution for the dissolution and consequential winding up of the company may be passed or given effect to;

iii. the execution of claims of a monetary nature against the company and the relative interest which may accrue shall be stayed;

iv. during the tenure of any lease by the company, no landlord may exercise any right of termination of lease in relation to such premises in respect of a failure by the company to comply with any term or condition of its tenancy, except where specifically provided for by the Court and subject to the terms and conditions imposed by the Court;

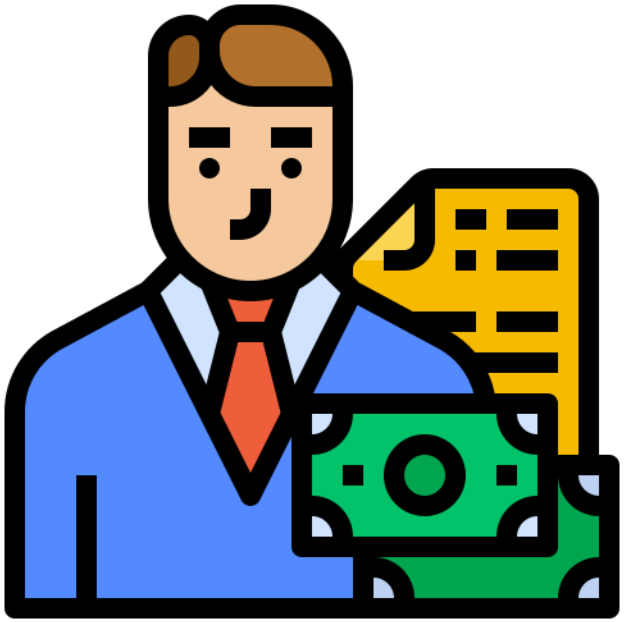
v. no other steps may be taken to enforce any security over the property of the company, or to repossess goods in the possession of the company under any hire-purchase agreement, except with the leave of the Court and subject to the terms imposed by it;

vi. no precautionary or executive act or warrant shall be made or continued against the company or any property of the company except with leave of the Court and subject to such terms as the Court may deem fit to impose;

vii. no arbitration proceeding shall be made or continued against the company or any property of the company; and

viii. no judicial proceedings may be instituted or continued against the company or in relation to its property except with leave of the Court and subject to such terms as the Court may deem fit to impose.

The Special Controller



Who takes over a company recovery procedure?

A **special controller** is appointed for a period not exceeding 4 months, but the court can extend the period by another 4 months on good cause being shown, provided that aggregate additional periods do not exceed a further 8 months (the total period cannot exceed 12 months).

The Appointment of the Special Controller

The Order issued by the Court should contain the appointment of an individual to act as Controller and to carry out those functions and powers as prescribed by the Court for the management and administration of the business and property of the company.

The Appointment of the Special Controller

- The management and direction of the company (and possibly operational subsidiaries) would be removed from the directors and handed over to the Controller that the court would have appointed for this purpose.

- Negotiations with creditors for potential compromises or other forms of arrangements would also need to be taken into account.

- The remuneration of the Controller shall be determined by the Court.

Powers and duties of the Special Controller

- During the period in which the Order is in force, the company shall carry on its normal activities under the management of the Controller.

- The Controller is obliged to perform his functions fairly and equitably taking into account the best interests of the company, its shareholders and creditors as well as any other interested party.

Powers and duties of the Special Controller

- Upon the appointment of the Controller all powers conferred on the company, its directors or officers are suspended and are assumed by the Controller.

- The Controller is to take under his control all the property of the company in pursuit of his obligation to manage and supervise the activities, business and property of the company.

- He is to examine the assets, affairs and business performance of the company.

Powers and duties of the Special Controller

In addition to the functions and powers prescribed to the Controller by the Court, the Controller has the power:

i. after informing the Court, by means of a note, to remove any director of the company and to appoint any individual to serve as a manager;

ii. to engage persons for professional or administrative services, and commit the company to the payment of their respective fees or charges; or

iii. to call any meeting of the members or creditors of the company.

The Act prescribes the following limitations on the powers of the Controller and he cannot, without the express authorisation of the Court:

iv. engage the company into any commitment lasting more than six months; or

v. terminate the employment of company employees as he considers necessary for insuring the continuation of the company as a viable going concern in whole or in part; or

vi. sell or otherwise dispose of property of the company to himself, or to his spouse or relatives.

Meetings of Creditors and Members

The Controller is required to convene a meeting or meetings of the creditors and members **within 1 month** from his appointment (convened either jointly or separately).

A minimum of **7 days' notice** of such meeting must be given to the members, creditors and also to any directors or other officers of the company whose presence at the meeting is, in the opinion of the Controller, required.

Meetings of Creditors and Members

The purpose of such meeting is to:

i. present the creditors and/or members a comprehensive statement of the company's affairs together with the preliminary proposals on the future prospects and management of the company;

ii. appoint a joint creditors and members committee, consisting of up to 3 creditors and up to 3 members, to advise and assist the Controller in the management of the affairs, business and property of the company; and

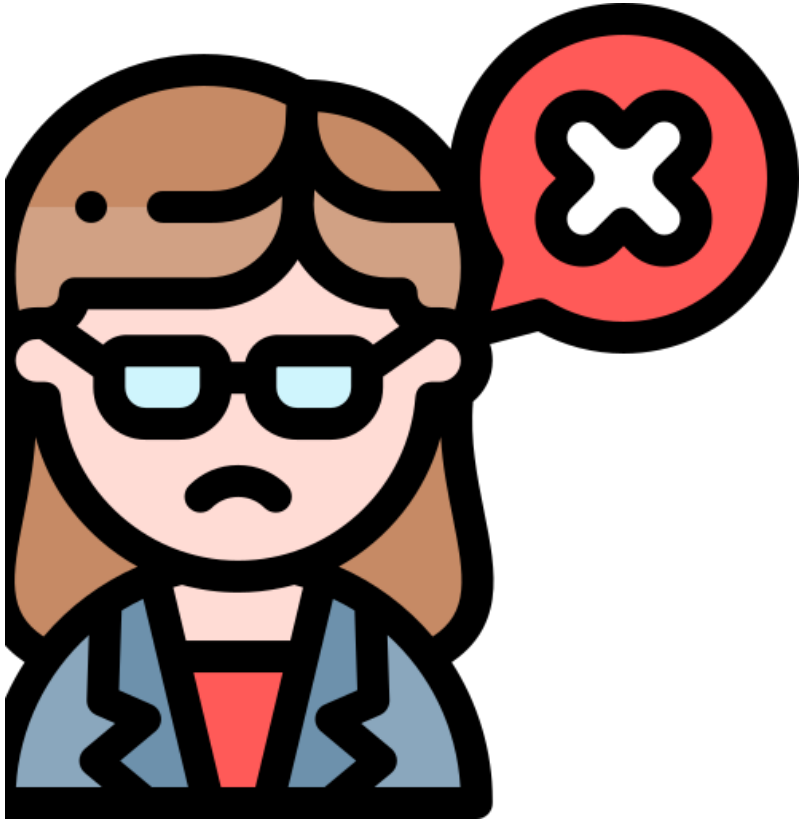
iii. discussing the proposals for the future prospects and management of the company, to be presented to the court

Powers of the Controller in relation to Fraudulent Trading

If during such time as the company recovery procedure is in force, it appears that any business of the company has been carried on with intent to defraud creditors of the company or for any fraudulent purpose, the Court on the application of the Controller, 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.

Where the business of a company is carried on with such intent or for such purposes, every person who was knowingly a party in the carrying on of the business in the manner aforesaid, shall be guilty to affine of not more than €232,937.34 or imprisonment for a term not exceeding five years.

Powers of the Controller in relation to Wrongful Trading



In the event that it appears that a person who is a director of the company knew, or ought to have known, that the company is unable to pay its debts or is imminently likely to become unable to pay its debts, the Court, on the application of the Controller of a company, may declare the person being a director liable to make a payment towards the company's assets as the Court thinks fit.

Recovery Plan

At the end of the original period of appointment or at the end of each extension, the special controller is to submit to the Court a comprehensive report in writing on the proceedings of his administration and of his proposals regarding the prospects for the recovery of the company as a viable going concern in whole or in part. This must be registered with the Malta Business Registry.

Where such report expresses the opinion that the company has a reasonable prospect of continuing as a viable going concern or where an application is made to the Court by the Controller who deems that the affairs of the company have improved, the report should additionally have attached to it a precise and detailed recovery plan.

The termination of the Order

The Controller is required to make an application to the Court, after consulting the joint creditors' and members' committee, for the termination of the company recovery procedure, which is still in force, if it results to him that either:

i. it would **serve no useful purpose for the company to continue with the said procedure**; or

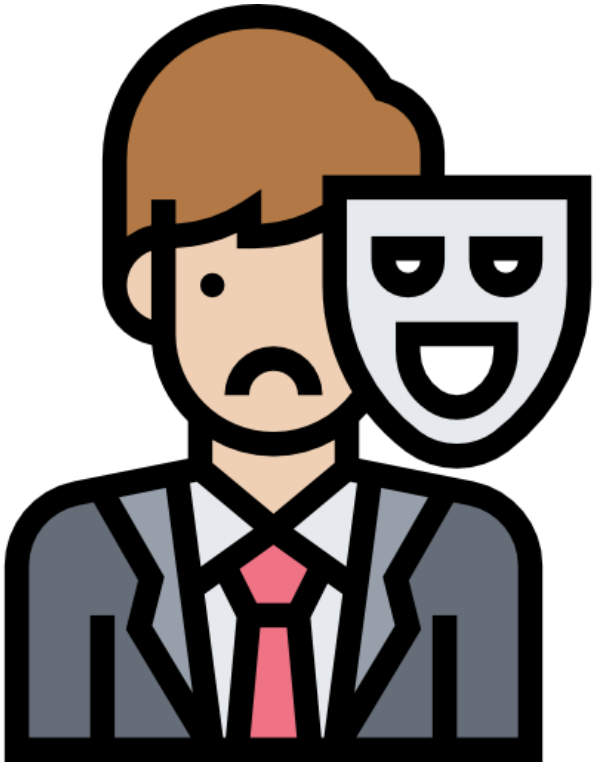
ii. the **affairs of the company have improved** to the extent that it is in a position to pay its debts.

The termination of the Order

At the termination of the Company Recovery Procedure the Controller is to submit a **final written report** which is to contain his detailed and comprehensive opinions and reasons as to whether or not the company has a reasonable prospect of continuing as a viable going concern in whole or in part and will be in a position to pay its debts regularly in the future.

Where the court accepts the proposed recovery plan, with or without amendments, the dissenting creditors may apply to the Court of Appeal (Inferior Jurisdiction) if they consider that their rights are likely to be reduced to a level which is lower than what they would be granted had the company been dissolved and wound up at the time of the recovery application.

Fraudulent and Wrongful Trading



Fraudulent Trading – Article 315

(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

(2) "Where the business of a company is carried on with such intent or for such purposes as is mentioned in subarticle (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 points:

- ✓ 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
- ✓ €232,937.34
- ✓ 5 years imprisonment

Which debts and liabilities are relevant?

The liability may extend to *"all or any of the debts or other liabilities of the company as the court may direct".* This appears to indicate that the person may be held legally responsible not only for the contractual or legal obligations connected to the fraud, but also in respect of debts and liabilities of the company not so connected to the fraud, and further is not limited to those debts and liabilities sustained in the relevant time frame, but also in respect of those debts and liabilities brought before or subsequent to the fraud.

Liability is not automatic but at the Court's discretion

Liability is only incurred if the court so orders, and to the extent so ordered. The Court decides the quantum of liability, at its absolute discretion.

Any person implicated in the fraud

Any manager, director, shareholder and any other person who is consciously party to the fraud will fall under art. 315 – meaning even creditors may be implicated in such fraud, if with intent, they are accepting money which has been obtained with the intent to defraud creditors.

A single transaction is sufficient

It has been settled by jurisprudence that a single transaction to defraud a single creditor is enough to be considered as fraudulent trading and satisfy the condition *"any business of the company has been carried on with intent to defraud creditors"* (the onus of proof is beyond reasonable doubt).

The victims or the general body of creditors?

Under English law, the offending party is liable *"to make such contributions (if any), to the company's assets as the court thinks proper"*, whereas under Maltese law, the offending party may be held personably and unlimitedly liable.

It thus appears that in the Maltese sphere, the Court would probably favour the victim(s) rather than the general body of creditors, since it is more likely to direct the offenders to be personally liable with regards to the victims. However, it is still possible for the court to hold the offending party for all and any of the debts and liabilities of the company, with or without capping. Under English law, it is held that all the creditors, and not only the defrauded ones, will gain under their provision on fraudulent trading.

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 points:

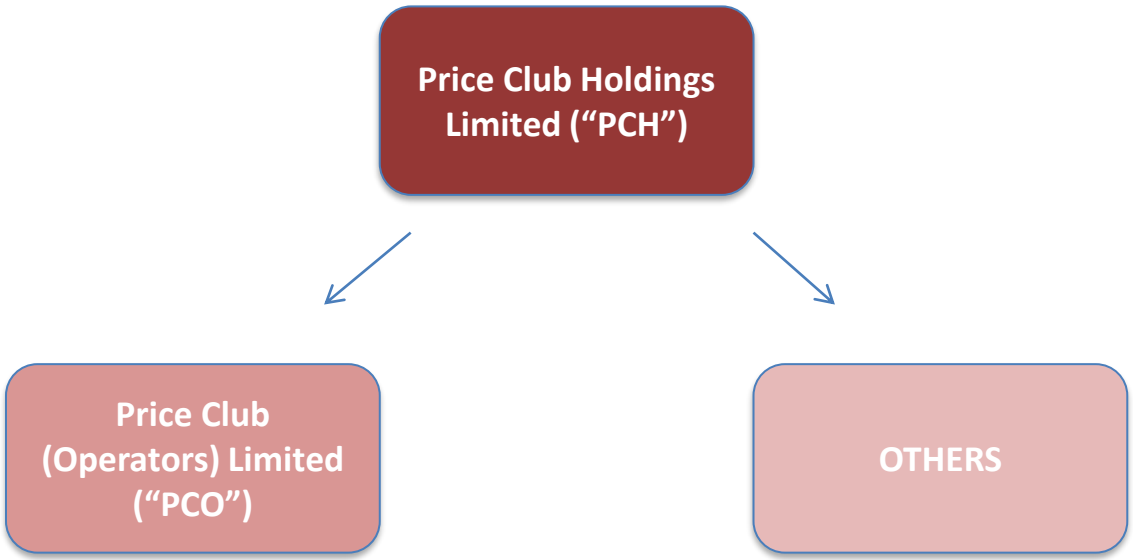
- ✓ An insolvent dissolution
- ✓ Director knew or ought to have known
- ✓ No reasonable prospect that the company avoids insolvent dissolution
- ✓ Contribution towards the company's assets
- ✓ Brought by the liquidator
- ✓ Defence where despite there being knowledge of no reasonable prospect, such director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

The Price Club Case

The Price Club Case

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 to the benefit of the directors' personal interests.

The structure of the group of companies is as follows:



Facts:

- The Price Club business commenced under a certain Frans Gauci which 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 the Gauci family (the Day-to-Day business).

- Eventually, the Price Club also operated in Gozo, Naxxar and Attard and operated a total of 8 supermarkets.

- They stopped 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 also alleged 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.

Decision:

- 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.

Conclusion

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