The Price Club Case (2010): an examination of wrongful and fraudulent trading in the light of liquidation and consequential winding up of limited liability companies

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Stephanie Zarb Adami, an Advocate at Ganado Advocates, explores the implications of the Price Club Judgements in relation to the fraudulent and wrongful trading actions. Her article tackles the theoretical and practical implications of the increased relevance of the fraudulent trading action in Malta. This subject formed the basis of her dissertation presented in part-fulfilment of her LLM (Corporate Law) studies at University College London, which were partially funded by the Strategic Educational Pathways Scholarship (Malta). This scholarship is part-financed by the European Union – European Social Fund (ESF) under Operational Programme II – Cohesion Policy 2007-2013, "Empowering People for More Jobs and a Better Quality of Life".

When an insolvent limited liability company is placed into liquidation, the liquidator of the company may augment the company's assets in various ways in order to enable its creditors to be paid. One such tool at his disposal is the institution of an action for fraudulent trading or for wrongful trading against a director who failed to act according to the required standards of care and skill.[1]

Although the fraudulent trading action was introduced into Maltese law in 1995,[2] it was only 12 years later that the Maltese courts had the opportunity to consider this provision in the seminal **Price Club** rulings. Indeed, when introduced, the fraudulent trading action was considered to be ineffective and the threat of a fraudulent trading action being brought was not perceived to be a serious one.

These rulings, confirmed by the Court of Appeal on the 14 May 2010,[3] regarded three actions brought against the directors of a corporate group which operated the Price Club chain of supermarkets (the Group).[4]

Briefly, the structure of the group of companies involved was as follows: Price Club Holdings Limited (PCH) was the holding company of the Group. PCH had a number

[1] A director is bound to act in accordance with the duties set out in Companies Act, Chapter 386 of the Laws of Malta, Article 136A.
[2] Ibid, Article 315.
[3] Dr Andrew Borg Cardona noe vs Victor Zammit et [Court of Appeal] 14 May 2010.
[4] Valle del Miele Ltd vs Wallace Fino et [Civil Court, First Hall] 12 November 2007; 27/2003 Dr Andrew Borg Cardona noe vs Victor Zammit et [Civil Court, First Hall] 12 October 2007; 26/2003 Dr Andrew Borg Cardona noe vs Victor Zammit et [Civil Court, First Hall] 12 October 2007.

of subsidiaries among which was Price Club (Operators) Limited (PCO). PCO was the operative company and transacted debts with suppliers for the benefit of the Group.

1. Fraudulent Trading Action and the Price Club Cases

Mr Justice Tonio Mallia considered the following factors when deciding whether or not the directors were guilty of fraudulent trading:

1.1 The Structure of the Group

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.[5] However, PCO was hugely undercapitalised. From the beginning of its existence, it had huge debts, no realisable assets, no immovable property[6] and a very low capital. There was no company in the Group which assumed responsibility for PCO's debts. Furthermore, whereas the directors gave personal guarantees to the banks for loans taken out by PCH, they did not give any personal guarantees to the creditors of PCO.

It could be argued that this was not fraudulent conduct on the part of the directors. However, by examining these facts in the light of all other available evidence, the court held that the manner in which the Group was structured was evidence of the directors' dishonest intent, from the outset, to avoid the company's assets being made available to creditors. It was also evidence of the expectation of the directors that the creditors would finance the operations of the Group and bear all the resultant risk.

1.2 The 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.'[7] The court viewed this misleading directors' report as a clear indication of the directors' intent to defraud the creditors.

[5] Adams v Cape Industries [1991] 1 All ER 929.
[6] PCO did not own any immovable property itself, however it paid rent to other companies within the Group which had been formed specifically to own immovable property.
[7] Case 27/2003 (n 4) p 8.

1.3 The Accounting Records

The obligation inherent in Article 177 of the Companies Act implies that the directors have a duty to verify the accounting records, and, if necessary, to bring any possible mistakes to the auditor's attention. Mr Justice Mallia pointed to an occasion when the directors clearly failed to do so.

When PCO took over Day-to-Day Supermarket's (Day-to-Day) business on 30 November 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 receive 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. The court held that the accounts were manipulated with the clear intention of acquiring more credit.[8]

1.4 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[9] and that there was no possibility of further financing,[10] the directors always presented the company's financial difficulties as being a temporary cash flow problem.

1.5 Creditors as Financiers of the Company

The court singled out a number of facts as evidence of the directors' intention that the creditors' funds would entirely finance their operations. At the beginning of the company's operations, the directors approached the bank with the intention of

[8] This behaviour is specifically mentioned as an instance of fraudulent trading in Brenda Hannigan, *Company Law* (Oxford University Press 2003) 843.

[9] This knowledge was as a result of the internal management accounts that indicated the losses and as a result of PWC's report that indicated debts of Lm 3.5 million.

[10] A request for further financing had been rejected by the banks.

obtaining a loan. This loan was obtained on the basis of a document presented by the directors as a business plan. In actual fact, this was not a business plan at all but a projected analysis based on the accounts of the operations taken over by the Group. Furthermore, the directors falsely described themselves in this business plan as having extensive experience and industry knowledge in the field of operating supermarkets.

Moreover, in his testimony, the Group's ex-chairman stated that the directors wished to enlarge the Group's business without having an appropriate structure in place and without being in possession of the requisite funds. He testified that the directors expanded the business at the creditors' expense. The court remarked that the directors (who were also the shareholders) did not seem to wish to invest their own assets in the business.

While the directors intended to use and did, in fact, use the creditors' funds to pay the company's bank loans, running costs, and investments, they did not devise any contingency plan to ensure that the creditors would be repaid expeditiously. The creditors were effectively unknowingly being used as the company's financiers. As a result, repayment was repeatedly postponed.

The court posited that failure to inform the creditors of the directors' intention to use their funds to expand the business constituted fraudulent intent. To this end, the Court pointed out that the directors should have informed the creditors about PCO's dire financial situation, rather than assuring them that there was simply a temporary cash flow problem. Consequently, the creditors would have been able to make an informed decision as to whether they wished to finance the company or not.

Upon examination of all the relevant facts, the Court held that it was clear that the directors were acting in a methodical and regular manner, intended to damage PCO's creditors.

2. Would it have been more appropriate to find the Directors guilty of Wrongful Trading?

When analysing the aforementioned facts, it is evident that the directors did not adhere to the required standards of skill, diligence and care when administering the affairs of the Group. Consequently, it would have been relatively easy for the court to find wrongful trading under Article 316 of the Companies Act since negligence was apparent in every individual act the directors performed.

Whereas the fraudulent trading action is based on acts carried out by persons throughout the period of the company's trading activity, the wrongful trading provisions apply only to actions taken by the directors after the point in time when those directors knew or ought to have known that there was no reasonable prospect of the company avoiding insolvent liquidation. Therefore, a successful wrongful trading action requires the definition of such a relevant point in time.

It could be argued that PCO was insolvent from the very beginning of its operations since there were not enough assets to carry out the business for which it was set up.

This could be the point in time identified by the court. Nevertheless, many companies start operating with a deficit. Hence, it is more likely that the court would determine the relevant point in time as being mid-1999, when, as emphasised by the court, the directors knew that they would not be able to repay their debts.

Additionally, if the fraudulent trading action is to be successful, it is necessary to prove that the directors had actual knowledge of the company's inability to pay its debts. On the other hand, in order to demonstrate wrongful trading, it is sufficient to prove that the director *ought* to have known that the company was unable to pay its debts.[11]

In a case of alleged wrongful trading, the court will examine whether the delinquent director had the required knowledge from a combined objective and subjective viewpoint. Article 316(4) of the Companies Act provides that a director is presumed to have the general knowledge, skill, and experience that may reasonably be expected of a person carrying out the same functions in that capacity. The court will also take into consideration the general knowledge, skill, and experience that the director actually has. A director is also assumed to possess the information which he was duty-bound to have ascertained, and which he was capable of ascertaining.[12] Therefore, in the **Price Club** cases, it is no defence for the directors to plead that they did not have the required experience, skill, and knowledge usually required for directors of a chain of supermarkets.

In the **Price Club** cases, the directors denied knowing that PCO was unable to pay its debts. However, the court concluded that the directors did indeed have such knowledge as a result of the internal management accounts which indicated the losses and from PWC's report, showing that PCO's debts amounted to around Lm 3.5 million.

3. A Defence for Directors

A director is exempted from liability by Article 316(3) of the Companies Act if it is proven to the satisfaction of the court that he took every step to minimise the potential loss to the company's creditors.[13] In the **Price Club** cases there is no evidence that the directors attempted to minimise the loss to PCO's creditors. On the contrary, they sought to obtain further credit and attempted to extend the time period within which to pay their creditors.

Nevertheless, it can be argued that the directors did negotiate alternative methods of financing. The directors entered into a sell-lease back agreement with Middlesea Insurance Agency p.l.c. They also (unsuccessfully) requested financing from the bank. In addition, the directors had entered into negotiations, which ultimately

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[11] John B St Claire, *The Law of Corporate Insolvency in Scotland* (2004) 233.

[12] *Re Produce Marketing Consortium* [1989] 5 B.C.C. 569

[13] Secretary of State for Trade and Industry v. Taylor [1997] 1 W.L.R. 407 para 414.

turned out to be unsuccessful, with foreign investors to sell the business. These actions could constitute a defence to an allegation of wrongful trading.[14]

However, the directors met with the creditors and requested longer credit periods in the full knowledge that the company was in financial dire straits and had no possibility of obtaining further financing. This action of the directors belies their defence that they attempted to minimise the loss to PCO's creditors. Instead of informing the creditors of PCO's financial difficulties, they attempted to extend the credit terms by promising payment 'in the near future'. This fact makes it evident that the actions of the directors do not merely constitute wrongful trading. On the contrary, this underlines the fraudulent intent required for the fraudulent trading action.

Although it might have been easier for the court to determine that there was wrongful trading, 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. It could be argued that the directors had no fraudulent intent at the time the business was commenced despite the fact that PCO did not have sufficient funds for it to engage in the business for which it was set up. However, 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.

Moreover, any benefit of the doubt accorded to the directors evaporates from the moment that they became aware of the gravity of the situation – identified by the court as June 1999. The fact is that from this point in time they continued trading while ignoring PCO's precarious financial situation. Therefore, the court was correct in concluding that the actions of the directors did not constitute mere negligence, but clearly demonstrated a fraudulent intent. The directors would have avoided liability for fraudulent trading had they ensured that they had enough funds to satisfy the debts owed to creditors before embarking on new projects requiring a large investment.[15] More importantly, the directors failed to implement the necessary managerial and technical safeguards for the business to be feasible.[16] This failure was ultimately to the detriment of the creditors.

4. The Consequences of the 'Price Club' Judgements

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*

[14] As confirmed in Hannigan (n 8) p 847.
[15] Such as the purchase of the Day-to-Day Supermarket.
[16] Matthew Saliba, *An Analysis of some of the Salient Legal Issues Arising out of the Recent Price Club Cases* (Malta, 2009) 119.

evidence of fraudulent intent, when considered as a whole, constituted fraud and not merely negligence and mismanagement.

The **Price Club** judgements are extremely important in the Maltese scenario. Subsequent to the court's judgement, the use of a fraudulent trading action under Article 315 of the Companies Act has become a tangible tool in the hands of the liquidator against incompetent and delinquent directors. Admittedly, due to the high level of proof required and due to the necessity of proving the dishonesty of the directors, it remains more difficult to prove an action of fraudulent trading than an action of wrongful trading. However, in the **Price Club** judgements, the court made these requisites more tangible, rendering it possible to infer the required dishonesty and fraudulent intent from the facts of the case. The court adopted an objective approach and reached the conclusion that the directors would not have carried out certain actions had they not had the intent to prejudice the creditors.

The **Price Club** judgements sent shockwaves throughout the Maltese business community.[17] A clear sign was now being sent to directors that it is unacceptable for them to run a business subject to their self-interests to the detriment of creditors. As a result of these judgements, directors are subjected to much more scrutiny than ever before. Directors are more careful to ensure that they reach the required standard of care, skill and diligence in their management. Such behaviour will definitely benefit creditors, who will also be more willing to extend credit to companies secure in the knowledge that they now have an added measure of protection from the courts. This is in line with the stated aim of the fraudulent trading legislation – to discourage directors from carrying on business at the expense of creditors.[18]

[17] George M Mangion, 'Wrongful and fraudulent trading' (*Business Today*, 16 October 2007) <http://www.businesstoday.com.mt/2007/10/16/opinion.html> accessed 15 May 2014.
[18] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press 2009) 696.