FRAUDULENT AND WRONGFUL TRADING – CASE STUDY OF A JUDICIAL APPRECIATION

Masters Thesis International Business Law

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Abstract

Maltese Company Law contains a provision on fraudulent trading, whereby the liquidator of a company can ask the Court to declare that any persons who were knowingly parties to the carrying on of the business with intent to defraud 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. This provision has to date only been applied once by the Maltese Courts in the ‘Price Club’ case where the liquidator of the Price Club Company filed an action against the Directors of the Company alleging that these directors were guilty of Fraudulent Trading and consequently requesting the Court to pierce the corporate veil of this Company and hold the Directors personally liable for the Company’s debts.

The Companies Act of Malta also contemplates wrongful trading: 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 liquidator in the ‘Price Club’ Case also filed an action against the Company’s Directors whereby he asked the Court to find them guilty of wrongful trading. In delivering its judgement in this case of wrongful trading the Court did not seem to differentiate between this offence and that of fraudulent trading.

I begin this thesis by considering these two provisions of Maltese Law, their differences and similarities and their origins. These provisions were adopted from English law, however whilst the UK Companies Act 1985 introduced certain amendments to the notion of fraudulent trading as originally enacted, for one reason or another our legislator failed to enact the same amendments so that today our provision reflects the situation in the UK pre 1985. Consequently I consider the Maltese provision by referring to pre-1985 UK case law on the matter, and I also attempt to bring out the differences between the Maltese scenario with the one in Britain post amendments. I then examine the constitutive elements of these provisions, particularly that of fraudulent trading. Subsequently I examine the Price Club case, which as stated above was the first and to
date, the only judgement the Maltese Courts have delivered regarding these two provisions. The next chapter embarks on a comparison between certain behaviour that was common both to the ‘Price Club’ and to the Enron cases. I conclude by addressing a number of questions regarding the general concepts of Fraudulent and Wrongful Trading, and by examining the implications of this judgement to date.
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CHAPTER I

A General Introduction to the Concepts of Fraudulent and Wrongful Trading

I. Introduction

Prior to separately considering the notions of fraudulent and wrongful trading, it is pertinent to briefly consider the principle of the separate juridical personality of a company; and intrinsically linked with it, the principle of limited liability. Provisions on fraudulent and wrongful trading are aimed principally at curbing the possibility on the part of the officers of a company to act opportunistically and take advantage of these basic characteristics in a manner which causes detriment or indeed prejudice to the company’s creditors.

The principle of separate and distinct juridical personality is a basic principle of corporate law according to which, once incorporated in accordance with the relevant laws of the jurisdiction in question, the company then acquires its own personality, and becomes a ‘person’ in its own right, separate to those of its members and consequently acquires its own legal standing. Once a company is vested with separate juridical personality it will automatically be able to hold both assets and liabilities in its own name. These assets and liabilities held in a company’s name would be deemed to be separate from the personal property of its shareholders. Consequently, in the event that a company incurs any debts, its creditors would be entitled to enforce their claims against the assets of the company and not against the personal assets of its shareholders. The company’s creditors would also be ranked prior to any creditors personal to any of its shareholders when it comes to the indemnification of any claims.¹

Some consideration must here also be had of the possibility available in some jurisdictions for the shareholder to avoid the possibility of having any personal creditors

advancing an action on his shareholding by holding the shares through a nominee company, for example, rather than in his own name. Hansmann and Kraakman refer to this aspect of separate juridical personality as ‘affirmative asset partitioning’.  

Davies comments that this basic company characteristic of separate juridical personality ‘is an inevitable consequence of the incorporation of a company’. According to Davies, ‘the notion that the company is a legal person separate from its shareholders, directors, creditors, employees, indeed from anyone else involved in it, is fundamental to the conceptual structure of company law’.  

In the UK, the principle of separate juridical personality was established by the House of Lords in Salomon v A. Salomon & Co. Ltd and has subsequently been referred to as the ‘Salomon principle’.  

Another basic characteristic of a limited liability company is the principle that the responsibility of its members is restricted to the amount, if any, paid (and/or unpaid, if under a certain jurisdiction’s laws such payment can be deferred in time) on the shares respectively held by each of them. This principle of limited liability implies that ‘the rights of the company’s creditors are confined to the assets of the company and cannot be asserted against the personal assets of the company’s members (shareholders)’. This in essence is what Hansmann and Kraakman mean by ‘affirmative asset partitioning’. The concept of separate juridical personality helps clarify matters when it comes to establishing whether in actual fact certain assets belong to the company or to its members.

As an exception to the principles of separate juridical personality and limited liability there are circumstances when the Law duly acknowledges, and for which it accordingly

2 ibid  
3 Paul Davies, Introduction to Company Law (2nd edn Oxford University Press 2010) 9  
4 ibid  
5 [1897]  
6 (3) 10  
7 (n.1)
provides the possibility, in very specific situations, for the corporate veil to be pierced. Once the corporate veil has been pierced then the creditors of the company whose veil has been pierced may satisfy their claims from the personal assets of the company’s shareholders.

The Court may order the lifting of the corporate veil in situations of fraudulent and wrongful trading. Fraudulent trading arises when one carries on business with intent to defraud creditors or for fraudulent purposes. Wrongful trading refers to a situation where a company has reached a stage of effective insolvency and continues to trade in spite of the fact that the directors of the company are aware, 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.

II. Fraudulent and Wrongful Trading as Considered under Maltese Law

With regard to fraudulent trading, Maltese Company Law provides that:

(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.

(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 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.
This provision has to date only been applied once by the Maltese Courts in what is referred to as the ‘Price Club case’\(^{13}\), where the Liquidator of the Price Club Company filed an action against the three Directors of the Company in question alleging that these directors were guilty of Fraudulent Trading and consequently requesting the Court to pierce the corporate veil of this Company and hold the Directors personally liable for the Company’s debts. The Liquidator in this case also filed another action against the Company’s Directors whereby he asked the Court to find them guilty of Wrongful Trading. This case shall be discussed in further detail in subsequent chapters.

Article 316 of The Malta Companies Act also contemplates wrongful trading:

\(^{13}\) Borg Cardona noe vs. Zammit et

(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.

(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 minimising 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 reasonably diligent person having both:

(a) 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) the knowledge, skill and experience that the director has.
(5) 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.

III. Origins of the Maltese Provisions and Comparison with English Law

III.I Wrongful Trading

Article 316 of the Maltese Companies Act finds its origins in the wording of the provision on Wrongful Trading which was introduced into the UK Insolvency Act 1986 after recommendations to this effect were made by the Cork Committee – a Committee established in 1977 and presided over by Sir Kenneth Cork which was charged with coming up with recommendations on UK insolvency law. This provision was introduced in order to expose directors to the consequences of their decisions to incur further debts at a time when the company has no reasonable prospect of recovery. The difference between this remedy and that offered by the Fraudulent Trading provision is mainly the burden of proof - whilst in cases of fraudulent trading the intention to defraud needs to be proven, in cases of wrongful trading it is enough to prove that the director negligently decided to carry on trading at a time when there was no prospect of the company recovering. Therefore it is much easier for creditors to be successful in bringing forward an action for wrongful trading than in bringing one for fraudulent trading since a lower burden of proof has to be satisfied in order for one to succeed in their claim.

The wording of both the Maltese and the UK provision is virtually identical. According to the UK Insolvency Act, the wrongful trading remedy applies where the directors of a company have continued to trade past the point when they ‘knew, or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation’ and

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15 Article 214 IA 1986 on wrongful trading just refers to what ‘that person knew or ought to have concluded.......’ whilst Article 213 IA 1986 on fraudulent trading specifically provides for the ‘intent to defraud creditors’.
they did not take ‘every step with a view to minimising the potential loss to the company’s creditors’. Subarticle (4) of Article 214 IA 1986 goes on to state that:

For the purposes of subsections (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 reasonably diligent person having both:

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that that director has.

Even here the wording is identical to that adopted by the Maltese legislator. In both Malta and the UK an application based on the wrongful trading remedy may only be instituted by the liquidator of the company in question.\(^{16}\) The wording of both these provisions differ - where the UK provision specifically provides that the wrongful trading provision is only applicable ‘in the course of a winding up’\(^{17}\), these particular words have not been used by the Maltese legislator;\(^{18}\) however, once our provision is in effect identical to that which may be found under the UK Insolvency Act 1986, then in coming to apply this provision the Maltese Courts may safely refer to UK jurisprudence on the matter in order to be able to carry out a proper application of this remedy.\(^{19}\) A judgement which proves helpful in the understanding of those scenarios where this wrongful trading remedy may apply was that handed down by the English Courts in the case *Re Produce Marketing Consortium Limited (No.2).*\(^{20}\)

\(^{16}\) Article 316(2) of Chapter 386 of the Laws of Malta and Article 214(1) IA 1986 – both provision specifically lay down that such an action may be instituted ‘on the application of the liquidator’

\(^{17}\) Sections 86 and 129 of the UK Insolvency Act define ‘the commencement of winding up’

\(^{18}\) This wording is however used in the provision on fraudulent trading to be discussed further along in this Chapter

\(^{19}\) Whilst the Maltese Courts do not follow any doctrine of precedent as applied by the UK Courts, previous judgements do tend to have a persuasive effect on any Court’s final decision.

\(^{20}\) [1989] BCLC 520
III.I.1 Essential Elements for its application:

The three requirements which must be proven in order for one to be liable for wrongful trading both in the UK and in Malta are:

(a) the company must be insolvent – Maltese Company Law specifies that the wrongful trading remedy applies wherein a company had been dissolved and is insolvent, whilst the wording under the UK provision refers to ‘insolvent liquidation’. According to Article 214(6) IA 1986, ‘a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up’; and

(b) prior to the dissolution of the company 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 wording used in the UK text is identical to this, however once again the words used here are ‘that the company would avoid going into insolvent liquidation’; and

(c) that person was a director of the company at that time – here once again both jurisdictions lay down that the definition of “director” also includes a shadow director. The idea of including shadow director in the definition of “director” is to cover those situations where in effect it is the shadow director who is really controlling the company. The idea of control, along with the other elements which should be present in order for a shadow director to be held liable were considered by the Court of Appeal in New South Wales in the case *Buzzle Operations Pty Ltd (in liquidation) vs Apple Computer Ltd.*\(^{21}\)

Shadow director is defined in Article 251 IA as ‘a person in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity).’ Under the Maltese Company Act, the Law refers to a shadow director when in Article 316(5) it provides that ‘for the purposes

\(^{21}\) [2011] NSWCA 109
of this article, "director" includes a person in accordance with whose directions or instructions the directors of the company are accustomed to act'.

An action under Article 214 IA may also be brought against present and past directors including the estate of a deceased director as shown in *Re Sherborne Associates Limited*\(^{22}\) and against *de facto* directors as established by *Re Hydrodan (Corby) Ltd*.\(^{23}\)

In *Re Farmizer (Products) Ltd*\(^{24}\), it was held that the relevant limitation period for a wrongful trading claim was that governed by Article 9(1) of the Limitation Act 1980, under which 'an action to recover any sum recoverable by virtue of any enactment shall not be brought after the expiration of six years from the date on which the cause of action accrued'.

Once these elements are proved then the Court can give an order for the directors to make a personal contribution to the assets of the company in order to pay off its outstanding creditors. In *Re Produce Marketing Limited*\(^{25}\) and once again in *Re Purpoint Ltd*\(^{26}\) the Courts held that the amount of compensation should compensate for any depletion in the Company's assets incurred during the time when the Director knew or ought to have known that there was no reasonable prospect of recovery.

**III.1.II Available Defence:**

In order to defend oneself against such an action of wrongful trading, one may prove that once one had the knowledge that there was no reasonable prospect that the company would avoid dissolution, one then took every step to minimise the potential loss to the company's creditors that one ought to have taken.\(^{27}\) In his article called *'The Wrongful trading Remedy under UK Law'*\(^{28}\), Hirt explains that no detailed guidelines exist as to what is required in order for such a defence to be successful.\(^{28}\)

\(^{22}\)[1995] BCC 40

\(^{23}\)[1994] 2 BCLC 180

\(^{24}\)[1995] 1 BCLC 589

\(^{25}\)[1989] BCLC 520, 553 d-e

\(^{26}\)[1991] BCLC 491

\(^{27}\) Article 316(3) of Chapter 386 of the Laws of Malta and Article 214(3) IA 1986

\(^{28}\)1 ECFR 71 2004, 92
Once again this defence is also available to a director against whom an action for wrongful trading has been instituted, under both the UK as well as under the Maltese Law. Article 316(3) of the Maltese Act specifically provides that ‘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 minimising the potential loss to the company’s creditors’. The Law further states that a director is to be judged as to whether he ought to have known that insolvency would not be avoided and therefore acted in such a way as to minimise potential loss according to the standard of what a reasonably diligent person having both

‘(a) 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) the knowledge, skill and experience that the director has’,

would have done in the same situation. The exact same defence along with the standard by which a director is to be judged can be found under Articles 214(3) and (4) of the UK Insolvency Act 1986. The standard applied involves both an objective and a subjective test. The objective test can be seen in (a) above and the subjective test stems from (b).

III.II Fraudulent Trading

Fraudulent trading was introduced into English law in the ‘Companies Act 1928’ following recommendations from the ‘1926 Company Law Reform Committee – the Greene Committee’. The Provision was left as it is apart for some minor amendments until 1986 when it was simplified and split up; the criminal part being kept in the

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Companies Act and the part on civil responsibility being placed under the Insolvency Act 1986.

Article 315 of Chapter 386 of the Laws of Malta clearly originated from the English provision on fraudulent trading. However, differently to Article 316 (wrongful trading) which as seen above also originated from English law, in the case of fraudulent trading, the Maltese legislator was selective in what he adopted from English law when he came to enacting this provision. In fact, as it stands today, the Maltese provision on fraudulent trading reflects the text of Article 332 of the English Companies Act 1948 and it fails to take into consideration the changes that were introduced in England with its 1985 amendments which were introduced following suggestions made by the Cork Committee Review.

In fact, Article 315 contemplates both the effects of a criminal offence and also those of personal liability in cases of fraudulent trading. This is exactly what was contemplated by Article 332 of the English Companies Act 1948, which read as follows:

(1) If in the course of the winding up of a company 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 manner aforesaid shall 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. On the hearing of an application under this subsection the official receiver or the liquidator, as the case may be, may himself give evidence or call witnesses.

(2) Where the court makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to that declaration, and in particular may make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in any mortgage or charge on any assets of the company held by or vested in him, or any company or person on his behalf, or any person claiming as assignee from or through the person liable or any company or person acting on his
behalf, and may from time to time make such further order as may be necessary for the purpose of enforcing any charge imposed under this subsection. For the purpose of this subsection, the expression "assignee" includes any person to whom or in whose favour, by the directions of the person liable, the debt, obligation, mortgage or charge was created, issued or transferred or the interest created, but does not include an assignee for valuable consideration (not including consideration by way of marriage) given in good faith and without notice of any of the matters on the ground of which the declaration is made.

(3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in subsection (1) of this section, every person who was knowingly a party to the carrying on of the business in manner aforesaid, shall be liable on conviction on indictment to imprisonment for a term not exceeding two years or to a fine not exceeding five hundred pounds or to both.

(4) The provisions of this section shall have effect notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is to be made, and where the declaration under subsection (1) of this section is made in the case of a winding up in England, the declaration shall be deemed to be a final judgment within the meaning of paragraph (g) of subsection (1) of section one of the Bankruptcy Act, 1914.\footnote{Available at <www.legislation.gov.uk> accessed 23 February 2012}

As a consequence of this wording, English Courts used to find against civil claims brought on the basis of fraudulent trading where dolo was not specifically proven. With the 1985 amendments, the English Companies Act only retained the part on criminal responsibility (the equivalent of the Maltese Article 315(2)) whilst reference to personal responsibility (the equivalent of the Maltese Article 315(1)) was removed and subsequently inserted into the Insolvency Act 1986.

When the Maltese Companies Act was enacted in 1995, the Legislator did not take into consideration these amendments and consequently kept both these concepts intrinsically linked – as was the situation in England prior to 1986.
Consequently, even when the Maltese Court comes to apply this provision, it must consider those judgements handed down by the English courts prior to 1986; as those handed down after 1986, reflect a legislative change which the Maltese Legislator clearly did not want to be reflected in the text of the Maltese provision. The Maltese text in the case of fraudulent trading contemplates both civil as well as criminal responsibility as having the same constitutive elements.

A once important judgement on fraudulent trading was that handed down in Re White and Osmond (Parkstone) Ltd where Buckley J stated:

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.

According to this, ‘ill-founded or reckless optimism’ – as Goulding calls it 31- could not lead to fraud as it lacked the essential element of dishonesty; however this position was eventually overturned by the Court of Appeal in Re R v Grantham, where the Court believed that if the Director knew that there was no short-term prospect of repaying the debt then it was irrelevant that some day the ‘clouds will roll away’:

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

31 (n.29) 81
Here one may note that - notwithstanding differences in the Courts’ *modus considerandi* – the intentional element required here stands out as one which, in order for an action of fraudulent trading to succeed, absolutely needs to be proved, and proved according to the burden of proof established by Law, and this *ad validitatem*. In the first case cited above (Re *White and Osmond (Parkstone) Ltd*) the test applied is essentially a purely subjective one whilst in the second case (Re *R v Grantham*) the subjective test is subjected to objective considerations. However, in both cases the intentional element, reflected in the English notion of *actual dishonesty*, has to clearly result.

### III.II.I The constitutive elements of the Maltese provision on Fraudulent Trading

The Law contemplates Fraudulent Trading in cases where the person concerned (a) acted with the intent to defraud creditors and (b) would have carried out business in such a way as to carry out the intended fraud. This is the gist of the provision on Fraudulent Trading which clearly results from the wording of Article 315. Fraudulent trading is established when it is proved that one had this harmful intention to defraud, and additionally, the person concerned would have actually started carrying out this fraudulent intention by means of concrete actions in the running of the business.

In this way, by drawing a parallel with the domain of criminal law, which one must necessarily do when it comes to cases of Fraudulent Trading, there have to result both the *actus reus* (acts carried out in the course of running the business intended to implement and carry out the intention to defraud) and also the *mens rea* (the intention to defraud).

As previously mentioned, even when the Maltese Court comes to apply this provision they look to those judgements handed down by the English courts prior to 1986 for guidance.
One of the first cases where ‘the intention to defraud’ was considered by the English courts was the case *Re William C Leitch Bros. Limited.* This case concerned a Director who had a debenture of the Company in his name and who forced the Company to order materials from a Creditor whilst at the same time knowing that there were not enough funds to pay for these materials, yet the materials ordered were going to be tied down to make good for the debenture which the Director had. The judgement handed down in this case established the principle that Fraudulent Trading could be inferred when it results that at the moment in which the debt was incurred the directors were knowledgeable that there was no reasonable prospect of the creditor being paid.

A year later the same judge, Justice Maugham, handed out another judgement in the case *Re Patrick and Lyon Limited* where he established another requisite for Fraudulent Trading when he said that the plaintiff has to prove “actual dishonesty involving…real moral blame”. Here a clear line is drawn clearly differentiating between “actual dishonesty” and “mere blameworthiness” – it is only the former that can result in Fraudulent Trading as it is only this that can bring out the necessary element of ‘dolo’.

In *Re London & Globe Finance Corporation Ltd*, Buckley J considered the element of fraud in the following manner:

> To deceive is to apprehend, to induce a man to believe that a thing is true when it is false and which the person practicing the deceit knows to be false. To defraud is to deprive by deceit; it is by deceit to induce a man to act to his injury. More tersely it may be put, that to deceive is by falsehood to induce a state of mind; to defraud is by deceit to induce a course of action.

When it came to considering an appeal from a judgement handed out by a lower Court where the presiding Judge said that dishonesty was not an essential element, the English Court of Appeal in the case *R vs Cox & Hidges*, whilst citing two other judgements stated that:

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32 [1932] 2 Ch. 71  
33 [1933] Ch. 78  
34 [1930] 1 CH 728 732  
35 [1982] 75 Cr App R 291  
36 Re Scott and Re Landy [1981] 72 Cr App R 237
The reported cases make it clear that in both the civil and the criminal jurisdiction the allegation of an intent to defraud contains the ingredient of dishonesty without which no jury would be entitled to convict a defendant of the offence charged, and no judge in the civil jurisdiction would be entitled to find for a person who fails to prove dishonesty on the part of him by whom he alleges he has been defrauded.

In the case *R v Grantham* the presiding Judge directed the jury that in order for person “D” to be found guilty of an offence under Article 332 of the 1948 Companies Act, they had to establish that “D”:

(i) played an active part;
(ii) had an intent to defraud creditors “C”; and
(iii) acted dishonestly.

The wording of Article 332 of the Companies Act 1948 – which is that provision intentionally chosen by the Maltese Legislator as having inspired Article 315 of Chapter 386 – does not only establish civil responsibility but also establishes a criminal offence, both having the same constitutive elements. As a result of this, the English Courts consistently denied pleas for the finding of civil responsibility in the absence of the element of “dishonesty” and insisted on a higher degree of proof, one extremely close to the degree required under criminal law, for cases of Fraudulent Trading.

### III.II.11 The Notion of Fraud under Maltese Law

Another element which one has to take into consideration when examining Article 315 on Fraudulent Trading is that of fraud - this due to the fact that whilst the legislator was clearly inspired by English law, he was very selective in which part of English law he was inspired by, in the sense that he looked at the Law prior to the amendments that were introduced to split civil responsibility from the criminal offence. Since today Maltese law still contemplates civil responsibility and the criminal offence in the same provision, from the wording of the provision it clearly results that they have the same constitutive elements. It is now necessary to briefly examine the offence of fraud as contemplated by Maltese law.
Fraud is contemplated in Articles 293 till 310 of the Criminal Code.\(^{37}\) One cannot talk about Fraudulent Trading without first of all considering those actions which are classified as fraudulent. The link between the concept of Fraudulent Trading and the concept of fraud found under criminal law (and this as mentioned above, always by following the model found under the English Companies Act 1948), makes a consideration of the criminal law concept of fraud absolutely necessary and applicable in order to have a proper examination of the concept of Fraudulent Trading.

A. In essence, under Maltese law, fraud falls under three different categories:

(i) misappropriation;
(ii) embezzlement; and
(iii) escroquerie.

(i) Misappropriation is contemplated under Article 293 of Chapter 9:

Whosoever misapplies, converting to his own benefit or to the benefit of any other person, anything which has been entrusted or delivered to him under a title which implies an obligation to return such thing or to make use thereof for a specific purpose, shall be liable, on conviction, to imprisonment for a term from three to eighteen months:

Provided that no criminal proceedings shall be instituted for such offence, except on the complaint of the injured party.

The essential elements of misappropriation are:

(a) appropriation;
(b) *animo lucrandi*;
(c) the entrustment of a delivered thing;
(d) the obligation to return the thing or to use it for a specific purpose.

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\(^{37}\) Chapter 9 of the Laws of Malta
(ii) Embezzlement is provided for by Article 127 of Chapter 9 of the Laws of Malta, however this is not applicable in the context of Fraudulent Trading as according to this provision it is limited to particular acts carried out by public officials:

Any public officer or servant who for his own private gain or for the benefit of another person or entity, misapplies or purloins any money, whether belonging to the Government or to private parties, credit securities or documents, bonds, instruments, or movable property, entrusted to him by virtue of his office or employment, shall, on conviction be liable to imprisonment for a term from two to six years, and to perpetual general interdiction.

(iii) Escroquerie (the obtaining of money or property by false pretences) is contemplated by Article 308 of Chapter 9 of the Laws of Malta. This Article stipulates:

Whosoever, by means of any unlawful practice, or by the use of any fictitious name, or the assumption of any false designation, or by means of any other deceit, device or pretence, calculated to lead to the belief in the existence of any fictitious enterprise or of any imaginary power, influence or credit, or to create the expectation or apprehension of a chimerical event, shall make any gain to the prejudice of another person, shall, on conviction, be liable to imprisonment for a term from seven months to two years.

The essential elements of escroquerie are:

(a) unlawful practise, the use of a falsity or the deceit;

(b) the messa in scena; and

(c) gain to the prejudice of third parties.

B. Nominal Falsity (Frodi innominat.)

Reference is also made to the following article, Article 309 of Chapter 9 which provides:

Whosoever shall make, to the prejudice of any other person, any other fraudulent gain not specified in the preceding articles of this sub-title, shall, on conviction be liable to imprisonment for a term from one to six months or to a fine (multa).
This article is basically an umbrella provision which covers all those cases of fraudulent gain to the detriment of third parties resulting from the intention to deceive, which do not fall under any other specific provision of the Criminal Code.

With regard to the requisite intention of fraudulent trading (dolo), one may refer to a judgement handed down by the Maltese Court of Appeal on the 31st March 1967 in the names Reverendu Sacerdot Don Francesco Zammit et vs Avukat Dottor Anthony Farrugia e’, where the Court embarked on the following considerations:


Illi l-gurisprudenza taghna bhal dik ta’ legislazzjonijiet simili ghal-taghna irreligious illi mhux kwalunkwe skaltrezza hi dolo u li fl-iskambi ekonomici (ghalkemm anke l-lealta’ kommercjali ghandha l-esigenzi taghha) certu ftahir tal-haga offerta da parti tal-bejjiegh mhux illecitu fil-kamp guridiku, apparti naturalment il-kamp purament morali, sakemm ma jilhaqx dak il-grad ta’ malvagita’ li hu propju tad-dolo.

-omissis-

In summary, what the Court stated in the above-mentioned case is the following:-

When considering the definition of *dolo*, one can still validly refer to that given by Labcone (fr. 1 :D.4.3) :- « dolum malum esse omnes camditatem fallaciam marbinationem ad circumverendum fallendum decipiendum alterum adhibitam ». In other words, *dolo* implies the malicious intent of one contracting party who acts through deceit (raggiri) to deviate the will of the other contracting party towards error (errore). Thus, seen from the point of view of the “deceptor”, the dolus is actual deceit whilst seen from the point of view of the “deceptus”, the dolus is actual error. The Law, which already separately considers this type of error as a defect of consent in its own right, goes much further in its consideration of this type of error such that it provides for the annulment of the contract even when the error is not itself such as to otherwise justify a defect of consent.

Maltese case law, like others in similar legal systems, deems that not every act of craftiness amounts to ‘*dolo*’ and that in commercial transactions (although ‘business ethics’ naturally has its requisites) a certain over-qualification of the thing being sold by the buyer is not in itself illegal – saving of course the applicable moral considerations and subject to this not reaching that degree of malice which essentially is tantamount to ‘*dolo*’.

Among the various distinctions of *dolo* arising from legal doctrine, there is one which is still truly and particularly relevant to the position contemplated by the Maltese Code, that is the distinction between an act of *dolo* which is determining and one which is not. Whilst this distinction may be clear to make with the use of reason and logic, its juridical application is not always so clear. Current legal doctrine and jurisprudence appear to lean towards the view of the necessity to identify the *dolo in concreto*, that is the *dolo* which subjectively refers to the *stato d’animo* of the particular victim in a particular case. A Judge has to take into consideration, on one hand, the intention and understanding which the victim had in his mind which led him to give his consent in the first place, and on the other hand, the degree of inexperience and lack of proper

III.II.III How fraud has been considered by various authors.

Fraud is considered under the title ‘Crimes of Dishonesty in Criminal Law – Greene’s Concise Scots Law’ by T.H. Jones and M.G.A. Christie.\(^{38}\) Maltese criminal law carries certain interesting parallels with Scottish criminal law. When it comes to defining fraud, Jones and Christie state the following:

Currently, a working definition of the crime might run as follows: that fraud consists of a false pretence made to another person in the knowledge of its falsity and with the intention that the other person should be deceived by it into acting in a way in which he would not otherwise have acted, provided that that other person is so deceived and does so act on account of it. It will be noted that the proviso reveals fraud to be a result of crime (see para 2-37 above); a false pretence is of no avail for the completed crime unless it causes the specific result….\(^{39}\)

These authors consider the false pretence to be the *actus reus*. In this respect the following is stated:

What may be pretended falsely and what may be the methods of conveying falsehoods to another are matters difficult to generalise. As Hume puts it: “It would be a vain, and a tedious attempt, to enumerate all the manifold shapes of cheating or fraud, in which falsehood is one of the chief ingredients of the guilt.” Yet, whatever it be that is expresses or implied, it has to be verifiably false there and then. If it happens to be true, then there can be no question of fraud. Of course, what is true or false is generally easy to establish. Whether a person is really who he says he is, whether the goods he has for sale are truly as he describes them, or whether he is really entitled to claim what he presently seeks, can be proved one way or the other with more or less difficulty. But if a person is, for example, induced to buy or to sell by reason of some future intention expressed by another, how can fraud ever be a relevant charge? It stands to reason that a person’s future intentions relate to things that he would wish or hope to be able to undertake.

But the best-intentioned hopes or wishes may never be fulfilled. They may turn out to have been over-ambitious, or to be frustrated by events; and it is

\(^{38}\) ibid p.302 et seq
their very uncertainty that leads to the conclusion that future intentions cannot form part of the province of fraud. A person’s intentions cannot generally be described as false when they are made. But it does not follow that express or implied statements of intent can never be false.

Jones and Christie go on to consider the other essential element of an offence, the *mens rea*:

The accused must know that what he says or writes or implies is false, and must intend thereby to deceive. It seems unlikely that recklessness as to the truth of statements made to another would be sufficient, as is apparently borne out by the decision of the Appeal court in Mackenzie v Skeen (1971 J.C. 43).

In *Textbook on Torts*, Michael A. Jones clarifies that:

Liability for fraudulent statements predates liability for negligent statements by almost two centuries (Pasley v Freeman (1798) 3 D & E 51). The requirements of an action for deceit are that the defendant knowingly or recklessly made a false representation to the claimant intending him to act on the representation, and that the claimant did act on it to his detriment.

A promise which the defendant has no intention of fulfilling is sufficient, because ‘the state of a man’s mind is as much a fact as the state of his digestion’ (Edgington v Fitzmaurice (1885) ChD 459, 483 per Bowen LJ). An unfulfilled promise, which was a true representation of the defendant’s intention when it was made, is not actionable in deceit.

The most significant restriction on the tort of deceit is that the claimant must prove fraud, i.e. that the defendant made the representation knowing that it was false, or recklessly, not caring whether it was true or false. In Derry v Peek (1889) 14 App Cas 337), the House of Lords held that dishonesty, in the sense that the defendant had no genuine belief in the truth of the representation, was essential to an action in deceit. A statement which is made not caring whether it be true or false is made without any real belief in its truth, and this is different from a statement honestly believed to be true which, through lack of care, is false (per Lord Herschell). It is not sufficient to show that there were no reasonable grounds for the defendant’s belief in its truth. This can be evidence from which fraud may be inferred, but it is not

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40 8th edn
conclusive. Therefore, although recklessness as to the truth of the representation may suffice, it must be such as to lead to the conclusion that the defendant was dishonest (Thomas Witter Ltd. v TBP Industries Ltd (1996) 2 All ER 573, 578), although it does not have to be dishonesty as the word is used in the criminal law.

-omissis-

Although the standard of proof is the usual civil standard of the balance of probabilities, an allegation of fraud requires a ‘higher degree of probability’ (Hornal v Neugerger Products Ltd. (1957) 1 QB 247, 258).\textsuperscript{41}

IV. Conclusion

The one and only time that an action was instituted in Malta based on the above-mentioned provisions on fraudulent and wrongful trading was in the so-called ‘Price Club’ case. Once a general introduction to these subjects has been made here, in the following chapter I will therefore consider the practical application of these provisions by reference to the proceedings in this case and ultimately by reference to the judgment handed down by the Court in these proceedings.

\textsuperscript{41}ibid p.98 et seq
CHAPTER II

Legal Issues arising from The ‘Price Club’ Case

I. Introduction

As previously stated, the first and to date the only claims based on Fraudulent and Wrongful Trading brought before and decide upon by the Maltese Courts were those claims that were instituted in what is referred to as the ‘Price Club Case’.

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

(i) case (Writ of Summons) number 24/2003 TM in the names Dr. Andrew Borg Cardona as liquidator of Priceclub Operators Limited vs. Priceclub (Holdings) Limited and by a Court decree the directors, Biochemicals International Limited and 2000 Holdings Limited were called into the case – this was a claim brought forward by the liquidator for the dissolution of Price Club (Holdings) Limited;

(ii) case (Writ of Summons) number 25/2003 in the names Dr. Andrew Borg Cardona as liquidator of Price Club Operators Limited vs. Price Club (Holdings) Limited; Price Club (Birkirkara) Limited; Price Club (Burmarrad) Limited; Price Club (Swaral Limited); Biochemicals International Limited and 2000 Holdings Limited – this was a claim whereby the plaintiff asked the Court to declare that the defendant Companies abused of the privilege of limited liability and consequently lost it making them therefore liable in solidum towards the Plaintiff Company;

(iii) case (Writ of Summons) number 26/2003 in the names Dr. Andrew Borg Cardona as Liquidator of Price Club Operators Limited vs. Victor Zammit et – by means of this action the plaintiff asked the Court to find defendant Directors guilty of Wrongful Trading; and

(iv) case (Writ of Summons) number 27/2003 in the names Dr. Andrew Borg Cardona as liquidator of Priceclub Operators Limited vs. Victor Zammit et – this was an action
brought by the liquidator on the basis of the Fraudulent Trading provision in the Maltese Companies Act. Two appeals were subsequently lodged from these decisions one on the Fraudulent Trading issue and the other on the Wrongful Trading issue, which appeals resulted in a confirmation of the original judgements as handed down by the Court of First Instance.

II. Groups of Companies: Abuse of Limited Liability

The first legal issue arising from the Price Club case which merits discussion is that raised in the action 25/2003. The claim advanced in this case by the plaintiff Company is that the defendant Companies abused of the privilege of limited liability granted to them by Article 67 of the Companies Act[42] and that the Court should declare that as a result of this abuse the said defendants (qua shareholders of the plaintiff Company) had thus lost this privilege and were consequently liable towards Plaintiff Company. In this case the plaintiff was the Liquidator of Price Club (Operators) Limited, (hereinafter referred to as PCO), and the action was brought against the Group’s Holding Company, against three other Companies which formed part of the same Group and also against two other Companies which were Shareholders of PCO.

The plaintiff’s action was based on the fact that the Plaintiff Company PCO, was liquidated and wound up because the circumstances in which it found itself were such as it was not in any position to pay off its debts. It resulted that when the Price Club Group was created and the Group structure was thus being planned and laid out, PCO was (within this Group structure) the Company used to carry out the actual operations of the Group whilst a number of other Companies, three of the defendant Companies in this case, were set up to separately own the assets of the Group. In this manner PCO – which being the Operating Company within the Group, would be that company set up to mainly engage with third parties and thus most likely to have third party trade creditors – was designed to be that Company with the least actual assets to its name. Therefore the plaintiff claimed that it was the very structure of the Group from the outset which left

[42] Chapter 386 of the Laws of Malta
the Company’s creditors with nothing on which they could execute their claims since PCO had no assets of its own. The plaintiff alleged that both the initial plan evidenced by the designed Group structure and the subsequent facts themselves constituted a clear abuse of the privilege of limited liability granted under Article 67 of Chapter 386.

It is to be noted at this stage that in actual fact all Article 67 does is state that: ‘A company is formed by means of a capital divided into shares held by its members. The members’ liability is limited to the amount, if any, unpaid on the shares respectively held by each of them.’ Article 67 does not itself expressly grant the remedy sought after by the plaintiff. Nowhere does this Article speak about abuse of the privilege of limited liability. However in its judgement the Court noted that over the years it had come to be accepted by doctrine and Maltese case law that, in the event that it results that there has been an abuse of limited liability, the Court would have the power to look beyond that limitation and to hold those persons directing the Company personally responsible for the consequences that result from the actions of the Company.

Before discussing the deliberations of the Court and their legal implications it would be helpful to look at the above-mentioned Company Structure of the Price Club Group. Below is a depiction of the Group structure relevant to this Chapter:-
In synthesis, the operations of the Group were carried out as follows: Price Club (Holdings) Limited (herinafter referred to as 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.

It is to be noted immediately that effectively nothing in the company structure employed by the Group is in itself illegal. This point was also confirmed by the Court in its judgement when it stated the following: ‘...this Court does not see that the creation of the structure under its examination, when examined alone, is in any way illegal such that it could result in the Court removing the corporate veil and keeping the company’s members responsible without limitation for the debts of the plaintiff company. That which the plaintiff is asking for in this case is that the Court sets aside the separate juridical personality of each company in the Group, and holds all the members responsible in solidum and without any limitation for the debts of only one company within the same Group. This does not seem to be possible’. 43

Yet at the end of the day the Court decided to accept the plaintiff’s pleas solely with regard to the Holding Company and to the three other defendant Companies which were subsidiaries of the Holding Company. In arriving at its decision the Court referred to the book ‘Company Law’ 44 which says that in principle ‘The English Courts 45 will pierce the veil only when the company structure is a mere façade concealing the true facts.’ The Court then went on to state that in this case it does not seem that the structure had been simulated, however it was possible that the same structure was abused of by the Directors at a moment when the financial state of the Company

43 Translated by author
44 Butterworths, 2003, Brenda Hannigan, p. 70
45 As noted in the previous Chapter, Maltese company law follows to a large extent British company law
required the interests of the Creditors to be taken into consideration,\textsuperscript{46} however it cannot be said \textit{ut sic} that the Company Structure was illegal.

A similar scenario to that faced by the Court in this case was that which emerged in \textit{Woolfson v. Strathclyde Regional Council} decided by the House of Lords in 1978.\textsuperscript{47} In this case Slade LJ made the following observation:

\begin{quote}
‘We do not accept as a matter of law that the court is entitled to lift the corporate veil as against a defendant company which is a member of a corporate group merely because the corporate structure has been used so as to ensure that the legal liability (if any) in respect of particular future activities of the group (and correspondingly the risk of enforcement of that liability) will fall on another member of the group rather than the defendant company. Whether or not this is desirable, the right to use a corporate structure in this way is inherent in our corporate law.’
\end{quote}

The creation of a similar structure ‘to evade such rights of relief as third parties already possess’\textsuperscript{48} is condemnable, however, the creation of such a structure before business commences does not result in an abuse of the system by the Company’s members.

On the other hand, after business began, it was expected that the operators of the Group do not take advantage of the Group’s Structure to the detriment of external Creditors, especially at a moment when they were supposed to be taking the interests of these Creditors into consideration.

The Court went on to refer to ‘The Liability of the Holding Company for the Debts of its Insolvent Subsidiaries’,\textsuperscript{49} which mentions various Group Structures that could potentially be harmful to creditors, two of these are the following:-

\begin{quote}
‘(1) The first refers to those situations where the subsidiary acts not in its own interests as a separate unit, but – to its own detriment – in the interests either of the holding company, or of one or more affiliated companies within the
\end{quote}

\textsuperscript{46} As it resulted to the Court in case 27/03 to be discussed further on
\textsuperscript{47} 38 P & CR 521
\textsuperscript{48} (n.44) pg 71
\textsuperscript{49} Profs. Andrew Muscat, Dartmouth, 1996, p. 64-65
group, or of the group as a whole. This type of subsidiary is referred to in this word as a ‘subservient subsidiary’;

(2) The second category comprises the situation where the subsidiary is organised with an inadequate or with a creditor-proof financial structure. This type of subsidiary is referred to as the ‘undercapitalised company’.

In the case at hand, the Price Club Group was in the Court’s opinion, created in this manner, and whilst it was shown that the creation of the structure itself cannot be considered to be an abuse, that which took place after confirms that not only the Holding Company, but neither of the other Companies within the Group did anything else other than keep back from involving themselves directly in the problems faced by PCO in such a way that resulted in a situation where the Trade Suppliers found themselves without an effective remedy. In its judgement the Court also referred to and agreed with another section of Prof. Andrew Muscat’s book which states:

Even where the insolvency of a subsidiary is not causally linked to the diversion of the corporate opportunity, it is at least arguable that the forced submission of the subsidiary to the will of the group creates a corresponding obligation on the part of the holding company to shelter it from an ensuing blizzard. The clue to an equitable solution may possibly lie either in the notion of adequate compensation for the loss of the corporate opportunity or in the extension of liability on the holding company in appropriate circumstances.

In this case PCO was not only a Subsidiary of the Group but it was also directed by the Holding Company in a direct and immediate manner, in the sense that a lot of the obligations and debts imposed on this Company were imposed in the interests of the Holding Company, the Directors, and/or their own personal companies, and not in the interests of the Operating Company itself. PCH was the ‘person’ that was directing PCO, and, therefore, once the latter Company ended up in a state of bankruptcy, it would not be right for that ‘person’ directing it not to assume any responsibility for what happened.

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50 ibid p. 75
Furthermore, it resulted that the Group in general and PCO particularly needed a substantial amount of capital, and their financial needs were in an abusive manner satisfied from the debts provided by the Creditors rather than from the capital of the members. Even here it was in the Court's opinion required that the Companies in the Group intervene. As Prof. Muscat said in his book:\(^{51}\)

If on the other hand the subsidiary is adequately financed for its current operations but plans to embark on a project requiring considerable additional financing, then – provided that the holding company is aware of the project and has the means of imposing its will on the subsidiary – the holding company's obligations to adequately finance its subsidiary should be viewed as a continuing one. Where the scale of the business has significantly altered, the issue of adequate financing should not be frozen arbitrarily by reference to the time of incorporation. To allow the subsidiary to proceed with a substantial project without ensuring adequate financing would be as scornful as the setting up of an inadequately financed subsidiary.

Although these principles may seem a bit innovative, the Court agreed with them and believed than in analogous situations the Holding Company should intervene in the interests of sustaining the Group. The fact that defendant Companies remained hidden behind their legal personality is to be considered as an abuse of this personality.

The main legal argument arising from this case is whether a Holding Company and the other Companies forming part of a Group of Companies should be deemed to have abused of their legal personality in the event that they fail to aid another Company within the same Group facing financial difficulties, or rather whether such Companies have a duty of doing so, and this also in the light of the principle of separate juridical personality.

It is probably best to begin with what is meant exactly by abuse of the privilege of limited liability. Abuse of limited liability has been defined as generally consisting of ‘improper use of the company’s assets and unfairly prejudicing the interests of creditors.’\(^{52}\)

\(^{51}\) Ibid p. 386
\(^{52}\) Andrew Hicks & S.H. Goo, ‘Cases & Materials on Company Law’, 6edtn, Oxford University Press, 2008
While as noted, the Cork Committee\textsuperscript{53} agreed that ‘review of the liability of a parent for the obligations of its subsidiary was a matter of urgency, it, nevertheless, ‘reluctantly’ concluded that it should not recommend a fundamental change in company law by means of proposals to effect a change in insolvency law’.\textsuperscript{54}

In fact the Cork Committee, in their Report, explained their position on this in the following manner: \textsuperscript{55} 

1925. The legal position is that each company in a group is a separate legal entity, and the directors of any one company are not entitled to sacrifice the interests of that company to the interests of the group as a whole. Even in the case of a parent company with wholly owned subsidiaries where the ultimate shareholding interest in all the companies in the group is the same, the existence of separate groups of creditors of each company requires the directors of each company to have separate regard to its particular interests.

1926. In practice, however, the affairs of companies in a group are often conducted by management by reference to the interests of the group as a whole. The control which the parent company has over the composition of the board of each of the subsidiaries and the series of common directorships which this often entails means that transaction between companies in the group can be, and often are, conducted on a basis which is not arm’s length……..

-\textit{Omissis}-

1929. There are two principal questions which arise in insolvency as regards groups of companies. First, whether or not one or more of the other companies in the group should be made responsible for the external debts of the company which is insolvent. Secondly, how should the claims of other group companies in the winding up of an insolvent group company be treated? …….

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\textsuperscript{54} Blumberg on Corporate Groups: Chapter 90 Liability of Parent Corporations for the Obligations of their Insolvent Subsidiaries under English, British Commonwealth, and European Union Law – 2006 Supplement, Aspen Publishers, Second Edition, Volume 2 – Section 90.02(c)
\textsuperscript{55} (n.52) directly quoting the Cork Committee’s Report
1954. So long as each company in a group is treated as a separate legal entity, distinct from every other company in the group, and with its own distinct class of creditors, the problems created by the existence of intercompany debts require a solution to be found. These are the debts owed by the company in liquidation to other companies in the group, which are entitled to prove for them in competition with the external creditors; and the debts owed to the company in liquidation by other companies in the group, which may or may not themselves be insolvent.

-Missis-

Misapplication of the company’s assets

1969. Notwithstanding the directions of the parent company, the directors of the subsidiary are bound to apply its property for the benefit of the subsidiary, and not for the benefit of the parent company or other companies in the group. Failure to observe this fundamental principle of company law will often lead to a misapplication of the subsidiary’s property, for which the directors will, in theory at least, be personally liable.

1970. .......Where the company is insolvent, or becomes insolvent in consequence of what has been done, the creditors will have been prejudiced, and the liquidator may wish to bring proceedings for their benefit, not only against the directors, but also against the parent company in order to recover the assets which have been misapplied.

IV. The protection of creditors

37. An issue of some concern within the United Kingdom relates to the liability of a parent for the debts of its subsidiaries....... 

40. ....... English law has opted for a system which imposes liability on a parent company only where it is shown to have ‘abused’ its position rather than imposing liability solely because of its status as a parent company. The English system of regulation is seen as providing a necessary degree of flexibility in the organisation of the affairs of a group and also avoiding what are seen to be some of the policy difficulties associated the imposition of liability because of the fact that a group form exists....... 

The question still remains whether liability could be imposed on one Group member for the liabilities of another Group member, in this respect ‘the New Zealand Companies Act, 1980 went well beyond anything in the Anglo-American law. It permits a court to impose liability on a related company for the debts of an affiliate being wound up if the
court is ‘satisfied that it is just and equitable to do so.’ This was a potentially revolutionary change. However, it has not been significantly utilized to date……...56

As discussed in Chapter I, the provision on Wrongful Trading both under English as well as under Maltese Law includes a shadow director in the definition of director under that particular provision. Since shadow directors are explicitly covered by this Article, it could indeed be validly argued that it is possible to have a Holding Company liable for what has happened to its subsidiary if it is proven that the Holding Company did in fact exercise a certain amount of control over the subsidiary. According to Blumberg: ‘as pointed out by an English commentator, this gives the courts fairly wide discretion to bring parent companies within the definition of a shadow director and appears at least theoretically, to have greatly extended the circumstances in which a parent company may be liable for obligations of an insolvent subsidiary. As a practical matter, it has had little effect on the law.’57

Blumberg also notes that: ‘just as directors of the subsidiary must normally act in the interests of the subsidiary, not in the interests of the group, the directors of the other companies of the group must act in the interest of their respective companies, not in the interest of another group company.’58 This comment leads one to understand that each individual Company within the same Group should only be preoccupied with its own business and not with that of the other Companies within the Group, possibly allowing one to arrive at the conclusion that since one should only act in the best interests of his own Company then there is no duty on the Directors to help out another Company within the Group facing financial difficulties, therefore since there no such duty exists then one cannot say that the privilege of limited liability has been abused of and consequently neither of these other Companies within the same Group should be held liable for the losses of another Company within that same Group.

56 Blumberg
57 Blumberg Section 90
58 Blumberg Section 90.03(B)
II.I. Fraudulent Trading

The issue of Fraudulent Trading was addressed by the Court in case number 27/2003. This case was an action was filed by the Liquidator of PCO against the three Directors of the same Company where the Liquidator alleged that these Directors by means of their actions guilty of fraudulent trading. As seen in Chapter I, in order for such an action to be successful the liquidator would have to prove certain facts that (a) would have been established and proven strictly to the degree of proof required by law in similar situations, and (b) that would strictly fall within the parameters of the law as discussed in the previous chapter.

The First Court accepted the plaintiff’s arguments and found the Directors guilty of Fraudulent Trading. Consequently the Court held all three Directors jointly and severally liable for what was due to the Creditors. This Judgement was subsequently confirmed on Appeal.

II.II. Wrongful Trading

A separate action was instituted by the Liquidator based on the provision in the Companies Act dealing with Wrongful Trading. A situation of Wrongful Trading exists 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. In this case the First Court’s judgment was also confirmed on appeal. The Courts established April 1999 (practically a year after its incorporation) as the date when the Directors ought to have known that there was no reasonable prospect that the Company could recover and therefore dissolution could be avoided.
II.III. Discussion

There are certain aspects of these judgments with which I have to express a certain disagreement. This varying opinion stems from what I believe could be a reasonable different appreciation of both the evidence that was presented during the proceedings and to the legal arguments presented respectively by the parties to the proceedings. Since the wrongful trading judgement referred to what was considered in great detail by the Court in the fraudulent trading judgement the following discussion refers interchangeably to both cases.

II.III.I. The Structure of the Price Club Group\textsuperscript{59}

The allegations made by the plaintiff in this respect are that the structure chosen for the Group of Companies collectively known as Price Club was from its inception established with a fraudulent intention vis-\(\text{a`-vis}\) the Creditors of the Price Club Group.

I do not believe that it can reasonably be claimed that the parties’ intention at the time of planning and setting up the Company Structure was that being alleged by the plaintiff in this case, especially in the light of the fact that the defendants invested substantial sums of their own money and also dedicated significant resources in addition to themselves with the aim of creating a successful venture. Within this structure, the defendants personally invested a sum equivalent to just over two million Euro, and additionally acted as guarantors \textit{in solidum} with the Company for a sum equivalent to practically seven million Euro.

Even when taking into consideration certain facts which were brought to light in the evidence stage of these proceedings, objectively one cannot but ask how the plaintiff arrived at such a conclusion of some pre-designed bad intention on the part of the promoters. From the evidence produced before the Court it resulted that the principal reason behind the adoption of such a structure was to enable the original vendor to

\textsuperscript{59} See above depiction of the Company Structure
legally benefit from substantial fiscal advantages at the time of sale, to the extent that for the purchasers (the defendants) the adoption of this structure was a *sine qua non* for the sale to be able to go through. In this respect it is interesting to note that in the plaintiff’s own final submissions to the Court he commented that on this point there was no contestation.

Additionally, the plaintiff never alleged that the Structure itself contravened any provision of Law. I think it is important to point out here that the Structure was one permitted by Law, and it was a Structure that was not unusual in the planning of any regrouping of commercial entities having the same scope. It is absolutely not unusual to have a Group Corporate Structure consisting of a Holding Company and Subsidiaries separated into those there just to hold assets and those subsidiaries used as trading companies. At the end of the day the structure employed in this case was logical, good, and such that could be clearly set up.

With regard to the intention of the Directors of the Company at the time the Company Structure was established, I believe that it is important to note that, as resulted from the evidence brought forward in this case, all three Directors sought right from the outset to engage the services of certain persons who are all persons having the necessary qualifications and deemed to be experts in their fields (legal advisors, financial consultants and accountants, management) in order for the business to be carried out in a proper and serious manner from day one. What is interesting to note with regard to the accountants involved in this case is that the plaintiff sought to attack them directly in the manner in which they carried out their work. The fact that the defendants took such care in employing reputable people goes to show their dedication and serious and long term intention to this venture, which is a far cry from the plaintiff’s allegation that the structure was created *ab initio* in order to defraud creditors from day one.

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60 Testimony of First Defendant: the Structure ‘was established by [the vendor] for him to be able to benefit fiscally from the sale, and it was acquired from him tale quale’
61 Plaintiff’s submissions – paragraph 2.11.1
The structure of the business also played an integral part in a study carried out by the defendant’s accounting firm subsequently used in a presentation made to a bank as part of a financing request. This request was approved by the bank after it had examined the document presented to them by means of its own bankers and legal advisors. This also goes to show that there was no fault to be found with the Company Structure.

Another significant factor is that, as resulted from the evidence produced in Court, the defendants as purchasers of the Company also had to carry out their own analysis of the method with which the Company was being managed by the vendor, from whom they were going to purchase the Company. Such an analysis was carried out in a detailed manner which therefore permitted the defendants to identify those areas of management which required further attention not only for the business to be able to grow but also to meet the expected challenges that Malta’s eventual accession to the European Union would bring with it in this particular sector (given the period during which the transaction was being planned). This clearly shows that the defendants had acted in a prudent manner when entering into this business, and that they had acted with forward planning by looking not only at the circumstances applicable to the relevant sector at that particular moment in time but also by looking at the anticipated change in circumstances in the future. The defendants turned this knowledge into concrete action:- (i) they immediately carried out a marked reorganisation of all human resources, (ii) they enhanced the management structure, and (iii) they employed the required experts in a number of sectors - which once again evidences their dedication and determination for everything to work out well and raises admissible doubts as to whether purely by applying a certain benefit of hindsight, it can be argued that the Structure was set up in the manner it was with a specific intention to defraud or prejudice eventual creditors.
II. III. II The carrying out of the business after its purchase

It results even from the plaintiff’s final submissions to the Court that even after the acquisition of the Business from the vendor, the Board of Directors continued working in a professional manner as is required of it. The managerial structure put into place by the defendants can be deemed to have been a serious structure which adequately met the challenges set forth by the complexity of this type of business:

The Board of Directors met regularly. Additionally an Executive Committee was established, and was charged with daily management, along with a number of specific Task Groups established to analyse and focus on particular aspects of the business. The choice of the senior management team, which was to participate in these specific Task Groups was carried out with caution and attention in order to locate as much as possible competent persons with experience in their respective fields. Naturally the structure employed here involved an increase in human resources expenses, however such a structure was very important for and expected in the management of any business as that *de quo agitur*.

It is noteworthy that nowhere in his submissions did the plaintiff criticise this managerial structure (along with the evident quantum leap quality in this structure pre and post acquisition) as one that was inadequate or unprofessional or not of that standard of prudence and diligence expected in the type of business as was the defendants’.

Additionally, along with this internal structure, constant referrals were made to a number of experts and external consultant, all of which enjoyed a certain reputation and experience in their field.
Another important aspect which *ex admission* was to a limited extent acknowledged by the same plaintiff,\(^\text{62}\) was the personal dedication of the defendants in the carrying out of the business and their enthusiasm for the said business to succeed.

The above was not something that the defendants thought of initially and threw on the back bench, but rather this was the way in which the Company was managed on a daily basis.

**II.III.III Consideration of the Financial Statements**

For a substantial part of his submissions\(^\text{63}\) the plaintiff went into detail on the figures that emanated from the audited accounts and the management accounts. The underlying philosophy in the plaintiff presenting these documents was to show that:

(i) where the figures showed an increase in losses the Directors were at fault for not notifying the Creditors of this whilst they were knowledgeable that the Company had entered a state of insolvency, and

(ii) when the figures showed positive signs\(^\text{64}\) the blame was to fall on the alleged disorganisation of the Company’s auditors.

The essence of these facts can be summed up in the directors’ Performance Review which is to be found in the Financial Statements and which statements were quoted *in extenso* by the plaintiff. This Performance Review stipulates:

> The directors are confident that the operational performance of the company will improve in the foreseeable future, following a tightening in control over costs and operational processes.

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\(^{62}\) Plaintiff’s submissions – paragraph 2.22  
\(^{63}\) ibid para. 2.39.5  
\(^{64}\) Eg: footnote 165 of the plaintiff’s submissions
In order for one to begin considering whether behind all that happened there existed any elements of fraudulent trading, one must clearly analyse the above-cited declaration, which the plaintiff amply criticised throughout these proceedings. In order for this to be done justly and according to Law, this analysis should, whilst also being subjected to an objective examination as to certain points of principle, be principally carried out with attention as to that which was the subjective position of the defendants and according to the situation in vigore at that specific time – with the complications, risks, particular circumstances and different consequences then present. It is as a rule always easy to criticise what happened in the past with the benefit of hindsight. The judicial review of such cases also runs the tightrope risk of falling into the trap of explaining past acts by fitting in them the results of subsequent actions or developments. The challenge is to properly distinguish cases where what happened ex post facto was the result of a pre-set design or consequence of previous lack of ordinary diligence from cases where what happened ex post facto was not in actual fact a consequence of such act or omission.

II.III.IV Observations on the duties of the directors

When the above-cited Performance Review declaration was made questions that could legitimately be raised were: (i) how intimately knowledgeable were the directors as to the position of the company? and (ii) how objectively and reasonably justified are they in showing faith that the operational performance had to improve in the future?

Worded as it is, this declaration signed by two of the Company’s Directors is ostensibly reflective of (i) their knowledge of the strengths and weaknesses of the operation of the Price Club Group; (ii) the result of a number of external consultations commissioned in order to identify the problems and suggest the ideal solutions in order for these problems to be solved; (iii) the determination of the directors to accept and implement all the advice and recommendations given to them by these experts; (iv) the fact that, in all this complex process, notwithstanding a detailed and profound study, none of the experts consulted by the Directors gave, neither directly nor indirectly, any hint or advise
to the effect that the situation was remotely irremediable, nor that any attempt to remedy the situation would have been useful, nor that an attempt should be made to come up with a contingency plan in the event of insolvency; (v) all indications given were that upon implementation of the experts’ suggestions and with an accelerated restructuring of the Price Club Group, the results were going to start being positive and would eventually result in the generation of actual profit.

II.III.V. Open Policy with the Creditors

With regard to this issue, the directors of PCO were more than open with the creditors. They did not limit themselves to statutory declarations – although these are public domain according to Law and consequently accessible both to the creditors as well as to the general public. The directors presented the facts to the creditors, who were requested to grant an extension to the credit terms then in vigore and who were also presented with a document enlisting the existing difficulties of the company as well as the plans to be followed in order for such difficulties to be overcome – this action cannot be deemed as reflective of a fraudulent intention.

What certainly was not expected was that a number of the larger creditors for one reason or another, created a sense of panic amongst the rest of the creditors, effectively causing a “run” with all its disastrous consequences. In this sense one should look at the testimony of one of the defendants, where in essence he said that the meetings with the creditors were held with one of the Directors, however with regard to those meetings at which he was also present, he could say that they were explaining to the creditors the steps that they were taking in order to improve their operations, and they also informed them about the company’s cash flow problems. Today, with hindsight, one may arrive at the conclusion that it was actually these meetings that instead of being interpreted as a sign of correctness and honesty on the part of the Directors, could have created a sense of panic amongst the creditors. Certainly however one cannot say that they were concealing the truth from their creditors.
Another significant element which may also shed light on the possible recovery of the Company was the fact that the largest importation company in Malta extended its credit line in favour of the Company, and this after as evidenced from the evidence produced in Court, it had carried out a detailed analysis on the Company Structure and on all financial aspects and feasibility of the Price Club Group.

**II.III.VI Auditors’ Report**

Certain important aspects of the strategy followed by the directors of PCO which also sheds some light on the manner which they employed their efforts to strengthen the Company, are reflected in a report commissioned by the auditing firm of which an expert witness produced by the plaintiff happened to be a partner. When this expert was called to testify as an *ex parte* witness of the plaintiff, he took a different line in certain significant aspects, which line goes against the impression given by his own firm’s report. In fact, from a reading of this report of this particular auditing firm, it was clear that PCO could be saved if a certain amount of good will was shown by all the parties concerned, and particularly by certain of its larger suppliers.

With regard to this one should point out that this expert testified to the effect that PCO had long been in a state of insolvency with no prospect of recovery, an assertion which has been proved to be untrue by a report carried out by his own firm in April 2001, which report clearly stated: ‘this is an encouraging scenario for PC Group, its marketing position, its branding and business concepts’.

Based on this report one can safely assume that the auditing firm still reasonably believed that PCO had potential. This also results in one not being able to understand this expert’s assertions pending the court case.

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65 Doc. A.15 – Court File
66 Pages 44 - 50
It maybe important to note that over and above the above assertion in the auditors’ report, the report goes further and states that ‘While the key performance indicators for recent months are not discouraging as a pointer to the business’s longer term potential…..’.

It is true that the same set of circumstances may equally indicate either that the company can be bankrupt or else that notwithstanding the difficulties it may have been facing there was a potential that was ‘not discouraging’ and such that could allow a turnaround. Here there is a clear and irreconcilable difference in such a fundamental and crucial point in this case between that which the expert testified to and that which the auditing firm concluded in its report. However there was no contradiction in substance of that which was formally concluded by the auditing firm and of the conclusion reached by the directors of PCO when, aware of all the difficulties faced and full of determination to overcome these difficulties, they believed in the prospects of the Company and kept on maintaining them.

**II.III.VII. Application of the Law**

It is opined that the original judgement may be validly criticised in its interpretation of the relevant Articles of Law- by means of which the original First Hall action was instituted where the First Hall declared that the concepts of Wrongful Trading and Fraudulent Trading are similar

Effectively, the First Court declared that the two concepts of Fraudulent Trading and Wrongful Trading are similar and that the merits of the Fraudulent Trading case are similar to the merits of the Wrongful Trading case.

It is worth noting that Article 316 of Chapter 386 of the Laws of Malta which deals with wrongful trading provides for the lifting of the corporate veil or for the personal responsibility of the directors for the debts of the company when consciously or unconsciously a director carries on trading from the ‘relevant date’ onwards when he
realised or ought to have realised that the company in question could not avoid dissolution and winding up due to its insolvency. On the other hand the article of Law which regulates fraudulent trading is Article 315 of the same Act and it talks about carrying on business with intent to defraud – they are therefore two different concepts.

Therefore, very differently, the concept of fraudulent trading in our Article 315 in practice contemplates the effects of a criminal offence as well as of personal responsibility of the person concerned where the director would have acted with the intention of defrauding creditors, and would have carried out business in such a way as to act upon his intention to carry out fraudulent trading. In this way, in a clear parallel with the criminal field, one has to carry out in cases of fraudulent trading an analysis to see whether there results both the *actus reus* (the act of carrying out business in such a way as to implement a wrongful intent) as well as the *mens rea* (the intention to defraud).

From this it results with all due respect to the First Court, that the above-referred to declaration made by the Court is erroneous for a number of reasons, not only because in reality the two concepts in their elements are very different however above all even for the following three main reasons:

a) The intentional element: in the offence of fraudulent trading the intentional element stands out as one which, for one to succeed in such an action, it has to absolutely result and this according to the degree required by law and this *ad validitatem*. With reference to teachings from the English courts it results that in *Re White and Osmond (Parkstone) Ltd* (judgement in first instance) the examination is essentially purely subjective whilst in the second instance (*Re R v Grantham*) the subjective test is subjected to objective considerations. In the two cases, however, the requirement of intention, reflected in the English notion of ‘actual dishonesty’, has to clearly result. On the other hand, Article 316 which deals with wrongful trading does not require any intention: rather the opposite – it is actually the lack on the part of the director to realise the gravity of the situation.
and instead closes his eyes to the obvious (the dissolution and liquidation of the company due to its insolvency) that is punishable under the same Article;

b) *dolus*: a judgement in favour of a conclusion of fraudulent trading has to arrive at moral conviction that the perpetrator was conscious of the fact that he was acting in a fraudulent manner – and therefore by intentionally planning to carry out those actions necessary to induce the victim to do something that he would otherwise not do. On the otherhand, the concept of wrongful trading does not require any *dolus* on the part of the person concerned.

c) **The degree of proof**: whist with regard to wrongful trading the degree of proof required is the generic civil one of *'a balance of probabilities'*; the position in England leans towards a state of legal fact that whilst that the degree of proof is not necessarily one of conviction of beyond reasonable doubt, neither is it one of the generic civil basis of probabilities. It is somewhere between the two, however, certainly given the origins of the provision of the law in our case, it is more and more oriented to the degree of proof in the criminal field – beyond reasonable doubt. Now given the above discussion carried out on the facts of the case I fail to see how the Court reached the conclusion that it did based on the required degree of proof.

Since the applications for Fraudulent Trading and Wrongful Trading were considered by the Court to be similar and were consequently considered together, a substantial part of the Court’s motivations to find the Directors guilty of Fraudulent Trading are effectively reasons pertinent and applicable to the case instituted based on Wrongful Trading. In the judgement handed down in the Fraudulent Trading case the Court incorporated the motivations for its decision in the Wrongful Trading case and vice versa, and this in such a way as to potentially create confusion as to the essential elements of these two separate concepts and as to the facts and circumstances which led the Court to decide on each of these applications. For example in the Fraudulent Trading Judgment the
Court referred to the issue of lease agreements between the ‘property companies’ and the ‘holding company’ yet it went on to say that if anything this is an example of wrongful and not fraudulent trading. Reference was also made to part of the testimony of one of the defendants where he spoke of certain conduct which according to the English Courts in *Re. Produce Marketing Consortium Ltd (No.2)* was deemed to be wrongful and not fraudulent trading. Another example is a passage by Hannigan quoted by the Court where the author mentions the period when the directors knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation – this is something exclusive to wrongful trading. There are a number of passages of the fraudulent trading judgement not applicable to the merits of that case and this along with a number of English judgments which deal exclusively with the question of wrongful trading.67

An accurate analysis of the judgment identifies the main motivations of the Court relevant to fraudulent trading - the Court identified the following as constituting fraudulent actions: the group structure; the under-capitalisation of PCO; the fact that the Court believed that the creditors became financers of the Company without their knowledge; the way the accounts were held, the Court believed them to be manipulated; and certain loans given by the Group.

As can be seen from Chapter 1, pre-1986 English authors opined that there need to be external acts including false pretences as material proof of guilt of fraudulent trading, yet this *actus reus* does not result in the above-mentioned motivations. In order for the Court the find the defendants guilty of fraudulent trading it had to first of all and this *ad validitatem*, consider the element of *actus reus* and to check whether in each of its motivations here listed the defendants carried out any false pretences, or in other words if they carried out any acts of whatever nature that were ‘verifiably false there and then.’ The *actus reus* will be proved to the degree required by Law when it is proved that the defendants with intent to defraud or by false pretences in each of the circumstances

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67 *vide* Purpoint Ltd, Produce Marketing and Continental Assurance Co – these deal with Wrongful Trading
indicated by the Court as being acts of fraudulent trading, effectively took the creditors for a ride – something which I believe did not emerge convincingly from the evidence produced in this case.
CHAPTER III

Some Common Elements Between Price Club and Enron

I. Introduction

There exist particular circumstances making the Price Club case a case to be held up for legal comparison with other larger scale famous corporate cases which occurred in recent years - an example of such corporate cases with which the Price Club case can be juridically compared - is the Enron case. Although the events that unfolded in the Price Club case did not take place on such a large scale as the events that occured in Enron and its effects were localised given that it occurred in a small country and it was not a public company, there is still a certain behaviour that was common to the collapse of both Companies, in particular in so far as the authenticity of the Company’s Financial Statements and the established *modus operandi* preceding such Financial Statements is concerned. Before embarking on a comparison of these cases, a brief introduction to the Enron case will first be given.

II. Enron

II.1 Background

Enron was founded in 1985 by Kenneth Lay through the merger of two natural gas pipeline companies, Houston Natural Gas and Internorth. Eventually Enron’s business vision was focused on a marked expansion and therefore it began a process of diversification: it became a financial trader and market maker in electric power, coal, steel, paper and pulp, water, and broadband fibre optic cable capacity. Enron also began embarking on overseas projects involving the construction and management of energy facilities. Therefore by the time the scandal broke out in 2001, Enron had become a Conglomerate that owned and operated gas pipelines, electricity plants,
paper and pulp plants, broadband assets, and water plants internationally, and traded extensively in financial markets for the same products and services.68

Following a turbulent period, and as a result of bad accounting practices and mis-management, in October 2001 Enron had no other option but to make a Public Announcement acknowledging that it was worth $1.2 billion less than it had previously claimed. As a result of this Announcement, the value of Enron stock plummeted. In December 2001, a proposed merger agreement with Dynegy collapsed after its public debt had been reduced to junk bond status and was therefore consequently withdrawn by Dynegy. This ultimately led to Enron having to file for bankruptcy on December 2, 2001.69

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**II.II Time Line of Critical Events for Enron (August 2001 to December 2001)**

*Reproduced *ad verbatim* from Exhibit 1 of ‘The Fall of Enron’, K.G. Palepu & P.M. Healy.*

Aug. 14, 2001  
Jeff Skilling resigned as CEO, citing personal reasons. He was replaced by Ken Lay.

Mid to late Aug.  
Sherron Watkins, an Enron vice-president, wrote an anonymous letter to Kenneth Lay expressing concerns about the firm’s accounting. She subsequently discussed her concerns with James Hecker, a former colleague and audit partner at Andersen, who contacted the Enron audit team.

Oct. 12, 2001  
An Arthur Andersen lawyer contacted a senior partner in Houston to remind him that company policy was not to retain documents that were no longer needed, prompting the shredding of documents.

Oct. 16, 2001  
Enron announces quarterly earnings of $393m, and non-recurring charges of $1.01b after tax to reflect asset write-downs primarily for water and broadband businesses.

Oct. 22, 2001  
The Securities and Exchange Commission opened inquiries into a potential conflict of interest between Enron, its directors and the special partnerships.

Nov. 8, 2001  
Enron restated its financials for the prior four years to retroactively consolidate partnership arrangements. Earnings from 1997 to 2000 declined by $591 million, and debt for 2000 increased by $658 million.

Nov. 9, 2001  
Enron entered merger agreement with Dynegy.

Nov. 28, 2001  
Major credit rating agencies downgraded Enron’s debt to junkbond status, making the firm liable to retire $4bn of its $13bn debt. Dynegy pulled out of the proposed merger.

Dec. 2, 2001  
Enron filed for bankruptcy in New York, and simultaneously sued Dynegy for breach of contract.

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II.III Main Reasons for Enron’s Downfall

According to Palepu and Healy, Enron’s complex business model ‘stretched the limits of accounting’. They go on to explain that with regard to the method of accounting employed by Enron, two main issues proved to be problematic, namely:

(i) that Enron’s trading business involved complex long-term contracts whilst at the same time, with regard to accounting, a market-to-market approach was used, this resulted in Enron making predictions regarding the price of energy and interest rates well beyond the near future; and

(ii) that Enron ‘relied extensively’ on structured financial transactions involving the setting up of Special Purpose Vehicles (SPVs).

With regard to this issue, the problem in synthesis was that ‘income was estimated as the present value of net future cash flows, even though in some cases there were serious questions about the viability of these contracts and their associated costs’. In their research paper, Palepu and Healy give a number of examples that help illustrate the problems associated with such transactions; one of the examples given in this regard is that in July 2000 Enron signed a 20 year Agreement with Blockbuster Video to introduce entertainment on-demand to multiple U.S. cities by the end of that year. Enron would store the entertainment, encode and stream the entertainment over its global

\[\text{\footnotesize{\textsuperscript{71}ibid p.10}}\]

\[\text{\footnotesize{\textsuperscript{72}Palepu and Healy define ‘market-to-market approac’h as: ‘once a long-term contract was signed, the present value of the stream of future inflows under the contract was recognized as revenues and the present value of the expected costs of fulfilling the contract were expensed. Unrealized gains and losses in the market value of long-term contracts that were not hedged were then required to be reported later as part of annual earnings when they occurred’ ibid p.11}}\]

\[\text{\footnotesize{\textsuperscript{73}ibid}}\]

\[\text{\footnotesize{\textsuperscript{74}ibid}}\]
broadband network. Pilot projects in Portland, Seattle and Salt Lake City, were created to stream movies to a few dozen apartments from servers set up in the basement. Based on these pilot projects, Enron went ahead and recognized estimated profits of more than $110 million from the Blockbuster deal, even though there were serious questions about technical viability and market demand.75

(ii) Enron ‘relied extensively’ on structured financial transactions involving the setting up of special purpose vehicles (SPVs):

A number of the SPVs set up by Enron were ‘designed primarily to achieve financial reporting objectives’. Here the Palepu and Healy research paper gives the following example: in 1997 Enron wanted to buy out a Partner’s stake in one of its many Joint Ventures. However, Enron did not want to show any debt from financing the acquisition or from the Joint Venture on its Balance Sheet. Chewco, an SPV that was controlled by an Enron executive, and raised debt that was guaranteed by Enron, acquired the Joint Venture stake for $383 million. The transaction was structured in such a way that Enron did not have to consolidate Chewco or the Joint Venture into its Financials, enabling it to effectively acquire the partnership interest without recognizing any additional debt on its books.76

The most controversial of the SPVs created by Enron were LJM Cayman LP and LJM2 Co-Investment LP, run by Andrew Fastow, Enron’s Chief Financial Officer. From 1999 to July 2001, these entities paid Fastow more than $30 million in Management Fees, far more than his Enron salary, supposedly with the approval of top management and Enron’s Board of Directors. In turn, the LJM partnerships invested in another group of SPVs, known as the Raptor vehicles, which were designed in part to hedge an Enron investment in a bankrupt Broadband Company, Rhythm NetConnections. As part of the capitalization of the Raptor entities, Enron issued common stock in exchange for a note receivable of $1.2 billion. Enron increased notes receivable and Shareholders’ equity to reflect this transaction, which appears to violate generally-accepted accounting

75 p. 11
76 p. 14
principles. Additionally, Enron failed to consolidate the LJM and Raptor SPEs into their Financial Statements when subsequent information revealed they should have been consolidated.  

It is also noteworthy that a number of the SPVs set up by Enron, also violated Accounting standards, requiring that at least 3% of its assets are to be owned by an independent Equity Investor. As a result of violating these standards, Enron avoided having to consolidate these SPVs and consequently Enron’s Balance Sheet understated its liabilities, whilst it overstated its equity and earnings.  

Another aspect which contributed to Enron’s downfall was a lack of disclosure on its part with regard to these SPVs.  

**II.IV Concluding Remarks**

In James Bodurtha’s paper called “Unfair values'- Enron’s Shell Game”, it is argued that from 1997 until its demise, ‘the primary motivations for Enron’s accounting and financial transactions seem to have been to keep reported income and reported cash flow up, asset values inflated, and liabilities off the books.’  

**III. PriceClub and Enron: Overlapping Elements**

As can be seen from the previous section of this Chapter, one of the factors that contributed to the collapse of Enron was the veracity of its Financial Statements. This is the principal element which is common to both the Enron and Price Club case.

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80 Jan.2002, McDonough School of Business, Georgetown  
81 p. 2
With regard to the Price Club case, one of the major areas of concern raised by the Creditors to show that the Financials did not reflect the truth was when, towards the end of 1998, Price Club (Operators) Limited (PCO) acquired the business known as Day-to-Day Supermarket, which belonged to the family of one of the Directors of PCO also behind one of the shareholding entities. This happened at a time when PriceClub was still in the beginning of its operations under the Directors of the Defendants in the case and also at a time when it was incurring losses. This take-over was to be carried out in two stages:

- in the first place PCO took over Day-to-Day along with all its assets and liabilities, and subsequently another company belonging to the PriceClub Group acquired the immovable property (supermarket premises in Birkirkara) at a price equivalent to €4,658,746 (then 2 million Maltese Liri); this was paid after a bank loan of €3,261,122 (then 1.4 million Maltese Liri) and the remainder after a capitalisation exercise was carried out in Price Club (Holdings) Limited.

- Then take over of this business took place in October 1998, and the Directors accepted to immediately give €1,048,218 (then Lm 450,000) from PCO to Taormina Holdings, (i.e. the parent company of Day-to-Day Supermarket,) on account of the price of the immovable property, and they also accepted to pay off the creditors of Day-to-Day Limited, which amounted to around another €1,397,624 (then Lm 600,000).

In its judgement the First Court commented that it clearly resulted that on the part of the Director of Price Club to whose family Day-to-Day belonged, he was clearly more interested in paying off his own family’s business Creditors rather than those of PCO.

It is interesting to note that when this business deal was done and the first payment of €1,048,218 (then Lm 450,000) was made, no formal agreement had been concluded between the parties, as the Office of Fair Competition had not yet given its approval for
this acquisition to take place.\textsuperscript{82} Notwithstanding the fact that a formal Agreement had yet to be concluded, PCO had effectively acquired the business and the immovable property of Day-to-Day, the above-mentioned payments had been effected, and Day-to-Day's creditors had been paid off.

When the Office of Fair Competition eventually gave its consent to this acquisition, the formal contract of acquisition of the immovable property in Brikirkara was subsequently concluded. When this contract was finalised, Taormina Holdings took the €3,261,122 (then 1.4 million Maltese Liri) which Price Club had borrowed from the bank and the sum of €1,048,218 (then Lm 450,000) that had been previously paid on account of the final price was refunded to PCO. This refund however was not done by way of a money refund (except for around €232,937 (Lm100,000)), the remaining balance was returned to PCO in two different ways: part was returned to Biochemicals International Ltd (a Company belonging to another of the Directors) as payment of products that Biochemicals had to sell to PCO at some time in the future, and part as acceptance for the assignment of credit which Day-to-Day had with Taormina Holdings. The latter was carried out so that the debt Taormina Holdings had with Day-to-Day was extinguished and assumed by Day-to-Day in relation to PCO. In this way, a viable Debtor Company (Taormina Holdings) was substituted with a bankrupt Company (Day-to-Day Limited). The credit of a Company that held assets (Taormina Holdings) was given to a bankrupt Company (Day-to-Day, and this credit was given to PCO as a refund for part of the payment on account that PCO had paid for the acquisition of the immovable property by another company within the PriceClub Group.

In connection with this acquisition, it resulted that when the take-over took place towards the end of 1998 and the first payment of €1,048,218 (then Lm 450,000) was made to Taormina Holdings, this was not recorded in the accounts of the Company as since permission for this acquisition had not yet been granted by the Office of Fair Competition, it could not be outwardly shown that PCO had effectively been carrying

\textsuperscript{82} This clearance would have been required in view of the fact that Day-to-Day was engaged in the same supermarket business and therefore the principle of avoiding a dominant market position following the acquisition had to be dealt with as a \textit{sine qua non} requirement.
out the business of Day-to-Day, therefore in PriceClub’s books it was registered that a loan had been given of €1,048,218 to Taormina Holdings. The payments that had been made to the Creditors of Day-to-Day were also registered as credits of PCO, and therefore this gave the impression to anyone who looked at Price Club’s accounts that Price Club had to collect this money, when in fact these represented payments that it had made for transactions that could not be shown to have been done officially, therefore the accounts gave the impression that Price Club was a creditor for this amount when in actual fact it had actually paid out this amount in the course of the above-mentioned acquisition.

When the above-described situation, with the exact sequence and chronology of events came to light, in the course of the legal proceedings discussed in Chapter II, the Court itself concluded that it was clear that the Company’s accounts had been manipulated so that, whilst they may have been in line with the prevailing accounting standards, they did not give a true and clear picture of the real situation in which the Company found itself. Apart from the fact that accounts are always supposed to be correct, they also have to be clear and give a clear and correct picture of the situation of the Company to third parties, which third parties are entitled to rely on the veracity of these accounts. The advances made in favour of Day-to-Day were not loans, and even if they were loans it should have been also indicated that Day-to-Day was insolvent and therefore it was impossible that these ‘loans’ were ever going to be repaid.

The same can be said regarding the ‘loan’ that was made to two other companies, which did not form in any way, a part of the Price Club Group. In this case PCO made a payment of €363,382 (then Lm 156,000) to these Companies in order to pay off their creditors. In Price Club’s books this payment was registered as ‘loan receivable’. As was the situation in the previous case, both these Companies were also insolvent, and therefore there was no chance that this amount was ever going to be paid back to Price Club – a fact which was not indicated in the company’s audited accounts thereby once again giving the impression that PCO was a creditor to this amount.
Therefore as a result of both these misrepresentations in the accounts, there was a situation where the accounts showed that a total of approximately €3,028,185 (Lm 1.3 million) was owing to Price Club when in actual fact no such amount was due. This fact contributed to the Court’s decision discussed in Chapter II that the offence of Fraudulent Trading had in fact been committed in the Price Club case.

As seen from the above, although on a smaller scale, certain overlapping behaviour existed between the modus operandi concerning the presentation of financial transactions and recording thereof that contributed to the fall of Enron and the relative action which resulted in the proceedings for fraudulent and wrongful trading instituted against the PriceClub directors – the most obvious overlapping behaviour was the judged manipulation of both Companies’ accounts so that losses were written down as though they were in fact owing to the Companies, therefore creating a false picture to all interested third parties. In the case of Enron, a contributing factor to its bankruptcy was that asset value was inflated and liabilities were kept off the books, thereby also creating a false picture of what the Company’s real financial situation was. In the ‘Price Club’ case the main argument put forward by the plaintiffs was the Company Structure, the issue of misleading financial statements was brought up as a subsidiary argument in part to validate the fraudulent trading claim, yet, when compared with what was done in the Enron case – where though what was actually done was different, it ultimately produced the same results, that of misleading accounts and consequently misleading the creditors, potential business associates and the public at large- it helps to bring out a common pattern in the behaviour employed by persons within a Company in the attempt to ultimately conceal reality and try to save the Company from facing a reality which would otherwise have starkly pointed towards bankruptcy.

83 see text to n.81
84 see previous sections of this chapter
I. A Few Observations on Wrongful and Fraudulent Trading

I.I Wrongful Trading

As noted in the first chapter, the Law on wrongful trading operates in such a manner that the actions of a Director are ultimately judged based on whether he ought reasonably to have known, realized or be aware at a determined point that insolvency could not be avoided and on whether, at that point, he would have acted in such a way as to minimise potential loss to Creditors and interested parties. This action will be appraised according to the standard of what a reasonably diligent person having both (a) 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) the degree of knowledge, skill and experience that the particular director would have and would therefore apply towards any decision he would have taken in the same situation.

In this regard, therefore, the legal requirements point to a degree of diligence required from a Director which would appear to go beyond that normally required from a bonus pater familias. The former degree of diligence is that required of the “ordinary man in the street” and thus demands from the Director (in cases such as the ones at issue) (i) ordinary diligence of care, (ii) reasonableness and (iii) caution. This is to an appreciable extent essentially an objective benchmark against which the Director will be judged and this is the same identical benchmark used in the consideration of actions in tort in general.
In this particular instance though, the wording of the law points at an additional criterion which extends this notion of the diligence of a *bonus pater familias* and seeks to incorporate the additional consideration of the use of the skills and experience particular to the Director in question. The law here therefore adds a subjective benchmark with reference to which the Director (in the event of proceedings for wrongful trading) must, on one hand, be found lacking whilst at the same time, be duly held accountable.

There are opinions supporting the idea that the requirement of these cumulative criteria adds an additional hurdle for the plaintiff in wrongful trading proceedings, which a plaintiff in ordinary actions of tort does not have to face.

This may *prima facie* be so, however, regard must be had of the fact that the provisions of wrongful trading, both of their very nature as also given the very serious consequences which kick in once the claim is proved, are such as to place such cases practically in a *sui generis* rule, not quite fitting completely in actions of tort and at the same time not quite fitting in penal actions, though elements of this latter action manifest themselves in wrongful trading cases.

My view is that the Legislator here has sought to reach a just and fair balance between the rights of the aggrieved plaintiff and the rights of the Director, who ultimately faces wider consequences if found responsible, then he would have to face in an ordinary action in tort. It is therefore reasonable for the director to be held accountable for failing to exercise not merely a degree of ordinary diligence but one which would not have been expected of him given his own particular skills and experience. This added dimension does not detract from the degree of proof required in the proceedings – these remain always essentially civil proceedings where proof is required to be shown on a ‘balance of probability’ as against ‘beyond reasonable doubt’. In this regard the legal position of the plaintiff remains safeguarded. The added dimension only serves to give due acknowledgement of the equity of the situation, such that the Director is found
gravely consequentially responsible in cases where he did not exercise the degree of diligence which, in his own personal case, he was expected to evidence.

The exact same defence along with the standard by which a Director is to be judged can be found under Articles 214(3) and (4) of the UK Insolvency Act 1986. The standard applied involves both an objective and a subjective test. The objective test can be seen in (a) above and the subjective test stems from (b).

Here we once again have a situation where the law imposes a cumulative test which must be met against which test the potential liability of a Director is to be judged. The provisions of the English Law therefore also acknowledge the equity in setting up this cumulative litmus test for the plaintiff to prove his case.

I.II Fraudulent Trading

With regard to Fraudulent Trading, the wording of Article 332 of the UK Companies Act 1948 – which as previously mentioned, is that provision intentionally chosen by the Maltese Legislator as having inspired Article 315 of Chapter 386 – does not only establish civil responsibility but also establishes a criminal offence, both having the same constitutive elements. As a result of this, the English Courts consistently denied pleas for the finding of civil responsibility in the absence of the element of ‘dishonesty’ and insisted on a higher degree of proof, one extremely close to the degree required under criminal law, for cases of Fraudulent Trading.

The situation created here is once again, as it is to a significant extent in wrongful trading cases, one which may be termed sui generis. The juridical framework of the case is still civil in nature, but here, the bar of the degree of proof required in civil proceedings – that of a balance of probability – is raised higher to practically reach the degree associated with criminal proceedings. This it does, however in a rather strange way, because whilst the penal higher degree of proof is introduced in these civil proceedings, the penal essential elements to establish criminal responsibility are not.

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This raises the question of whether (and if so, to what extent) the element of *dolo* is necessary to establish civil responsibility in cases of Fraudulent Trading. Under general civil law the element of *dolo* is not required for civil liability to be established, mere negligence is generally sufficient, whilst the element of *dolo* is on the other hand clearly required in the criminal field in order to establish criminal responsibility. The provision dealing with Fraudulent Trading found in the Maltese Companies Act and in the 1948 English Code are rather peculiar in the sense that rather than drawing a clear-cut line between criminal and civil responsibility we have a situation where the criminal element of *dolo* is in practise required for what is essentially a 'civil wrong'. It is true that fraud in itself constitutes criminal behaviour and that alone the element of *dolo* is and should always be required, yet when talking about the provision on Fraudulent Trading, a provision which is in fact not found in the Maltese Criminal Code, is proving this element really necessary, especially in the light of the fact that the criminal part of the Fraudulent Trading provision in England was removed and subsequently inserted as a provision on its own?

Having to prove the element of *dolo* also implies that the plaintiff must prove his case beyond reasonable doubt rather than on a balance of probabilities, as is the norm in civil cases.

This also leads to the additional consequential question of whether a civil court is actually competent to hand out the criminal sanctions contemplated by the provision of Fraudulent Trading found in Malta’s Companies Act.

It would appear that the Legislator is here attempting to strike an acceptable and just balance between the rights of the Creditors and those of the Directors. On the one hand, the hurdles that the Creditors have to face in proving their case should not be too high, as to render any substantive provision guaranteeing their rights effectively a dead letter or such that may only be applied in ultra exceptional cases. On the other hand, the Directors (who are generally faced with tough or complex situations to resolve on a
regular basis and are thus more exposed to potential risks of ill judgment) should not be open to legal action in the event of any ordinary lack of diligence unless this is tainted with a higher degree of act or omission causing or increasing the Creditors’ prejudice or damage. If a parallel could be drawn, the situation that the Legislator here seeks to create may be viewed as similar in substance to the jurisprudential line which the Courts have taken in regard to civil negligence cases brought against the traditional Professions – Lawyers, Doctors and Architects. In such cases, although the general provision on tort is the same as in any other negligence case, the Courts have over the years always required a higher degree of proof, one that points at gross negligence as opposed to ordinary negligence. In such cases, in practise, the Courts apply both an objective and a subjective test in establishing civil tortuous responsibility or otherwise. One could therefore say that what the Courts have done in one area (that of the exercise of the traditional professions), the Legislator has done in another (that of corporate bankruptcy).

II. A Few Observations on the PriceClub Judgements

With regard to the first Judgement handed down in the PriceClub case, (case number 25/2003), I do not fully agree with the line taken by the Court’s in its conclusion that a Holding Company and/or the other Companies forming part of a Group of Companies should be deemed to have abused of their legal personality merely for the fact that they failed to aid another Company within the same Group facing financial difficulties without going into the deeper picture involved.

As for the main Judgements regarding Fraudulent and Wrongful Trading, disagreement could well be registered on the fact that the Court considered both these actions together in an almost interchageable manner and in a way implied that being found responsible under one of these provisions necessarily meant responsibility for the other. In a way the Court considered them to be equal, yet as discussed in Chapter I they are clearly not, each consisting of its own separate constitutive elements and each carrying its own penalty.
These Court proceedings also brought to light the question of whether creditors are sufficiently protected under Maltese Law in the event that their debtor goes bankrupt. Generally such a Company’s remaining assets, provided there are any, are sold off by the Liquidator (who would have been appointed specifically to collect the Company’s outstanding dues, if any, and subsequently pay off any of its Creditors) and then the Creditors are paid off according to the general rules regarding the ranking of creditors as provided for in the Civil Code (Chapter 16 of the Laws of Malta). Since the creditors are paid off according to their ranking it could be that whilst the secured creditors do get paid, there would then be nothing left to be given to the smaller, unsecured creditors. Although the Law provides adequate security for the repayment of creditors, especially through the established system of privileges and hypothescs, there are always going to be a number of creditors which due to their standing are not going to get anything back.

Creditor’s rights are very important in cases such as that of Price Club. The Judgements handed down in these proceedings lead one to ask whether the Court successfully balanced the rights of the Creditors with the rights of the Directors. I believe that the fact that both actions were considered in the same way may have been prejudicial to the Directors with regard to the Fraudulent Trading action. In considering the actions in the same way, the Directors seem to have been judged by the lower standard of proof required for a successful action of Wrongful Trading for the action of Fraudulent Trading which, as previously established, requires a higher burden of proof than the former does, in fact it requires a standard of proof much closer to the criminal ‘beyond reasonable doubt’.

III. Conclusion

The PriceClub cases caused a substantial stir in Maltese legal and commercial sectors. This was the very first time in which such drastic action was taken, particularly in respect of a front-line commercial group.
Whether the Judgement itself brought about a change in mentality may not be easy to see or gauge straight away. In many ways, the effects of the Judgement will likely be felt behind the closed doors of Boardrooms of Companies and Conference Rooms of Auditing Firms. It is reasonable to believe that echoes of these Judgements will ring in the minds of professionals briefed to give advice on the drawing up of corporate and fiscal structures; of shareholders planning out their short and long term investments and particularly of persons deciding whether or not to accept Directorship posts in certain cases.

Beyond its social and business implication, the judgement itself definitely proved to be also legally controversial due to the way in which Fraudulent and Wrongful Trading were deemed to be analogous to each other in a manner in which one could conclude that they were thus effectively treated as one and the same thing. This would clearly depart from the intention of the Legislator which may be had from the reading of the particular provisions of law relative to one and the other.

It would thus seem that in order to have a proper evaluation of this important judgement, one would have to wait for the next similar case – in order to see whether the ratio decidendi of the Court remains a solitary exercise or else starts to become actual established jurisprudence.

As in many a situation – only time will tell.
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