THE PARI PASSU ASSET DISTRIBUTION MECHANISM AND ITS PRACTICAL APPLICATION WITHIN A WINDING UP SCENARIO

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A Thesis Submitted in Partial Fulfilment for the
Degree of Doctor of Philosophy (Ph.D.)

Faculty of Laws
University of Malta
May 2021

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To my family

with gratitude

Abstract

The *pari passu* principle was conceived and developed through the centuries to better serve the interests of unsecured creditors in a liquidation process. It was originally intended to ensure the *pro rata* distribution of assets of a company in liquidation. The principle has stood the test of time because it managed to evolve and is best manifested in the nullification of prejudicial pre-liquidation transactions and in the judicial shielding of companies being wound up. The *pari passu* principle however is not without its critics mainly because in practice its objectives are very often stultified and rarely achieved.

Malta has made great strides along the years to keep abreast with the ever-increasing and exacting demands required to preserve and incentivise a thriving corporate business community. At the same time one cannot but help notice that it has lagged behind in the gamut of insolvency law and corporate restructuring. The time is now ripe to follow the lead of other countries such as the United Kingdom and Italy and move towards a holistic approach through the drafting and subsequent implementation of an Insolvency and Bankruptcy Code. For this purpose a number of far-reaching proposals are being put forward in the hope that they would act as a catalyst for reform in the Maltese legislative corporate system. The overall objective is to ensure that Malta be well-equipped and able to face the challenges that lie ahead in the context of a turbulent economic aftermath of the current global pandemic and beyond.

Preface

The rationale, justification and objectives of the *pari passu* principle are reviewed in detail in Chapter 1. Subsequently, significant historical antecedents to the *pari passu* principle and its development within the modern-day insolvency reality are discussed in Chapter 2. The main emphasis in Chapter 3 concerns the *pari passu* principle as an asset distribution mechanism in a winding up process. In order to better assess its efficacy, a comparative exercise is undertaken between the Maltese, English and Italian legal provisions relating to the principle. The comparison is important and useful since it provides an insight in the manner in which the principle applies within the whole range of legal systems that is a common law system (the United Kingdom), a civil law system (Italy) and a hybrid legal system (Malta). Furthermore, international initiatives aiming at a harmonised approach in this area of law are also analysed with a view to identifying the basic criteria required for an efficient and effective insolvency framework.

An overview of those commentators who are sceptical about the importance given to the *pari passu* principle is also carried out. It is only in this way that one can obtain a complete picture of the principle and pinpoint its limitations. The efficacy of the principle is moreover weakened as a result of a number of preferences and privileges created by a variety of special laws that bestow certain classes of creditors a higher ranking right in the case of insolvency. For this reason Chapter 3 elaborates on the manner in which the principle is provided for in different legal jurisdictions as well as an expose' of its major its critics.

In Chapter 4 various judgments dealing with insolvency delivered by Maltese Courts as well as a number of leading English Court cases and *dicta* by eminent English text-writers authoritatively referenced by the local Courts are analysed. Such a review of salient cases within the ambit of insolvency and more importantly the interpretation and application of the principle given by the Courts is of pivotal importance to better understand the manner in which the principle works in practice. It also serves as a

springboard for a smorgasbord of proposals presented and explained in the final chapter of this thesis. The proposals are far-reaching in extent and can be classified into three main categories: circumstantial or situational, remedial or rehabilitative.

I would like to thank all those who assisted me in writing this thesis. I am particularly indebted to my co-supervisors, Professor Andrew Muscat of the University of Malta and Professor Dan Prentice of the University of Oxford, for their invaluable suggestions, useful comments and constant guidance in the course of my research. Special thanks are also due to Dr Louis Cassar Pullicino and Mr Justice Joseph Zammit McKeon.

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INTRODUCTION

GENERAL INTRODUCTION

Insolvency proceedings have a tendency of leading to catastrophic effects whenever they are set into motion and, even worse, their effects are of a lasting nature and cannot be reversed. It is for this reason that a robust insolvency regime is called for in every sound legal system. Corporate Insolvency law has progressively increased in importance both domestically as well as cross-border. Similar developments were inspired both by the economic growth as well as by the dramatic collapses on a global level. The efficacy of the insolvency regime is tested against the best possible return to the general body of creditors. Unfortunately, traditional insolvency set-ups have proven to be insufficient and this realisation has in turn led to a resurgence of a corporate rescue culture. On this matter, Malta has on the whole managed to weather the global financial crisis admirably. By contrast, many competing jurisdictions have had to overhaul their commercial and insolvency laws due to the economic downturn suffered during the financial crisis[1]. It seems that, Malta may be said to have escaped rather unscathed by the crisis. However, this positive outcome should not leave us complacent or inert in so far as our legislative efforts are concerned. Suffice it to say that in accordance with the Global Insolvency Outlook 2020[2], it is predicted that the rate of business failure is expected to rise for the fourth consecutive year (+6% y/y). The factors leading to this increase are various in nature and extent such as *"low-for-longer pace of economic momentum, notably in advanced economies and in the industrial sector, and the lagging effects of trade disputes, political uncertainties and social tensions"*[3] will keep companies under pressure. The liquidator has a role of great responsibility in the economy that

[1] Conrad Portanier, 'Justice Reform in the Commercial Law Sphere' (2016): <https://ganadoadvocates.com/resources/publications/justice-reform-in-the-commercial-law-sphere/?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original> accessed 7 January 2019.

[2] Maxime Lemerle, 'Global Insolvency Outlook 2020' (2020): <https://www.eulerhermes.com/en_global/economic-research/insights/global-insolvency-outlook-2020.html> accessed 9 March 2020.

[3] Ibid.

involves protecting the interests of creditors, employees, consumers and for investigating financial wrongdoings. However, it is more than certain that a central function of any liquidator is the ranking of creditors. The starting point here is the *pari passu* principle. Is it a truly effective remedy in practice to properly address and protect the collective interests of creditors? This crucial element and other related aspects, constitute the central issue that will be examined and researched in this thesis.

Thesis' Hypothesis

The present research is primarily concerned with the practical application of the *pari passu* principle in a winding up scenario. The main focus seeks to address the question as to whether the application of the *pari passu* principle as an asset distribution mechanism is adequate to enable the efficient achievement of the goals of corporate insolvency proceedings. I propose to comparatively analyse in detail the legal aspects of this principle primarily in the context of three different jurisdictions – Malta, England and Italy.

The overall intention of the thesis is that its recommendations would be actively considered and possibly taken on board in the shape of a general reformulation of the *pari passu* principle in Maltese corporate insolvency legislation. My aim is to identify and analyse the shortfalls of the present legislative framework regulating asset distribution in a winding up scenario. It is hoped that this research, particularly its conclusions, proposals and recommendations, may serve and act as a catalyst for a sorely needed legislative action thereby creating a more efficient asset distribution mechanism.

Aims of the Research

One main objective of this work is to critically assess whether the current Maltese corporate insolvency regime adequately supports and satisfies the exigencies of modern business. On the basis of this analysis, I will then proceed to put forth legal reforms that might better achieve the main objectives of our insolvency law set-up. Since Malta has experienced significant economic growth in the last decade it is important that the Maltese legal system is capable of catering for the needs of additional internal and external investment. Although we can say that the Maltese insolvency set up has proven to be strong and resilient, it has had its challenges. For example, one may make reference to the recent case of Nemea Bank[4]. In a 2019 audit firm PricewaterhouseCoopers (PwC) tabled in the House of Representatives[5] a letter dated 26 November 2019 to the Parliamentary Secretary for Financial Services, Digital Economy and Innovation. It contained six reports that PwC had been requested to present in its role as the competent authority of Nemea Bank plc, about activities and transactions made throughout the periods of July-December 2017, January-June 2018, July-December 2018 and January-June 2019. It was revealed that Nemea Bank still owed customers EUR13.2 million in deposits. Nemea had its licence withdrawn in 2017 by the financial regulator. PwC has been administering the running of the online bank since 2016 after the regulators found serious breaches in the running of the bank. Owing to Nemea's inability to pay back depositors, the Malta Financial Services Authority (MFSA) triggered the depositor compensation scheme. This meant that individual creditors received up to an upper limit of EUR 100,000. Yet the bank still owed millions. Despite the dire financial position of the bank, it has not been put into liquidation since the process has been stalled as Nemea's owners are disputing the regulatory action taken against it. One vital issue to be tackled is whether the financial regulator should be more proactive to better safeguard creditors. As at present, despite the huge amounts owed by the bank the

[4] Joseph Borg , 'Depositors still owed €13 million by Nemea' (*Times of Malta* 27 January 2020) <https://timesofmalta.com/articles/view/depositors-still-owed-13-million-by-nemea.766371> accessed on 7 February 2020.

[5] https://parlament.mt/en/paper-laid/?id=32103&page=1&criteria=Nemea&itemsPerPage=10

MFSA is still considering Nemea liquidation[6]. Thus it is of the utmost importance that the Maltese legislative system provides a corporate insolvency regime that is both solid but flexible enough to cater for the varying needs of businesses in distress. Paramount as always is the manner in which creditors are offered protection through the system. For our purposes emphasis is placed on the application of the *pari passu* principle in safeguarding creditor equality.

The thesis will also delve into whether the alternative to the corporate insolvency in the guise of corporate rescue truly works in the Maltese corporate set up. Some of the issues and areas of interest to be addressed include the following: What is link between the *pari passu* principle and corporate rescue? Why rescue? What effect is the emerging role of banks through the rescue of companies? The pivotal role that Banks play in the modern economy has long been recognised[7]. When a company is in financial distress it is customary to commence some form of rescue process. Again it is the norm for a Bank to be a major creditor. The Bank usually becomes concerned and takes it upon itself to take action. This can be twofold – either by taking to task the company directors or by more direct involvement in the monitoring of the managerial performance[8]. The Banks have in recent times taken the "rescue culture" to heart and may have a team of specialists dedicated to the provision of turnaround services to debtor companies. The role of the unsecured creditor – the major actor in a *pari passu* scenario does change in the modern shift towards preventative approaches.

[6] Joseph Borg, 'MFSA still considering Nemea liquidation' (*Times of Malta*, 30 January 2020) <https://timesofmalta.com/articles/view/mfsa-still-considering-nemea-liquidation.766903> accessed on 7 February 2020.

[7] *"When banking stops, credit stops, and when credit stops, trade stops, and when trade stops—well, the city of Chicago had only eight days of chlorine on hand for its water supply. Hospitals ran out of medicine. The entire modern world was premised on the ability to buy now and pay later."* - Michael Lewis, *The Big Short: Inside the Doomsday Machine* (W.W. Norton Company, 2015).

[8] Vanessa Finch and David Milman, *Corporate Insolvency Law: Perspective and Principles* (3rd edn, Cambridge University Press 2017).

A leading professional of a "mergers and acquisitions" group has explained and synthesised the present ideological shift as follows:

> *Turnaround opportunities are increasing because tighter market conditions, high leverage, bad management and over-trading are squeezing poor performers out. In the past, if a company was facing insolvency, it was seen to be prudent to cut off one's losses and liquidate what is salvageable to pay off creditors. Nowadays, investors and businesses have sophisticated mechanisms for quantifying and evaluating risk. So the focus is shifting towards bespoke solutions to what can be temporary strategic problems*[9].

In the UK the voice of unsecured creditors has a new power in two respects. Firstly, in the Enterprise Act 2002 administration process, the unsecured creditor has a right to be listened to and the insolvency practitioner has a duty to heed their interests when deciding strategy. Secondly their voice is given a new platform in the movement towards more open, transparent and accountable management that is driven by specialised branches within banks. This is achieved by granting access and information to those unsecured creditors who have a continued business rapport with the company in distress[10]. What effect will all this have on the application of the principle? What importance is given to the rescue culture in the Maltese insolvency regime? Are delinquent directors properly sanctioned? Should Maltese insolvency legislation contain more debtor friendly measures? Is it about time to consider the setting up of some form of Insolvency Fund to be retained and used solely for the interest and benefit of the general body of creditors?

The comparative exercise with respect to Malta, England and Italy will be undertaken with a view to reflecting upon the lessons and experiences taken from these important jurisdictions in order to hopefully assist Malta's pathway towards a meaningful reform. As a basis for international perspective, due consideration will be given to the Legislative Guide on Insolvency designed by UNCITRAL which among other things sets the tenets for establishing an efficient legal framework. On a

[9] A Lester, "Recovery" (Winter) 18, 2002.

[10] Vanessa Finch and David Milman, *Corporate Insolvency Law: Perspective and Principles*(3rd edn, Cambridge University Press, 2017).

regional level, the EU stance notably through the notion of giving businesses a "second chance" is also addressed.

Methodology

The thesis is structured in three parts. The first part of the thesis will set out the principles underpinning the asset distribution system and in particular highlighting the practical effect of preferences and priorities in any asset distribution exercise. Furthermore, since the *pari passu* principle has a long legal tradition, I propose to trace and deal with significant historical antecedents of this principle. In my opinion, the historical relevance of this principle will serve to give added value to its importance as asset distribution mechanism. The aim of the first part would be to set out the basis upon which the framework of the legal principle should rest.

The second substantive part of the thesis will be approached by analysing the *pari passu* principle from three diverse angles: in the first place, by examining various legal formulations of the principle in different jurisdictions including an exposition of the permitted exceptions to this rule; secondly, by presenting the opposing perspectives expounded by commentators on the efficacy of this asset distribution principle in practice; finally, through analysing a number of topical *pari passu* judgments, particularly relating to sovereign debt instruments which shed light upon the interpretation given to the application of this principle in practice. This second part would be meant to apply the constructed framework to the primary analysis of English, Italian and Maltese corporate insolvency law in order to test the efficacy of the framework and the adequacy of the existing legal mechanisms.

Finally, on having researched and presented my views as outlined above, I would hope to be in a better position to propose an acceptable and satisfactory "reformulation" of the *pari passu* principle.

I. First Part (The Framework)

The thesis will examine the underlying purposes that the Maltese, English and Italian asset distribution mechanisms within corporate insolvency seek to achieve. The issues to be dealt with aim at covering the following topics and related queries: what are the current objectives of corporate insolvency law, particularly of asset distribution mechanisms? What rules are in place to seek to attain these objectives? What evident similarities and trends exist in the comparative jurisdictions analysed? Essentially, it will demonstrate that the corporate insolvency systems in place in these jurisdictions is an attempt to tackle the same primary concern – that is, the losses caused to various parties due to a business failure. I will then proceed to show that these jurisdictions focus their legislation on two pivotal points:

(i) The Collective Nature of Insolvency Procedures: which basically enshrines the preeminent concern in any winding up scenario – that is, the interests of the general body of creditors;

(ii) Preferences and Priorities: those which effectively concern the ranking of claims of affected parties.

One chief objective is to demonstrate that the impact of preferences and priorities on the ranking of claims distorts the practical application of the *pari passu* asset distribution mechanism.

II. Second Part: Practical Application

In the second part, the main purpose would be to analyse the principle from different practical applications and in so doing, I intend:

(i) Verify whether the present system of law properly regulates and caters for the divergent interests of various creditors;

(ii) Analyse emerging trends as expounded by text-writers and commentators on how this area of corporate of insolvency law should be regulated;

(iii) Identify leading case-law in this respect and effectively analyse the approach taken by the Courts in asset distribution schemes proposed by liquidators in winding up scenarios.

In other words, the aim here would be to examine the adequacy of present asset distribution mechanisms, thereby focusing mainly on whether the *pari passu* principle is effectively achieving its goal of fairly balancing out the competing interests of secured and unsecured creditors. This part of the thesis will *inter alia* address the following issues:

(i) to verify whether the present law creates optimal conditions for the distribution of assets within a winding up scenarios, particularly in view of the varying interests of creditors;

(ii) to identify the existing mechanisms in place that creditors resort to in order to circumvent the application of the *pari passu* principle;

(iii) to examine what controls are in place to ensure the proper application of the *pari passu* principle.

III. Third Part: A Possible Reformulation of the Principle

The legal analysis would be based on a comparative approach. It should be noted that apart from discussing in detail Maltese law (a hybrid legal system) and English law (a common law system) I also intend to refer to other significant jurisdictions, such as Italian law (civil law systems). Additionally, it would be opportune to consider the harmonised rules of the European Union. It is hoped that through the

comparative approach a more in-depth insight of each system would be attained enabling a better understanding of those legal rules and their respective advantages and setbacks. The need of a reformulation and possible harmonisation is desirable given the increasing number of cross-border insolvency cases and the different approaches currently adopted.

Finally, the purpose of the last Chapter would be to focus upon the legal aspects regarding the application of the *pari passu* principle which ought to be amended and then pass on to provide specific proposals for a possible reformulation.

The reforms would be centred around the maximisation of four major objectives:

i. Restoration of the debtor company to profitable trading;

ii. Maximisation of the return to creditors as a whole - where companies cannot be saved;

iii. Establishment of a fair and equitable system for the ranking of claims and distribution;

iv. Provision of a mechanism by which the causes of failure can be identified.

In this context, the thesis will actively engage in the reformulation of the present Maltese insolvency system through a number of positive mechanisms:

a) A proposal for an *ad hoc* Maltese Insolvency Act;

b) Insolvency Rules which would offer practical guidelines for the proper implementation of the rules enshrined in the proposed Insolvency Act;

c) The creation of a specialised court to address the particular needs of creditors in a winding up process;

d) Comprehensive delineation of the exceptions and bypassing devices permitted by the *pari passu* principle;

e) Holistic treatment of the rules governing the distribution of assets in a winding up process;

f) Proposals for the better protection of the "vulnerable" creditors, namely:

   i. Creditors who are unable to secure preferential positions in distribution;

   ii. Creditors who cannot rearrange loan rates to reflect the risks they bear;

   iii. Creditors who are ill-equipped to absorb losses[11].

The proposals for reform are intended to better serve the interests of the general body of creditors. The practical effect of these amendments would involve the application of the true rationale of the *pari passu* principle, namely:

[11] *Vide* Lucian Ayre Bebchuk and Jesse M. Fried, "The Uneasy Case for the Priority of Secured Claims in Bankruptcy" 105 Yale LJ 877, 864 (1996) pp. 864-5 and 882-891; and Lucian Ayre Bebchuk and& Jesse M. Fried L Bebchuk & J Fried, "The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics", Cornell Law Review, Vol. 82, pp. 1279-1348, 1997. The term "nonadjusting creditor" is used in this regard to refer to a creditor who *"cannot or does not adjust the terms of its loan to reflect the effect on its loan of all the arrangements the borrower enters into with other creditors, including the creation of security interests which, under full priority, completely subordinate the nonadjusting creditors' claim in bankruptcy.";* See also John Armour, "Legal Capital: An Outdated Concept?", Working Paper No. 320, Centre of Business Research, University of Cambridge, 2006, where the term is explained as *"those who do not alter the terms on which they extend credit in response to a debtor's riskiness."* This category of creditors is deemed to include tort victims and governmental tax claims. A separate category including consumers, employees and trade creditors is also identified and it is recognised that these creditors *"may lack the economies of scale to be able to adjust their terms easily to respond to the individual characteristics of each borrower."*

i. The protection of legitimate expectations: essentially this part will deal with the issue of whether set off, which under the general rules of procedure is accepted as a mode of extinction of an obligation, is justifiable in insolvency proceedings since it may have the effect of creating a preference;

ii. The need to obtain the continuing supply of goods and services for the beneficial winding up of businesses;

iii. A desire to provide safeguards for those who have not voluntarily assumed a risk and are ill-provided to cater for it such as: employees or tort creditors that have been injured by the debtor and that are unable to recover fully from the debtor's insurance;

iv. Conversely the wish to subordinate the claims of those who are expected to bear a higher risk than the general body of creditors. Basically care is to be taken that the ranking system is to be structured in a manner that shareholders will partake from any surplus assets of the company in liquidation once all the creditors have been paid in full.

In this way, creditors would be better placed to know exactly where they stand. This in turn would have the added benefit of positively improving the present system by enabling creditors to take an informed decision as to the most appropriate mode to protect and preserve their best interests.

Furthermore, since the research is a comparative study, two important issues need to be addressed. Firstly, whether the comparative legal method used is appropriate to the topic and its relevance to the goals of the thesis. Secondly, whether it relates to the choice of jurisdictions to be compared.

(i) Relevance of Comparative Research

Experience has shown that business ventures in any country operating within a competitive free market are susceptible to financial distress and insolvency. This is largely due to the fact that market forces encourage the best use of resources to ensure maximum turnover. It is a recognised fact that an insolvency regime is an intrinsic link in any effective legal system[12]. It is a truth universally acknowledged that insolvency problems are wont to arise in various parts of the world. Although differences do exist in different legal jurisdictions there is a commonality in the incidence of insolvency. Thus, it is relevant to carry out a comparative analysis of insolvency rules since the laws which perform a similar function, operative in different jurisdictions, are more conducive towards creating an effective system of insolvency rules. It is argued that a comparative analysis of insolvency law will be of academic value and practical significance to Malta, especially in its reform efforts.

Professor Attard[13] clearly opines that, *"every state has a legal system which is particular to itself."* However, he goes on to acknowledge that the law operates within a social order, *"it is this order that determines the way in which the law is applied, and it therefore shapes the very development and function of law in that society."* This is especially true in the Maltese context wherein we have a hybrid legal system. The Maltese legal system is the product of a very long evolutionary legal, political, social and constitutional process which precedes Independence, the British colonial period and, one might say, also the period of the Knights of St John[14]. In order to formulate a better knowledge of the laws of any given jurisdiction, it is required to venture beyond the strict understanding of the legal norms and delve into the social and political realities that shape legal rules. In a nutshell, a comparative legal method is a sound methodology as it is a good tool for the legal analysis of national legal systems, creating awareness of the cultural and social

[12] Terence C Halliday and Bruce G Carruthers, *Bankrupt: Global Law Making and Systematic Financial Crisis* (Stanford University Press 2001).
[13] David J Attard, *The Maltese Legal System Vol I* (Malta University Press 2012).
[14] See Austin Bencini, 'Our Legal System As it Simply Is' *Times of Malta* (7 April 2013): <https://timesofmalta.com/articles/view/Our-legal-system-as-it-simply-is.464701> accessed 9 December 2019.

character of law in any given country. Such a holistic approach should provide an insight of what happens beyond the domestic reality towards a more diverse and flexible system of rules.

(ii) Choice of Comparative Jurisdictions

The subject of the comparative analysis carried out refers to legal jurisdictions. The main reasons for selecting Malta as a research factor stem from the fact that the author is Maltese. Malta is defined as having a mixed legal system because it has its roots both in the Civil law (Continental) family but is also endowed with the presence of many features evidently derived from the Common Law (British) tradition. For these reasons, the Maltese legal system lends itself well to comparative analysis[15].

How does Malta score on insolvency and corporate rescue when compared to other legal jurisdictions? It is relevant to point out that despite a marginal score increase on a similar study last year, Malta remains nevertheless the lowest ranked European Union country in the World Bank's ranking on the ease of doing business[16]. Malta is placed the 88th place out of 190 countries with a score of 66.1 out of 100. Malta's rank dropped by four places even though its score increased by a marginal 0.6. According to a recent World Bank report, it is easier to do businesses in the 27 other EU countries, and other countries such as Kenya, Kosovo, Mexico, Kazakhstan, Uzbekistan, Kyrgyzstan, Mongolia, Vietnam, Zambia, Azerbaijan, and Panama. The Doing Business project, which was launched in 2002, affirms that it provides objective measures of business regulations and their enforcement while looking at domestic small and medium-size companies and measures the regulations applying to them through their life cycle. It gathers comprehensive, quantitative data to compare business regulation environments across economies and over a period of time.

[15] Noel Grima, 'The basics of the Maltese legal system' *The Malta Independent* (13 April 2015).
[16] 'Doing Business 2020' (World Bank Group, 24 October 2019): <https://www.doingbusiness.org/en/reports/global-reports/doing-business-2020> accessed 29 January 2020.

While Malta has an overall score of 66.1 and sits in 88th place, it is New Zealand (86.8), Singapore (86.2), Hong Kong, and Denmark (both 85.3) who top the rankings. Georgia, the United Kingdom, Sweden, and Lithuania also fare well, while the EU countries which are ranked closest to Malta are Greece (68.4), Luxembourg (69.6), Bulgaria (72.0), and Italy (72.9)[17].

It must be admitted that Malta's scores and rankings for resolving insolvency, registering property, and getting credit make for some grim reading. Under the heading of "resolving insolvency", the following factors are measured and taken into account: time, cost, outcome, and recovery rate for a commercial insolvency and the strength of the legal framework for insolvency. In this regard, it is relevant to note that the World Bank Group President, David R. Malpass has gone on record to observe that, *"at the same time, the least reformed area was resolving insolvency. Putting in place reorganization procedures reduces the failure rates of small and medium-size enterprises and prevents the liquidation of insolvent but viable businesses[18]."* In the overview of this Report, it is highlighted that, *"thirteen economies implemented reforms making it easier to resolve insolvency. A characteristic feature of these reforms was the introduction of a reorganization procedure. Keeping viable businesses afloat is one of the most important objectives of bankruptcy systems. The highest recovery rates are recorded in economies where reorganization is the most common insolvency proceeding for viable businesses in financial distress[19]."* Keeping the above in perspective, it is submitted that the comparative exercise proposed in this thesis acquires an added dimension.

In opting for a comparative approach, it is hoped that lessons learned from these other legal jurisdictions will help and enable the author make pertinent suggestions and recommendations on how to improve and even buttress the present corporate insolvency regime in Malta.

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[17] Albert Galea, 'Malta remains most difficult place in EU to do business, despite score increase - World Bank' *The Malta Independent* (25 October 2019).

[18] David R Malpass, 'Forward to Doing Business 2020' (World Bank Group, 24 October 2019): <https://openknowledge.worldbank.org/bitstream/handle/10986/32436/9781464814402.pdf> accessed on 29 January 2020.

[19] Doing Business 2020, 'What have businesses achieved and, who falls behind?' https://openknowledge.worldbank.org/bitstream/handle/10986/32436/9781464814402.pdf

The choice of the United Kingdom was an obvious one. It is safe to say that a great number of principles of company law in Malta are modelled on their English counterpart. Although the doctrine of judicial precedence is not part and parcel of the Maltese legal system, undoubtedly successive judgments delivered by the English Courts have exercised an important authoritative significance on its development. In addition, the UK enjoys a long history of bankruptcy law which dates back to the enactment of the Bankruptcy Act[20] in 1542[21]. Its long tradition in this area of law, together with its proactive stance, mostly definitely places the UK as an influential trendsetter in insolvency reform. Furthermore, schemes of arrangements that are largely regarded as the first attempts at financial rescue originated in the UK and have henceforth served as an inspiration for reform in other jurisdictions as well. In addition the latest trends being demonstrated, most notably by the US Chapter 11 procedure, are credited to the UK in that it always promoted a modern corporate rescue culture. According to UK Insolvency Statistics for 2019[22] the total company insolvencies increased slightly in Quarter 3 2019 compared with Quarter 2 2019 and this was driven by increases in administrations and creditors' voluntary liquidations. It was noted that administrations have reached their highest quarterly level since Quarter 1 2014 according to recent patterns of growth. High profile administrations in 2019 include Debenhams, Mothercare, Thomas Cook and Four Seasons Health care – an impressive list from some big names in the world of trade and international business companies.

In recent years companies also had to face uncertainty around Brexit and the future of the UK's trading relationship with the EU. In terms of the Withdrawal Agreement[23], the UK and the EU have until the 31 December 2020 to negotiate a

[20] Statute of Henry VIII.

[21] Roy Goode, *Principles of Corporate Insolvency Law* (4th Revised edn, Sweet & Maxwell 2011).

[22] The Insolvency Service, 'Company insolvency statistics, Q3 July to September 2019' - <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/856060/Company_Insolvencies_-_Commentary_-_Q3_2019.pdf> accessed 7 March 2020.

[23] 'New Withdrawal Agreement and Political Declaration' Policy Paper, Department for Exiting the European Union, 19 October 2019: <https://www.gov.uk/government/publications/new-withdrawal-agreement-and-political-declaration> accessed on 30 October 2019.

future agreement regulating their relationship. Failing to do so will lead to a "cliff edge" no deal scenario[24]. These are definitely uncertain times, ever more so with regard to the viability of companies as business concerns. Commission President von der Leyen commented as follows in this regard,

> *But the truth is that our partnership cannot and will not be the same as before. And it cannot and will not be as close as before – because with every choice comes a consequence. With every decision comes a trade-off. Without the free movement of people, you cannot have the free movement of capital, goods and services. Without a level playing field on environment, labour, taxation and State aid, you cannot have the highest quality access to the world's largest single market[25].*

The UK's official withdrawal process from the European Union led to numerous concerns as to the manner in which certain branches of the law, including corporate insolvency law, will operate once the UK is out of the EU. On its part, the Maltese Government has already taken measures to give some form of support to businesses trading with the UK. Most notable of these is the Brexit Support Scheme[26] consisting of cash grants which are open to duly registered SMEs operating in Malta and engaging in significant import and export activities involving the UK.

It is apt to point out that European law was originally composed of a mixed legal tradition. The European law system was originally based on civil law tenets since the founding Member States were civil jurisdictions. Common law started leaving an important influence upon the UK's accession[27]. A striking example would be the

[24] Clifford Chance, 'The EU-UK future relationship: What happens after Brexit?' 29 January 2020: <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/01/the-eu-uk-future relationship-what-happens-after-brexit.pdf> accessed on 2 February 2020.

[25] Speech by Commission President von der Leyen at the London School of Economics, 8 January 2020: <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/01/the-eu-uk-future-relationship-what-happens-after-brexit.pdf> accessed on 2 February 2020.

[26] 'Get Ready Scheme Guidelines', Malta Enterprise, 14 November 2018: <https://www.maltaenterprise.com/support/get-ready> accessed 9 February 2020.

[27] Ivan Sammut, 'The EU and Maltese Legal Orders: What kind of marriage between them?': <http://docplayer.net/21639208-The-eu-and-maltese-legal-orders-what-kind-of-marriage-between-them.html#show_full_text> accessed 9 December 2019.

Second Company Directive[28]. In this regard, it remains to be seen what the impact of Brexit will have on the developments within EU corporate law seeing that now the majority adopt a continental civil law approach.

The choice of Italian law relating to Insolvency for research and comparative purposes was a natural one. The fragmented pieces of legislative enactments under the Knights of Saint John were in the Italian language and this practice continued under the French occupation[29] as well as under British Rule until Maltese replaced the Italian language. Up to 1933 even the language used in Maltese Courts was Italian. Malta's proximity and commercial ties with Italy are also a factor to be taken into consideration.

The business relationship between the two countries has always been healthy and thriving. This also means that the possibility of the occurrence of a business entering into insolvency proceedings was a reality. One typical instance that may be mentioned would certainly be the financial collapse of a hypermarket chain operating under the name of "Mercato Uno", which was run by a Maltese concern. The case will be examined in depth at a later stage.

Italy also serves as a good model for a corporate system which is based on a civil law tradition. It is interesting to point out that Maltese jurist, Paolo DeBono published an academic study in Italian entitled "Appunti di Lezioni sul Fallimento nel Diritto Maltese" in 1907 with reference to Maltese Law on Bankruptcy at the time. Incidentally, the eminent Maltese jurist had occasion to highlight the hybrid character of Maltese Civil Law Procedure way back in 1897 when he maintained that the form of trials before Maltese courts mainly followed Canon Law at the time whereas Common Law rules determined matters relating to proof and rules of

[28] Second Council Directive 77/91/EEC of 13 December [1976] OJ L 26, 31.1.1977, p. 1–13 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent.
[29] 1798-1800.

evidence[30]. Italy is ranked 58 among 190 economies in the ease of doing business, according to the latest World Bank annual ratings[31].

Literature Review

The thesis adopts a doctrinal legal research methodology which is mostly library oriented. It includes mainly a comprehensive review of primary and secondary sources of law. The primary sources referenced are legislation, decided cases and government reports. The secondary sources include text-books, learned journals' articles and reports by internationally recognised financial and banking institutions such as the World Bank.

From a review of salient works by leading experts in the field it is evident that the issues raised in this thesis are current and relevant. Numerous eminent text-writers analyse elements of the *pari passu* principle specifically in relation to sovereign debt instruments which evidence the interpretation given to the principle in practice. For example, Gelpern[32] believes that with regard to sovereign debt contracts, contrary to the prevailing view that the *pari passu* clause goes back to the nineteenth century but no judicial interpretation is found before 2000, there were at least three court rulings from the 1930s and an arbitral decisions from 1980 that deal with *pari passu* at length prompting injunctions against Argentina[33]. At the same time these "discoveries" also confirm the limits of traditional contract interpretation in sovereign debt. But more importantly, according to Gelpern[34], are the implications of policy intervention in the sovereign debt contracting process.

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[30] Paolo Debono, *Sommario della Storia della Legislazione in Malta* (1987) 322.
[31] Trading Economies, 'Ease of Doing Business in Italy' (2020): <https://tradingeconomics.com/italy/ease-of-doing-business> accessed 25 March 2020.
[32] Anna Gelpern, 'Courts and sovereigns in the *pari passu* goldmines' (2016) 11 Cap Mkts L J 2.
[33]See also Mitu Gulati and Robert E Scott, *The Three and Half Minute Transaction, Boilerplate and the Limits of Contract Design*, (University of Chicago Press, 2012). Lee C Bucheit and Jeremiah Pam, 'The *Pari Passu* Clause in Sovereign Debt' (2004) 53 Emory LJ 869. Rodrigo Olivares-Caminal, 'Understanding the *Pari Passu* Clause in Sovereign Debt Instruments: A Complex Quest' (2009) 43 Intl 1217.
[34] Anna Gelpern, 'Courts and sovereigns in the pari passu goldmines' (2016) 11 Cap Mkts L J 2.

The function of the *pari passu* clause in sovereign debt contracts probably changed several times during the twentieth century, even as it retained much of the wording and a broad equitable thrust. Since the first successful use of *pari passu* as enforcement device by Elliot Associates against Peru in 2000, *"… the clause could not 'mean' rateable payment because it could not 'work' as rateable payment where a sovereign debtor was involved[35]…"* Financial groups and academic experts have argued for removing the clause from sovereign bonds, but have run into staunch resistance on the part of the creditors, whose response is that of retaining it as a precaution[36] (a safety valve). The industry sector appears to agree to narrow its meaning to ranking, and expressly excluding rateable payment[37]. This would ensure that it would not be used ever again as governments do not subordinate when they can simply not pay.

Retaining such a clause is meant to address concerns about inter-creditor equity in sovereign debt, which concerns remain justified even today. In this respect some form of a work able terms has to be found to address the equity generally.

According to Flandreau[38] also referred to by Gelpern[39], the time devoted *"to drafting and interpreting the phrase pari passu is better spent in reconsidering the institution of trustee and the payment of mechanics of sovereign bonds[40]."* The gaps left by judicial enforcement and other sanctions in sovereign debt[41], have been filled by entities like stock exchanges and payment and clearing systems. In controlling market access and fund transfers, these entities within the market structures, exert

[35] John V Orth, 'A Gathering of Eagles' (2014) 9 Cap Mkts L J 283.
[36] Leland Goss, 'NML v Argentina: The Borrower, the Banker and the Lawyer – Contract Reform at a Snail's Pace' (2014) 9 Cap Mkts L J 287, 289-90.
[37] Ibid.
[38] Marc Flandreau, 'Sovereign States, Bondholders Committees, and the London Stock Exchange in the Nineteenth Century (1827-68): New Facts and Old Fictions' (2013) 29 Oxon Rev Econ Policy 668.
[39] Anna Gelpern, Sovereign Damage Control (Peterson Institute for International Economics, PB13-12, 2013.
[40] Marc Flandreau, 'Sovereign States, Bondholders Committees, and the London Stock Exchange in the Nineteenth Century (1827-68): New Facts and Old Fictions' (2013) 29 Oxon Rev Econ Policy 668.
[41] Anna Gelpern, *Sovereign Damage Control* (Peterson Institute for International Economics, PB13-12, 2013.

meaningful pressure on immune sovereigns. Measures to make sovereigns pay their debts by deploying paying and clearing utilities should not be done at a minimum, for the benefit of individual creditors, 'but as part of a coherent framework benefitting the sovereign's creditors as a group.[42]' The majority of arbitrators seemed to suggest that *pari passu* generally meant ranking, but with the goal of rateable payment in financial distress, when the debtor's obligation to pay is uncontested.

An innovative approach to this issue is presented by Paulus[43] in investigating the manner in which the general principles of national insolvency law contribute to the development of a state of an insolvency regime. Apart from the outcome of modern insolvency law, one other feature for constructing a sovereign debt restructuring mechanism is the underlying situation of a common pool problem. Both in the sovereign or commercial case, the debtor does not have the means to finally satisfy its creditors. According to Paulus[44], *'insolvency law supports such negotiations by liberating them from the commercial unanimity requirement and replacing it by a majority vote[45].'*

A mechanism should be in place to structure the negotiation process. Insolvency law applies a mechanism which is vital for any restructuring process. The German word *zwangsgemeinschaft*, according to Paulus aptly sums the mechanism: both debtor and creditors are, as it were, placed in the same boat which allows all of them to be subject to a majority vote.

Whereas outside of the proceeding the unanimity principle applies, within the proceeding a majority vote suffices to cope with hold-outs. There are at least two ways how to attempt achieving a binding effect: a statutory approach or a

[42] Anna Gelpern, Sovereign Damage Control (Peterson Institute for International Economics, PB13-12, 2013.
[43] Christoph G Paulus, 'How could the general principles of national insolvency law contribute to the development of a state insolvency regime' (2017) ECSB Legal Conference, European Central Bank.
[44] Christoph G Paulus, 'How could the general principles of national insolvency law contribute to the development of a state insolvency regime' (2017) ECSB Legal Conference, European Central Bank.
[45] Ibid.

contractual one[46]. In both instances, the objective is to achieve 'resolvency', namely to establish the way back to debt sustainably.

A frequent argument against the introduction of any one of the proposed instruments is that it would change dramatically the existing situation with unpredictable consequences. On the positive side, one must consider and assume the fact that the legal framework of every jurisdiction would be geared to cope with this kind of shock by setting transition periods during which all parties concerned and all the stakeholders be in a position to adjust to the new instruments and accompanying conditions.

The situation in Europe after the outbreak of the Greek crisis in early 2010 shows the dangers of employing *ad hoc* solutions and remedies, as was usually the case. There is always the *"danger that the whole process gets politicised and tensions emerge. When this happens, the project of a unified Europe becomes suddenly endangered irrespective of its much higher importance, seen from a historic and political perspective[47]."*

All the above considerations, combine with the advantage of giving guidance in a chaotic scenario (led Paulus[48] to believe and hope) that the time is more than ripe for ushering in a stage in which an orderly and structured resolvency proceedings for sovereign states exists.

It is pertinent to point out that in November 2012, the member countries of the Eurozone adopted the Treaty Establishing the European Stability Mechanism (ESM)[49]. Its objective was to mobilise funding and provide stability and support for

[46] Christoph G Paulus, 'A Statutory Proceeding for Restructuring Debts of Sovereign States' (2003) Recht der Internationalen Wirtschaft (RIW) 401 ff.
[47] Christoph G Paulus, 'How could the general principles of national insolvency law contribute to the development of a state insolvency regime' (2017) ECSB Legal Conference, European Central Bank.
[48] Ibid.
[49] Treaty Establishing the European Stability Mechanism, T/ESM 2012-LT - <https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf> accessed on 4 March 2021.

Eurozone members that are experiencing severe financing problems. The very fact that there is now such a mechanism in place given the Eurozone countries a legal platform through which to enact legal changes, binding on all member states that can facilitate a debt restructuring by a member country. An amendment was proposed in 2013 to the ESM Treaty that would immunize the assets of a member country held in, or passing through the Eurozone from attachment or other legal process sought by a creditor that had been invited, but refused, to join an ESM-supported debt restructuring[50]. The idea here was to discourage prospective holdout creditor behaviour in future Eurozone sovereign debt workouts by impairing the ability of such a creditor to enforce court judgments against the sovereign debtor in the Eurozone. The ESM Treaty provides a convenient way for enacting legal changes that could assist future Eurozone sovereign debt workouts. The ESM can moreover be amended in ways that will discourage creditors from declining to participate in future ESM-backed debt workouts.

A number of very recent amendments that are due to come into force into 2021 and focus on four main areas focus on:

i. clarifying and expanding the ESM mandate on economic governance;
ii. ESM governance issues;
iii. The ESM precautionary financial assistance instruments; and
iv. The establishment of the ESM as a backstop to the Single Resolution Fund[51].

From the above it is clear that a dynamic insolvency regime is required in every sound legal system. If the objectives of the *pari passu* principle are to be achieved the insolvency framework must be robust enough to cater for extraordinary circumstances. The above-cited eminent text-writers shed light on the difficulties that arise in the instance of sovereign debt contracts. However, their teachings

[50] Lee C Bucheit and Mitu Gulati, 'Sovereign Debt Restructuring in Europe' (2018) 9 Global Policy S1, p.65-69.
[51] 'The proposed amendments to the Treaty establishing the European Stability Mechanism' (2021) - <https://www.europarl.europa.eu/RegData/etudes/IDAN/2019/634357/IPOL_IDA(2019)634357_EN.pdf> accessed on 4 March 2021.

acquire added value in light of the current extraordinary and exceptional COVID-19 pandemic.

CONCLUSION

This thesis seeks to examine how the Maltese insolvency regime can develop and push forward its present insolvency asset distribution mechanism based on the *pari passu* principle. The point of departure consists of an overview of the *rationale* behind the principle followed by concrete examples of its application in practice. The implementation of the principle largely through the function of the liquidator and often through Court intervention will understandably shed light on its efficacy in the protection of creditors. If Malta is to remain credible and effective in its protection of creditors in winding up proceedings it must undertake to review and update its laws in this area. It will be demonstrated that a revised and more appropriate construct of the *pari passu* principle in Maltese insolvency law is called for. This exercise is followed by a set of proposed reforms in the domestic sphere with a view to improving upon and updating the obtaining legal system and procedural rules pertaining to insolvency proceedings.

Chapter 1 Introduction to Basic Principles of the Maltese Winding Up Asset Distribution System

1.1 General Introduction

This Chapter addresses the fundamentally important issue of the relevance of the *pari passu* principle in light of modern developments in the field of corporate insolvency. Firstly, the principle will be defined. The focus will then shift towards an understanding of the manner in which the *pari passu* principle has been reflected in law and amplified by case-law including a selection of landmark judgments, local judgments and contributions by authoritative text-writers. Alongside the fundamental rule of insolvency of *pari passu,* the so-called *"anti-deprivation"* rule has developed. This thesis examines the evident overlap existing between the two rules and the variations found in judicial expressions used in determining individual cases according to their particular circumstances. Although the two principles are inter-related, there exist nonetheless distinguishing aspects between them. Another area that is focussed upon concerns the law of avoidance of transactions intended to secure collectivity, a *pari passu* distribution and to avoid the possibility of unjustified enrichment.

The importance of the *pari passu* principle as an asset distribution mechanism can only be truly examined if properly contextualised. It will be shown its relevance and thereby its efficacy has been endorsed by a number of eminent text-writers. However, there are also some commentators who hold a contrary opinion and criticise the principle in no uncertain terms. The arguments raised by these critics are of paramount significance since one of the principal objectives of this thesis is to propose a possible reformulation of the *pari passu* principle within the legal framework governing dissolution and consequential winding up and corporate recovery. Furthermore, the fact that *pari passu* is at times aligned with the anti-deprivation rule does not bode well with respect to its application. There is a general consensus that the true relevance of *pari passu* is particularly felt in the area of law

of avoidance of transactions that would have taken place during the suspect period at the pre-liquidation stage. In addition, it is amply evident that the effects of *pari passu* through the application of the provisions dealing with judicial shielding of companies in the process of being wound up or undergoing a corporate recovery procedure are amply relied upon in numerous judicial proceedings, which undoubtedly aid in boosting its relevance.

1.2 The *Pari Passu* Principle Defined

> *The normal rule in a corporate insolvency is that all creditors are treated on an equal footing – pari passu – and share in insolvency assets pro rata according to their pre-insolvency entitlements or the sums they are owed. Security avoids the effects of pari passu distribution by creating rights that have priority over the claims of unsecured creditors[52].*

Within the ambit of modern law of corporate insolvency, the Latin phrase *pari passu*, also known as *par condicio creditorum,* contemplates a situation where *"all unsecured creditors standing in positions of relative equality at the onset of insolvent liquidation are treated equally[53]."* Maltese jurist Paolo Debono[54] opines that the creditors of the bankrupt have an equal right (*un uguale diritto)* in the estate of the bankrupt. Although DeBono makes this observation in relation to bankruptcy it could safely be said to apply to corporate insolvency since at the time the bankruptcy provisions in the Maltese legislative system also applied to corporate insolvencies. The principle is also sometimes referred to as the "race to grab"[55] which presupposes a scenario wherein each creditor might anticipate the difficulties of negotiations and then plan to defect before other creditors do so. This would in turn lead individual creditors to incur higher costs than they would bear if creditors acted collectively[56].

[52]Vanessa Finch, 'Security, Insolvency and Risk: Who Pays the Price?' [1999] 62 *MLR* 633, 634.
[53] Oditah Fidelis, 'Assets and the treatment of claims in insolvency', [1992] 108 LQR 459.
[54] Paolo Debono, *'Appunti di Lezioni sul Fallimento nel Diritto Maltese", Seconda Edizione Riveduta, Ampiata e Corretta*' 1907.
[55] Rizwaan Jameel Mokal, "Consistency of Principle in Corporate Insolvency", SSRN, December 2001.
[56] Lawrence Weiss, *Corporate Bankruptcy, Economic and legal perspectives* (Cambridge University Press, 1996).

By and large, the *pari passu* principle is generally accepted as being *"the foremost principle in the law of insolvency around the world*[57]*."* It is described as being fundamental and all-pervasive[58] in character. Its effect is to strike down all agreements which have as their object, or result in, the unfair preference of a particular creditor by removal from the estate on winding up of an asset that would otherwise have been available for the general body of creditors.[59] Thus, both procedural and substantive fairness can be assured in so far as it seeks to prevent a race in the enforcement of claims among creditors in the same class, that is most likely to be won by the strongest and swiftest and it also involves equality of treatment between unsecured creditors[60]. The priority system is reinforced by a long line of Court judgments, whose underlying principle serves to ensure that creditors cannot contract out of the statutory regime. According to Mellish LJ, the general principle is that *"a person cannot make it a part of his contract that, in the event of bankruptcy, he is then to get some additional advantage which prevents the property being distributed under the bankruptcy laws*[61]*."* By the application of this principle an insolvency regime is making a clear statement that claims of different creditors will be treated 'exactly as it finds them[62].' As a result winding up creditors share rateably in those assets of the insolvent company that are available for residual distribution. 'Rateably' in the sense that creditors' claims are to be treated in common proportions according to the extent of their pre-insolvency claims[63].

In times of prosperity a creditor's ability to seek payment and enforcement against a company's assets is governed by a 'first come, first served' or 'race goes to the swiftest' legal environment. In contrast, during the company's twilight, the environment in question is disorderly and unrestrained. Once a company enters insolvency, this creditor environment is replaced by another where creditors hold

[57]Andrew Keay & Paul Walton, "The preferential debts regime in liquidation law: in the public interest?' [1999] C.f.i.L.R. 84, 85.
[58] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell, 2011 pp. 114).
[59] Ibid (No 38) pp. 239
[60] *Vide* Joseph Finnis, *Natural Law and Natural Justice* (Clarendon Press, 1980, p. 190).
[61] *Re Jeavons, ex p Mackay* [1873] LR8 Ch App 643 (Mellish LJ).
[62] *Re Smith, Knight & Co, ex p. Ashbury* [1868] LR 5 Eq. 233, at 226, (Lord Romilly M.R).
[63] Vanessa Finch, *Corporate Insolvency Law Principles & Perspectives* (Cambridge University Press, 2009).

general rights, standing alongside all others within their general body of creditors, to a rateable slice of the distribution of the net proceeds *pari passu*[64]. The objective is that losses existing in the insolvency should be borne by the creditors equally, with each creditor receiving a certain proportion per euro of debt[65].

The shift in objective above referred to has been exemplified in a local judgment, **NIBC BANK N.V. vs Chemmaster Shipping Limited *et*[66],** wherein the Court clearly stated that upon the onset of insolvency proceedings, the interests of shareholders become subordinate to the interests and protection of creditors[67]. Fletcher[68] observes that,

> *In exercising their discretionary powers...the courts have evolved an approach which aspires to balance the collective interest against the relative hardship and injustice, which may be experienced by the individual creditor, under circumstances where it is inevitable that any mitigation of that person's loss will be at the expense of the general body of creditors, and hence will amount to a judicially-sanctioned exception to the pari passu principle.*

Thus it would naturally follow that, *"Before a creditor is entitled to claim a preferential position it must be demonstrated that deviation from the inveterate and equitable pari passu principle is warranted*[69]*."*

This paradigm shift is of utmost importance when trying to understand the *pari passu* system as an asset distribution mechanism. The above demonstrates the relationship between the judicial system and the insolvency framework, in that the success of any insolvency system is closely dependent upon the efficiency of the

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[64] *Re Gray's Inn Construction Ltd* [1980] 1 WLR 711.
[65] Stephen Hill, 'Understanding s239 Preference under Insolvency Act 1986'(2014). Available at: < https://www.33bedfordrow.co.uk/insights/articles/understanding-s239-preference-under-insolvency-act-1986> accessed on 18 June 2019.
[66] First Hall Civil Court, 12 December,2011.
[67] *"Izda meta jkun hemm proceduri tal-istralc, l-interess tal-azzjonisti jrid icedi ghall-interess u ghall-protezzjoni tal-kredituri."*
[68] Ian Fletcher, *The Law of Insolvency*, (5th edn, Sweet & Maxwell, 2017).
[69]Andrew Keay & Paul Walton, 'The preferential debts regime in liquidation law: in the public interest?' [1999] C.f.i.L.R. 92.

Court system. This extends from access to justice issues for creditors and debtors alike, to the Courts' ability to process cases effectively.

Again in **Kinsela v Russell Kinsela Pty Ltd**[70] it was held that:

> *In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise … But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.*

Furthermore in **Colin Gwyer & Associates Ltd vs London Wharf (Limehouse) Ltd**[71], it was held that directors owed their fiduciary duties to creditors when the company is facing imminent insolvency. The fiduciary obligation owed by directors was explained as follows,

> *There seems to be in the application of this principle a tension between the 'two fundamental principles of credit and insolvency law', that of freedom of contract which allows one to bargain for priority and the mandatory pari passu principle*[72]*. The whole purpose of the pari passu principle is to ensure that once a company becomes insolvent, no individual creditor should be allowed to steal a march on his competitors. The principle first come, first served, gives way to that of orderly realization of assets by the liquidator for the benefit of all unsecured creditors and distribution of the net proceeds pari passu. In that all creditors participate in the common pool in proportion to the size of their admitted claim.*[73]

In light of the above-cited judgments it is clear that the insolvency regime has a position of immense importance in the economy, one that involves protecting the interests of creditors, employees and consumers as well as individual debtors. It is

[70] [1986] 4 ACLC 215 u [1986] 10 ACLR 395.
[71] [2003] BCC 885.
[72] Michael Bridge, 'The Quistclose Trust in a world of secured transactions' [1992] 12 OJLS 333,340.
[73] Roy Goode, Corporate Insolvency Law, (4th edn, Sweet & Maxwell, 2011, p. 235, 236, 505).

also instrumental in the pursuit of good standards of corporate governance and in the sanctioning of financial wrongdoing.

The shift of interest in favour of creditors in liquidation proceedings has been long established by Maltese Courts. In **Salvatore Bondin vs Paul Vella *noe*[74]** for example the Court reaffirmed the established principle that upon the passing of a resolution to wind up the purpose of the company changes completely. When a company is a viable concern the business of the company is carried out to maximise profit. However, upon the commencement of a winding up process, the carrying on of the business is merely to properly wind up the activities of the company with a view to realize the assets of the company, pay its debts and any remaining assets are then distributed to the shareholders in order for the company to be struck off from the Register of Companies. The Court went on to emphasise that the function of the liquidator appointed by the shareholders of the company being wound up is that of preserving the assets of the company[75], to investigate all the claims brought against the company by its creditors, to decide any issues about the ranking of creditors, to prepare a scheme of distribution and to distribute the assets according to the approved scheme. This judgment is incidentally in line with those economic theories that focus on creditor interests. Essentially, according to this school of thought the collective actions of liquidations will diminish the transactional costs of the individual creditor in favour of a more administratively efficient system[76].

In **All Invest Company Limited vs X *et*[77]** the same Court rejected an application for the appointment of a provisional administrator as it wanted to ensure that the interests of the general body of creditors were properly safeguarded as opposed to those of individual creditors. The Court after taking due consideration of the

[74] Commercial Court, 10 May 1993.
[75] Vol. XVI.p.11.p.69.
[76] Gino Dal Pont and L Griggs, 'A Principled Justification for Business Rescue Laws: A Comparative Perspective, Part II' [1996] 5 International Insolvency Review 47 at 62.
[77] First Hall Civil Court, 17 March 2014.

particular circumstances of the case[78] noted that it would not appoint a provisional administrator. It came to its conclusion after considering that the assets of the company were not in jeopardy nor was it the case that the company was in deadlock due to a dispute between the directors and shareholders. On the contrary, in this particular case the company, directors and shareholder are "rolled in one." It was neither a case of a dissipation of assets since its particular line of business, that is financial services, the company could not engage in new business. It is pointed out that this was a long drawn out case[79]. The above evidently shows the complexities involved in trying to safeguard the collective interests of the general body of creditors – the technical issues that are faced by the Courts and tribunals are both of substantive as well as procedural nature.

Although it is manifestly clear that one cannot but recognise the benefits of the *pari passu* principle – especially when the rule is to be understood in light of other basic legal principles such as collectivity, fairness and equality of treatment of creditors - yet this principle is subject to exceptions. It will be seen in the course of the thesis that the general notion of "equality among all creditors" has in practice been modified through a number of judicial and legislative interventions which have established certain specific groups of creditors which are accorded preferential treatment or some form of privilege. The whole crux of the issue underpinning this thesis is whether these accepted exceptions or deviations from the application of the *pari passu* principle – annihilate the benefits of the rule in practice.

[78] *"Fil-kaz tal-lum, il-kredituri u/jew l-investituri ta' All Invest qeghdin jghidu le ghall-hatra ta' amministratur provizorju. Il-Qorti ma tistax tinjora l-fehma taghhom f'sitwazzjoni singolari ghall-ahhar bhal ma hija dik tal-lum."*

[79] Vanessa Macdonald, 'End in sight for All Invest Creditors' *Times of Malta* (22 January 2019). Available at: <https://timesofmalta.com/articles/view/end-finally-in-sight-for-all-invest-clients.699777> accessed on 10 March 2019.

1.3 Application of the Principles of "Fairness" and "Equality of Treatment"

The notions of fairness and equal treatment which are taken to be inherent characteristics of the *pari passu* principle represent "fundamental" ingredients of insolvency law, the hallmarks of the modern approach to distribution of assets in liquidation proceedings[80]. Goode[81] too supports this assertion by arguing that the equality approach taken by the principle marks off the rights of creditors in a winding up from their pre-liquidation entitlements and that the principle puts an end to the notion of the 'race goes to the swiftest' after insolvency proceedings have commenced. Indeed, the principle supercedes the notion of 'first-come first-served' which in turn allows for *'the orderly realization of assets by the liquidator for the benefit of all unsecured creditors and distribution of the net proceeds pari passu[82]'*. The principle also serves to ensure 'parity of benefit', no matter what resources one has. In fact, if there were no *pari passu* principle of distribution in insolvency law, we would return to the rather mediaeval "first come first served" policy which entitled those with the greatest resources and power to the debtor's estate[83].

The above sets a scenario wherein a default position of equality must prevail. This is best exemplified in **Emanuel Azzopardi *et* vs M.V. Maltese Falcon[84].** The salient pronouncement here was that once a debtor obtained an executive title acknowledging his debt through a Court judgment, it followed that it was up to the Court seized with the ranking of creditors which was to determine whether the particular claim was privileged or not. The Court noted that, in this case, the creditor had his claim confirmed by an executive title but there were other circumstances that needed to be considered in relation to the ranking of creditors. In this instance, the applicant's credit had already been confirmed by means of a *res iudicata* judgment but since it involved a request for the declaration of a privilege, which affects the

[80] Fidelis Oditah, 'Assets and the treatment of claims in insolvency' [1992] 108 LQR 459.
[81] Roy Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, 4th edn, 2011).
[82] Ibid. (No 61).
[83] Andrew Keay & Paul Walton, 'The preferential debts regime in liquidation law: in the public interest'? [1999] C.f.i.L.R. 92.
[84] Court of Appeal, 3 April 2009.

equality between the creditors of the same debtor, the issue was to be determined in the ranking of creditors proceedings before the Court[85].

If this were not the case, the general body of creditors would be prejudiced and the *pari passu* principle breached[86]. The Court cited **Zammit vs Caruana *noe*[87]**, which *inter alia* held that creditor claims would be dealt with collectively. Reference was also made to **Spiteri vs Agius**[88], wherein the Court of Appeal cited Baudry Lacantinerie in order to illustrate that a privilege confers on its holder the right to be preferred over the other creditors, including hypothecary creditors. The privilege thus creates a preference by virtue of which the privileged creditor is paid out before all others. Thus it has the effect of determining the ranking order of the creditors of the same debtor[89].

Not only does the principle of distribution find solace with Goode, Keay and Walton but Finch likewise affirmed that the principle *"conduces to an orderly, collective means of dealing with unsecured creditor claims and … involves lower distributional costs than alternative processes such as 'first come, first served[90]".* Finch goes even further to suggest that the *pari passu* principle ably assists the law of insolvency in producing acceptable combinations of efficiency, fairness, accountability and transparency characteristics. This implicates that the devices and processes that make up the regime for *pari passu* distribution offer players in the market-place a

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[85] *"F'dan il-kaz, il-kreditu tar-rikorrenti huwa gia` kanonizzat b'sentenza li ghaddiet in gudikat, izda t-talba ghad-dikjarazzjoni ta' privilegg, la darba din timmodifika l-ugwaljanza li timmilita bejn il-krediturituri tal-istess debitur, trid tigi ezaminata fil-konkors li hemm pendenti quddiem dawn il-Qrati (ara Concorso di creditori sul ricavato del vapore 'Raetaria', deciza minn din il-Qorti fl-20 ta' Novembru 1922)."*

[86] Alberto Trabucchi, *Istituzioni di Diritto Civile* (CEDAM, 29 Ediz, 1988, pagna 602) a privilege *"si attua sostanzialmente in danno degli altri creditori, i quali, per contrapposto, si chiamano chirografari".*

[87] First Hall Civil Court, 8 January 1958.

[88] Court of Appeal, 6 October 2000.

[89] *"che il legislatore non ravvisa nel privilegio che il diritto di preferenza che produrra i suoi effetti aspetto agli altri creditori dello stesso debitore. Quando di loro potra` essere invocato, il privilegio conferisce a chi ne investito il diritto di essere preferito agli altri creditori, anche ipotecari. Il privilegio dunque genera un privilegio di preferenza in virtu` del quale il creditore privilegiato e' pagato prima di tutti gli altri. Serve cosi a regolare i rapporti dei creditori di uno stesso debitore a determinare l'ordine col quale saranno collocati."*

[90] Vanessa Finch, *Corporate Insolvency Law Perspectives and Principle* (Cambridge University Press, 2009).

low-cost mode of protection against insolvency risks whilst also avoiding allocating risks in a way that produces unfairness or inefficiency[91]. Similarly in **Vica Limited vs Terry Limited *et*[92]** the Court of Appeal concluded that no one creditor should be allowed to take an unfair advantage to the detriment of the general body of creditors. For this reason the Court felt it necessary to appoint a liquidator for the insolvent company in order to ensure that the assets of the company are distributed according to law.

Another important practical purpose is that of invalidating pre-liquidation transactions by which a creditor hopes to secure an advantage over his competitors where these transactions are not in accordance with statutory exceptions[93]. It is for this reason that the principle is regarded as being very much at the heart of the rationale for the avoidance of pre-liquidation transactions thereby reaffirming 'insolvency law's commitment to the principle of equality'[94]. Given the pervasive nature of the principle, it would appear, as Goode suggests, that *"in certain conditions adjustments of concluded transactions which but for the winding-up of the company would have remained binding on the company may be required. The notion of equality of treatment is also a significant inherent characteristic of the principle given that it provides key practical and justificatory purposes which bring social benefits"*[95].

A thought-provoking practical application of the *pari passu* principle of distribution can be seen in a situation where, on the eve of insolvency, creditors, aware of the company's troubles and able to influence its decisions, try to steal the first portion of assets from the asset pool by getting the debtor to repay them. While the individual creditors most certainly will gain by their hurried intervention, this is done at the expense of the collective group. It is submitted that this is precisely the reason why the "first-come, first-served" approach, which is in direct contrast to the *pari passu*

[91] Rizwaan Jameel Mokal, 'Priority as Pathology: The *Pari Passu* Myth' CLJ 581-621[2001].
[92] Court of Appeal, 14 May 2010.
[93] Roy Goode, *Corporate Insolvency Law* (Sweet & Maxwell, 4th edn, 2011).
[94] Fidelis Oditah, 'Assets and the treatment of claims in insolvency' [1992] 108 LQR 459.
[95] Ibid. (No 71).

principle, would not amount to a viable alternative in insolvency law in that it encourages creditors to engage in multiple, and thus wasteful monitoring, of their debtor in order not to be left behind in any race to the pool. It also adds uncertainty and therefore decreases the utility of risk-averse creditors[96]. The individualistic pre-insolvency debt-collection regime in contrast to the *pari passu* principle of distribution could be seen as a mad race to the asset pool, which method is clearly undesirable.

One landmark judgment in this area of law is **Dr Andrew Borg Cardona *noe* vs Victor Zammit *et*.**[97] Essentially, the Maltese Court of Appeal confirmed a Civil Court judgment finding the directors guilty of wrongful and fraudulent trading when they continued to do business in full knowledge the business was in financial distress. In brief, the company that operated the chain enterprise had no assets but paid the debts on the property of other companies within the Price Club Group. Creditors only had a relationship with the shell company with no assets to its name. Directors asked for more credit from suppliers knowing they would never be in a position to repay. The First Hall Civil Court chided the respondents for planning to expand the business of the company not through the use of their own personal funds but rather by using the credit belonging to their trade suppliers. The respondents devised a scheme whereby the creditors unwittingly became investors of Price Club Group. In no uncertain terms the Court declared this *modus operandi* to be a classic case of fraudulent trading[98]. What interests us for the purposes of the application of the *pari passu* principle is how the Court sought to protect the interests of creditors whilst highlighting once again the fiduciary duty of directors towards the creditors. The Court concluded that the directors acted in breach of their obligations towards the creditors and were liable of both wrongful and fraudulent trading.

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[96] Thomas H Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain' 91 Yale LJ. 857 [1982].

[97] Court of Appeal, 14 May 2010.

[98] *"As from day one, l-intimati hasbu biex jizviluppaw n-negozju tal-kumpannija mhux minn flushom, izda minn flus it-trade suppliers u l-pretensjoni taghhom ienet li jekk il-kumpannija tghhom iddum, anke snin twal, biex tibda tiggenera qliegh tajjeb, dawn it-trade suppliers, kellhom jibqghu jistennew ghall-flushom. Il-kredituri saru finanzjaturi bla ma jafu tal-Grupp Price Club. Dan fil-fehma tal-Qorti huwa kummerch bi frodi …"*

The principle of fairness is distinct from the *pari passu* principle or *par condicio creditorum*. Although the two principles overlap they are not the same. The *pari passu* principle requires that all creditors should be paid the same proportion of their debt in their debtor's liquidation. In reality however equality is rarely achieved in the ranking of creditors. This is where the concept of fairness comes into play since it may be possible to justify deviations from the principle of equal treatment on the basis that one person is more deserving than another[99]. It is argued that it is for this reason that the law permits a variety of lawful causes of preferences and privileges. Mokal[100] deploys the Authentic Consent Model in order to demonstrate that the rule (generally referred to as the 'equality' principle) has little to do with 'real' equality. In this respect the Italian Constitutional Court[101] has also reaffirmed the fact that although the *par condicio creditorum* principle is by and large recognised as being the general rule in insolvency proceedings exceptions to the principle are permissible at law, *'pur discutendosene il fondamento, e' communemente riconosciuto che la par condicio creditorum e' la regola del procedimento fallimentare*[102]*'.* In fact, the Italian Constitutional Court proceeds to make a decisive pronouncement in stating that, *'…il principio costituzionale di eguaglianza, infatti, tollera disparita' di trattamento se queste siano gustificate da ragioni apprezzabili, e tanto piu' se lo siano dall'attuazione di un valore costituzionale*[103]*.'* This in itself demonstrates that the principle of fairness is a wider legal concept and goes beyond the *pari passu* principle and may even require that certain classes of creditors be granted preferential treatment in terms of laws, for example employees of a company being wound up.

This having been said the rationale underpinning the *pari passu* principle is the end of the race of individual actions for debt collection towards a fairer system based on the equality of treatment of creditors. Once a company becomes insolvent, the main

[99] Sarah Paterson, 'Debt Restructuring and Notions of Fairness' (University of Oxford, 28 June 2016) <https://www.law.ox.ac.uk/business-law-blog/blog/2016/06/debt-restructuring-and-notions-fairness> accessed on 6 March 2021.
[100] Rizwaan Jameel Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press 2005).
[101] Cfr Corte Cost., 20 aprile 1989, n.204, in Fallimenti, 1989, 590.
[102] Niccolo' Abriani and Antonio Maria Leozappa, *Sul Principio Del Par Condicio Creditorum Nelle Procedure Concorsuale* (Giuffre' Editori 2014).
[103] Cfr Corte Cost., 20 aprile 1989, n.204, in Fallimenti, 1989, 590.

aim of the legislator is clearly to protect the so-called "weakest link" - which as a class would be the general body of creditors. If there were no controls exercised on the manner in which creditors claim repayment of their debt in insolvency cases this would lead to a scenario where the rights of the general body of creditors would be completely trampled upon with absolutely no protection being afforded to them. Paramount among the protection afforded to the general body of creditors is the possible invalidation of pre-liquidation transactions and the "shielding" of the insolvent company.

1.4 State of Insolvency

Since the application of the *pari passu* principle is triggered in the case of insolvency of a company being wound up, understanding and analysing what is meant by a state a insolvency is of the utmost important. A number of judgments delivered by the Maltese Courts have had occasion to review and elaborate upon these so-called "tests of insolvency." In **Panta Contracting Limited vs D.A. Holdings Limited *et***[104] the Court analyses article 214(5)(b) of the Companies Act which lays down the tests of insolvency. The Court observed that when the new Maltese Companies Act was drafted, in order to replace the Commercial Partnership Ordinance 1962, it was modelled upon the English Companies Act 1985. Under English law, dissolution and winding up on a company are regulated by *ad hoc* legislation that is the Insolvency Act 1986. When Act XXV of 1995 on Company Law was promulgated, dissolution and winding up were governed by the provisions of the same Act. A company which is deemed unable to pay its debt has a precise meaning which is defined at law. Under English law, its meaning is wider. The concept of insolvency under Maltese law is narrower than that found under English law even though the two overlap. The Court moreover proceeds to refer and cite Boyle and Birds[105] to explain that,

> *There are two principal, although not exclusive or exhaustive, tests of insolvency: a company is insolvent if it unable to pay its debts as they fall due ("cash flow insolvency"); it is also insolvent if its liabilities exceed its assets ("balance sheet insolvency") ...*

[104] First Hall Civil Court, 17 March 2016.
[105] AJ Boyle & John Birds, *Boyle & Birds' Company Law* (9th edn, Jordan Publications 2016) 859.

The Court then goes on to analyse article 214(5)(b) of Chapter 386 of the Laws of Malta and highlights the following considerations. The Court highlights that the English text of article 214(5)(b) of the Companies Act reads as follows,

> *For the purposes of sub-article (2)(a)(ii), a company shall be deemed to be unable to pay its debts … if it is proved to the satisfaction of the court that the company is unable to pay its debts, account being taken also of contingent and prospective liabilities of the company.*

The Court remarks that in the English Insolvency Act 1986 there is a similar provision albeit one which is not identical. The applicable provision under English law, that is article 123(2) of the Insolvency Act 1986 which states that,

> *A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company`s assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.*

It is worth noting that the Court delves into the differences in the legislative drafting between the Maltese and English provisions. According to the Court, this is because, although the legal provisions in the two jurisdictions are similar they are not identical. Whereas the Maltese disposition states that, "*the company is unable to pay its debts account being taken also of contingent and prospective liabilities of the company",* its English counterpart refers to the "*the value of the company`s assets is less than the amount of its liabilities ... by taking into account ... contingent and prospective liabilities."* The Court observed that this was not simply a difference in drafting style but rather one in substance. The significant difference between the two texts being that under English law express reference is made to the term "value" which was deliberately omitted by the Maltese legislator. Having acknowledged this difference the Court noted that due note was to be taken of English doctrine on "balance sheet insolvency" in relation to Article 123(2) of the English Insolvency Act, 1986.

The Court also cites Keay and Walton[106] on the assessment of balance sheet test within the context of the Insolvency Act 1986, in that a Court is to take into account contingent and prospective liabilities but not contingent and prospective assets[107]. An important point was made that "liabilities" is a broader term compared with "debts"[108]. "Liabilities" is defined for the purposes of winding up in rule 13.12(4) of the Insolvency Rules to mean *"a liability to pay money or money`s worth, including any liability under an enactment, any liability for breach of trust, any liability in contract, tort or bailment and any liability arising out of an obligation to make restitution".* With this test it is clearly only possible to take into account the assets owned by the company including the uncalled capital of the company[109].

Additional reference was made by the Court to Goode[110] in that, *"the idea underlying this test …is that it is not sufficient for the company to be able to meet its current obligations if its total liabilities can ultimately be met only by the realisation of its assets and these are insufficient for the purpose."* The point was made that the mere excess of liabilities over assets is not in itself determinative. What has to be shown is that by reason of the deficiency of its assets the company had reached the point of no return.

The different types of "liability" are defined as follows:

(i) The meaning of contingent liability has been restricted to a liability or other loss which arises out of an existing legal obligation or state of affairs but which is dependent on the happening of an event which may or may not occur. In considering whether there is a contingent liability the court has regard to the existing commercial situation, not merely an existing legal obligation.

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[106] Andrew Keay & Paul Walton, *Insolvency Law – Corporate and Personal* (Longman, Pearson Education Limited 2003) 19.
[107] *Byblos Bank SAL v. Al-Khudhairy* [1986] 2 BCC99, 549 (CA).
[108] *Re A debtor* (No 17 of 1966) [1967] Ch 590; [1967] 1 All ER 668.
[109] *Re National Livestock Insurance Co* [1858] 53 ER 855.
[110] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn Sweet & Maxwell, 2011) 114.

(ii) Prospective liability has been defined as a debt which will certainly become due in the future, either on some date which has already been determined or some date determinable by reference to future events. Such a definition encompasses all forms of *debitum in praesenti, solvendum in futuro* including an indisputable claim for unliquidated damages which remains only to be quantified and will result in a debt far more than a nominal amount.

In coming to this elaborate decision as to the insolvency of the defendant company, the Court[111], relying on the report drawn up by the court appointed legal expert, observed that[112]:

1. The situation could be determined by reference to the balance sheets once it is determined that the assets are less than its liabilities. However it is not sufficient for the company to be able to meet its current obligations if its total liabilities can ultimately be met only by the realisation of its assets over a lengthy period[113]. Therefore the creditors are not expected to have to wait for the company to dispose of its assets in order to be repaid.

2. It was abundantly clear that with the profits generated by its operations, the company was not in a position to pay its proven debts that were also accruing interest.

3. The Court was not satisfied that it was a *bona fide* disputed debt that could be prejudicial to a winding up order.

4. It was proved that respondent company had defaulted in its repayments.

[111] Panta Contracting Limited vs D.A. Holdings Limited *et,* First Hall Civil Court, 17 March 2016.
[112] Reference made to Axel John International AB vs Aluminium Extrusions Limited decided, First Hall Civil Court, 28 May 2003.
[113] *Re European Life Assurance Society* [1869] LR 9 Eq. 122.

5. This particular case dealt with a company which was set up to build and operate a retail complex. It had a minimal start-up capital when compared to the huge expenses needed in the running of the shopping complex.

6. The debts claimed by creditors were certain, liquidated and due. The same could not be said in respect of the assets of the respondent company. The fact alone that the respondent company needed to sell off its assets to pay off its debts did not mean that the company was no longer insolvent.

7. During the Court proceedings a dispute arose as to the manner in which the assets of the company could be sold, that is whether in whole or in part. Should this be done to pay off creditors or to give a lifeline to the company? This conundrum in itself was evidence of the state of insolvency the company was in.

8. The particular facts of this case did not involve a short-term of fixed duration wherein the company stopped paying its debts. But rather one wherein the company stopped completely paying its principal creditors and that is those who were directly involved in the building of the complex.

9. In determining a state of solvency, the Court is to consider whether a company is a going concern as if this is the case its asset value would continue to increase. However, even in this case the company did not try to regenerate its business through the injection of fresh capital in order to remain a viable concern. For all the above reasons, the Court concluded that the requirements set out in article 214(5)(b) of the Companies Act had been satisfied.

Through these judgments the Maltese Courts provided a very useful overview of those requirements that will be considered to determine whether a company is in a state of insolvency or otherwise.

The Court concludes that in its considered opinion the respondent company had arrived at a point of no return. In its current state, the respondent company was not generating enough revenue to pay all the creditors. In the circumstances of the respondent company its dissolution and winding up was inevitable[114].

In **Axel John International AB vs Aluminium Extrusions Ltd[115]** the Court held that the company's inability to pay debts could be established by the presentation of its balance sheets. The Court went on to observe that a company was not solvent if it could only meet its current obligations by selling its assets over a period of time. There was no reason why creditors should wait until the company sold its assets in order to receive payment.

In **Mark Nurton and Paul Nurton vs PMN International Ltd[116]** plaintiffs who were the majority shareholders and directors in the defendant company, PMN International Ltd, claimed that there existed good reasons for the company's dissolution. The company commenced business operations in 2006 and despite an investment of approximately €400,000, the company did not make a profit and by 2008 it was running at a loss. As a result it had a long list of creditors, including suppliers and also had outstanding credit facilities with Banif Bank. By March 2009, it shut down operations. The Court considered the only audited accounts of the company for the period July 14, 2006 to December 31, 2007. It resulted that for the initial seventeen months of the company's operations, the company was trading at a loss. In the period covered by the audit, the company suffered a loss of three thousand nine hundred and twenty three Maltese lira (Lm3,923). It was clear that the company was not in a position to meet its commitments unless its shareholders were prepared to contribute more funds. Its shareholders injected as much funds as possible, until they felt they had to draw the line. There was no doubt that the company was

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[114] *"Hija l-fehma meqjusa tal-Qorti illi s-socjeta` intimata waslet at a point of no return. Fl-istat li tinsab fih llum, l-intimata mhijiex tiggenera dhul bizzejjed sabiex thallas il-krediturili ppartecipaw fil-procediment tal-lum, sabiex thallas id-djun li l-gestjoni tal-kumpless iggib maghha, u anke eventwali bejgh tal-assi jhalli lis-socjeta` minghajr skop ta` negozju u mhux bilfors ikopri l-hlas dovut lill-krediturili. Ghalhekk ix-xoljiment u l-istralc tal-intimata huwa inevitabbli."*

[115] First Hall Civil Court, 28 May 2003.

[116] First Hall Civil Court, 18 April, 2011.

insolvent and that it did not have enough assets to pay its debts. At the time of these proceedings it had ceased trading for over two years. Also there was no possibility for any turnaround, for the company to re-establish its goodwill, or to re-acquire its clientele and business partners. The Court noted that the company's failure to file the financial accounts in a timely and regular manner was a serious breach, since said accounts enabled its creditors to consider its financial condition. A company was insolvent when it ceased to pay its debts. It was not a requirement to prove that it did not have funds or assets to pay its debts. Thus the Court held that under article 214(2)(b) it had to dissolve the company[117].

In **Mitchell Allen Platt *et* vs Local Billing Solutions Ltd[118]** dealing with the balance sheet test, the Court came to the conclusion that the company had stopped its business operations with effect from 1 January 2011. As there was no economic activity there was no revenue. An inactive business concern cannot generate profit and therefore it cannot pay its debts. The Court observed that it was clear that the shareholders were not willing to make any fresh injections of capital. All the facts pointed towards a situation wherein the company had arrived at appoint of no return and the disposal of its assets would not suffice to pay off all its debts. The Court was satisfied that on the basis of the evidence brought forward the respondent company was unable to pay its debts in terms of articles 214(2)(a)(ii) and 214(5)(b) of the Companies Act[119].

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[117] Karl Grech Orr, 'Company is deemed insolvent when it ceases to pay its debts' *Times of Malta*, (15 August 2011).

[118] First Hall Civil Court, 26 March 2015.

[119] *"Jirrizulta li n-negozju tal-kumpannija waqfet topera b'effett mill-1 ta' Jannar 2011. Ghax ma hemmx attivita' ekonomika, ma hemmx revenue. Azjenda kummercjali inattiva jew illi ma toperax ma tistax tiggenera dhul u kwindi ma tkunx tista' thallas id-djun taghha. Huwa evidenti li l-azzjonisti mhumiex disposti jaghmlu fresh injections of capital. Kollox jindika li l-kumpannija waslet at point of no return u l-bejgh tal-assi taghha ma jistax iwassal biex jigi saldat id-dejn.*
Fuq l-iskorta tal-provi li ngabu a konjizjoni taghha, din il-Qorti hija sodisfatta illi l-kumpannija Local Billing Solutions Ltd mhijiex f'qaghda li thallas id-dejn taghha abbazi tal-art. 214(2)(a)(ii) u tal-Art. 214(5)(b) tal-Kap 386".

Another relevant judgment confirmed on appeal which dealt with the tests of insolvency is **Fimbank plc vs Almeco Limited**[120]. The Court cited Boyle and Birds[121] and explained that upon the failure of a company to pay a undisputed debt which is due this was tantamount to evidence of cash flow insolvency. In practical terms what this meant was that a company which adopted a "late payment of bills policy" would be susceptible to an action for a winding up order or an administration order. Such an action would not be quashed at an early stage as a form of improper pressure and an abuse of the process of the court, because, as Staughton LJ explained in **Taylor's Industrial Flooring**[122] that creditors, not late payers, are more worthy of insolvency law's protection:

> *many people today seem to think that they are lawfully entitled to delay paying their debts when they fall due or beyond the agreed period of credit, if there is one ... This can cause great hardship to honest traders, particularly those engaged in small businesses recently started. Anything which the law can do to discourage such behaviour in my view should be done.*

The Court concluded that[123] with reference to paragraph (a) of sub-article (5) of article 214, the fact alone that the claimant bank obtained a judgment in its favour against the respondent company did not satisfy the criteria of paragraph (a). Whilst reaffirming the fact that a judgment is an executive title, paragraph (a) of article 214(5) also required the execution of said executive title by means of an executive act. The respondent bank company did not present any documents in Court to prove that it had enforced the execution of the judgement. Therefore the period of twenty four (24) weeks prescribed by law had not yet started to run. Thus the action could not succeed in terms of article 214(5)(a) of the Companies Act.

In **Vica Limited vs Terry Limited**[124] the Court of Appeal decided that the defendant company Terry Limited was not solvent when it stopped paying its debts. It was not

[120] Court of Appeal, 27 October 2017.
[121] A J Boyle and John Birds*, Boyle & Birds' Company Law* (9th edn, Jordan Publications 2016).
[122] 1990, BBC 44 at 51.
[123] Fimbank plc vs Almeco Limited, Court of Appeal, 27 October 2017.
[124] Court of Appeal, 14 May 2010.

necessary to prove that it had no assets to pay its liabilities. The failure to file audited accounts at the Registry was an act of mismanagement, so that the Court concluded that,

> *…it was proven that Terry Ltd had stopped doing business and making payments for many years, and it was unable to pay its debts. It was unlikely that the company would resume business in the short-term and pay out its debts. In the Court's opinion the company was insolvent and a liquidator was to be appointed to distribute the company assets and settle all proven debts in accordance with law.*

In **Jane Mizzi v JAJ Company Ltd**[125] the Court held that a shareholder was entitled to apply for the dissolution of a company if he could prove that the company was unable to pay its debts within the meaning of article 214 (5) (a) and (b) of the Maltese Companies Act. Plaintiff, *qua* shareholder of defendant company, JAJ Company Ltd, filed legal proceedings under article 214(2)(a)(ii) of the Companies Act requesting its dissolution on grounds of its insolvency. The company was unable to pay its debts under article 214(5)(a) and (b) of the Companies Act and the company's financial position was dire. It had been without any director for over three years, its last director having resigned on October 3, 2011. It had no company secretary and ran debts of over €700,000. Executive warrants had been served against the company by the tax authorities and by its former employee. The last annual accounts filed at the Registry of Companies were for the year ending December 31, 2007. Its accounts for 2008 had been prepared but had never been filed at the Registry of Companies. The Court reiterated that under our law the fact that a company was unable to pay its debts had a precise meaning. The position was wider under English law. The concept of insolvency under our law was more restrictive than under English law, though there were overlaps. The applicable Maltese provision was Article 214(5) of the Companies Act which establishes when a company was to be deemed to be unable to pay its debts from a legal standpoint. Whether a company is cash flow insolvent is principally a question of fact and one which may be established in a number of ways:

[125] First Hall Civil Court, February 26 2015.

• If a debt was unpaid after twenty four weeks from the execution of an executive title against the company by one of the executive warrants mentioned in article 273 of Chapter 12[126]; or

• If it was proven to the satisfaction of the court that a company could not pay its debts in view of its assets and liabilities.

Our law in a more restricted way resembled the English concept of cash flow insolvency. Under English law the concept was more generic, a company was insolvent if it was unable to pay its debts as they fell due. The Court considered that the company had stopped operations more than three years before, which was a long time in business. The company only accumulated debts, and its shareholders appeared to have given up on the company. In this respect its dissolution and liquidation was inevitable, pointed out the court[127].

The Court of Appeal in **Dr John Refalo *nomine* vs Garden of Eden Ltd[128]** observed that article 214 of the Companies Act determined when a company was unable to pay its debts. The rule was clear. If a company failed to pay within twenty four weeks from the enforcement of an executive title by an executive warrant, it was deemed unable to pay and could be placed in dissolution by the Court. A debt due by the company remained unpaid for more than twenty four weeks from the enforcement of the judgement of the English courts (which constituted an executive title) against the company in Malta, by the issuance of a garnishee order against the company in Malta. The Companies Act did not require that the debtor be notified of the issuance of the warrant. It was not relevant that the garnishee made no deposit. The court pointed out that this did not affect the debtor's obligations. It noted that the Court of Appeal's decision against the company, did not contain any conflicting statements.

[126] Code of Organisation and Civil Procedure.
[127] Karl Grech Orr, 'Dissolution of Companies' *Times of Malta* (16 March 2015).
[128] Court of Appeal, 18 September 2009.

Nor was the company justified to delay payment, until it settled its claim with its insurance company. This was not a valid reason to withhold payment.

The very fact that there are numerous judgments delivered by the Maltese Courts as to what constitutes a "state of insolvency" with respect to companies demonstrates the importance this decision has on the continuity of the company as a business concern and thereby the impact this decision will have on the claims of creditors of the company. Domestic courts have on numerous occasions highlighted the fact that, although the Maltese legislator took the English Company Act, 1985 as a model, the approach taken differs. When it was decided to update the Commercial Partnership Ordinance, the Maltese legislator opted to include the provisions dealing with "dissolution and consequential winding up" in the Companies Act, with a number of special laws creating lawful preferences and privileges. In practice, this has led to a piecemeal and fragmented approach to the ranking of creditors. Presently, we are faced with a state of affairs where the liquidator must refer to multiple pieces of legislation in order to determine the ranking of claims. This is not at all ideal, more so when one considers that legal certainty is of paramount importance in any sound legal system. In England and in contrast to the position obtaining in Malta as outlined, insolvency is dealt with an *ad hoc* piece of legislation with complimentary Insolvency Rules. At a glance an obvious difference in the legislative approach in the two jurisdiction emerges and what is to be considered is whether Malta should embark upon a holistic overhaul of its corporate insolvency legislation. This issue will be dealt with in greater detail in a subsequent Chapter specifically dealing with a possible reformulation of the *pari passu* principle.

1.5 Insolvency Regimes

In terms of legal policy, Fletcher[129] identifies two basic alternatives that can be followed in the case of the debtor's insolvency. On the one hand, he describes the so-called "race of diligence" which is triggered between individual creditors who are in a competition *inter se.* The inherent risk of this approach is that this system is prone to give rise to anomalies which emerge from the diversity of the claims and the individual creditor's familiarity with the legal system. Ultimately, the final result is that the creditor who is the fastest will get the 'prize.' On the other hand of the spectrum there could be an insolvency regime which in itself dictates a collective regime.

The development of a collective regime was spurred by a desire to establish a system which would reasonably address the needs of fairness for all parties as well as the practical needs of a credit-based society. This gave rise to the so-called *pari passu* distribution of an insolvent debtor's assets. Maltese, English as well as Italian insolvency law, as will be seen, are based on this pivotal principle. The impact of the application of this principle is extremely far-reaching and can also possibly influence the nature of the creditor-debtor relationship long before formal insolvency proceedings are instituted. The practical consequence is that special care must be taken by all parties when a debtor is manifestly or even probably insolvent.

Fletcher also proposes an intermediate approach which would be based on a chronological priority. In essence, in such an insolvency regime, the insolvent debtor's debts would be discharged in the order in which they occurred. Again, this system can be hampered by in-built flaws. Creditors could be prejudiced due to the accidental timing of events and completion of transaction which would still make them suffer the arbitrariness of outcome. Similarly, debtors could be at a disadvantage as they could possibly be denied the benefit of credit because those

[129] Ian F Fletcher, *The Law of Insolvency* (4th edn, Sweet & Maxwell 2009).

dealing with them would not be in a position to reasonably foresee their chances of being paid their dues.

Look Chan Ho[130] steers a different course and endorses a separatist model, arguing that two versions of the *pari passu* principle are clearly discernible in the context of modern insolvency law. On the one hand, he argues that the orthodox *pari passu* approach takes claimants exactly as it finds them, such that the distribution of assets within an insolvency forum (liquidation or administration) is based on the pre-insolvency form of claims[131]. On the other hand, he argues for the existence of a *pro rata* distribution approach within the various classes of claimants established by insolvency law itself, that is, claims subject to the principle are to be met rateably[132].

In essence, the above variations in insolvency regimes stem from different versions of corporate insolvency. Finch[133] identifies the two variants as either the 'creditor wealth maximising' vision of corporate insolvency as opposed to one based on a redistributional role. If corporate insolvency law is concerned with the maximisation of assets available for distribution to creditors, then the rights of creditors within a liquidation scenario are to be treated in accordance to the pre-liquidation entitlements. By contrast, the purpose of insolvency law is seen to have a redistributional role where the system would allow prior private bargains to be adjusted in the public interest or in pre-established policies outside the scope of insolvency.

What is certain is that in Malta the legislation has opted for a collective insolvency regime. Both its advantages and disadvantages will be discussed in this and subsequent chapters. Fully comprehending the present insolvency regime is a *sine*

[130] Look Chan Ho, 'The principle against divestiture and the *pari passu* fallacy' [2010] Butterworths Journal of International Banking and Financial Law.
[131] *Re Smith, Knight & Co, ex p Ashbury* [1868] LR 5 Eq. 223, 226.
[132] The principle of rateable distribution within class is value-free, has no substantive content, and is wholly subservient to any insolvency distribution policy.
[133] Vanessa Finch, *Corporate Insolvency Law Perspectives and Principle* (Cambridge University Press 2009).

qua non as it is only in this manner and on this basis that one may proceed to propose a possible reformulation of the present insolvency regime.

1.5.1 The Principle of Collectivity

A collective insolvency regime is centred on the basic tenet that the debtor's estate and the creditors' claims are to be treated irrespectively of their chronological order in which the debt was created. The collective nature of insolvency proceedings demands that the general body of creditors be protected from disposing of the company's assets in the period leading up to liquidation which give an unfair advantage to any creditor[134].

The case for *pari passu* is that within a mandatory collective regime it is conducive towards an orderly means of dealing with unsecured creditor claims. The collective action of unsecured creditors as a class is enhanced by the *pari passu* principle. Insolvency proceedings are thus rendered more efficient in that it avoids additional costs being imputed in the treatment of claims on their individual merits[135]. Mokal[136] develops the argument that it is this principle of collectivity and not *pari passu* which avoids value-destroying races to collect. He opines that *pari passu* is not necessarily efficient[137].

The Maltese Courts through successive judgments have emphasised the collective nature of insolvency proceedings. In **Panta Contracting Limited vs D.A. Holdings Limited[138],** the Court made the following observations in relation to the mandatory nature of the collective nature of insolvency proceedings,

[134] Vanessa Finch, *Corporate Insolvency Law Perspectives and Principle* (Cambridge University Press 2009).
[135] Ibid.
[136] Rizwaan Jameel Mokal, 'Priority as Pathology: The *Pari Passu* Myth' CLJ [2001] p. 593.
[137] A critique of the principle is presented in Chapter 3 of the thesis.
[138] First Hall Civil Court, 26 February 2015.

1) The Court referred to Fidelis Oditah[139] to affirm that, *"winding up is a collective procedure for the benefit of creditors generally and it does not benefit specific creditors individually."* If the party trying to intervene in the court proceedings is seeking to obtain leave of court in order that some future action hits out against the guarantors, then its request is rejected. If in its action the party is trying to also involve respondents then its request is also being rejected as with the appointment of a Provisional Administrator, especially in view of the wide discretionary powers in the hands of the court, today there is more control on the operations of the respondent company, and above all direct accountability to the Court of all of respondent company's transactions. If the creditors had any doubts on the director's behaviour in the period preceding the appointment of the Provisional Administrator, this doubt could be laid to rest since the Provisional Administrator was given all the powers of the directors, thereby all the powers of the directors were suspended. Furthermore, the Provisional Administrator was obliged to render an account at regular intervals to the Court in the presence of the creditors.

2) Among the primary functions of the Provisional Administrator is that under Court supervision, assets of the company should be preserved, expenditures and accruing of debts is controlled with a view that should the Court – on the basis of the evidence brought before it – reach the conclusion that a winding up order is to be delivered then the liquidator may proceed to distribute assets among its creditors.

3) The collective interests of the creditors require that each creditor who has a claim against the respondent company has to actively participate in the winding up proceedings – which is permissible at law without the need of any individual creditor action – in order for there to be determined a scheme of

[139] Fidelis Oditah, "Winding Up Recalcitrant Debtors" [1995] LMCLQ 107.

distribution. In any case, any further litigation would dissipate the assets of the company further.

4) It was the Court's considered opinion that the debt owed to the party wishing to intervene by the respondent company was well protected *ex contractu* and *ex lege*. The Court wanted to ensure that within the winding up proceedings, all creditors commence from the same starting line, meaning that the admissibility of a creditor's claim is to be determining at the moment of winding up and not before.

5) The Court did not grant the permission requested by the party wishing to intervene since on a balance between convenience and needs of justice, the Court has to exercise its discretion in the manner requested by the party wishing to intervene[140].

The case under review is particularly interesting, due to the fact that the Court is citing the works of Oditah who highlights one important function of the Provisional Administrator in preserving the assets of the company and thereby safeguarding the collective nature of winding up proceedings. This judgment also illustrates the balancing act that the Court carries out when weighing the various interests of the involved parties in liquidation proceedings.

1.5.2 The Anti-Deprivation Rule

We now move on to a related issue which merits our consideration because of its high importance. Fletcher asserts that alongside the fundamental rule of insolvency law, that it is contrary to public policy to contract out of the *pari passu* principle of distribution there exists a separate, but in certain aspects overlapping, rule which in recent times has come to be known as the "anti-deprivation rule". This rule owes its

[140] Reconfirmed in the winding up order of D.A. Holdings Limited, First Hall Civil Court, 8 February 2018.

origins to decisions concerned with cases of personal bankruptcy happening in the eighteenth century. In one of the said cases, this rule was explained as follows: *"There cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors*[141]*."*

Due to the overlap between to the two rules and the variations found in judicial expression used in determining individual cases according to their particular circumstances, a steadily increasing state of uncertainty exists as to what will be considered to be legally valid. Thus, though the two principles are inter-related it is important to distinguish the *pari passu* principle from the anti-deprivation rule. The *pari passu* rule is designed to ensure that one creditor does not get more than his fair slice of the pie, whereas the anti-deprivation rule seeks to secure that the size of the pie is not reduced by withdrawal of an asset from the company. In this way the latter seems to be concerned with ensuring that the size of the pie available for division is not improperly reduced whereas, the former has to do with the appropriate division of the pie[142].

Goode[143] observes that owing to the similarities shared by the two principles, many court judgments cited as decisions on the *pari passu* principle are in fact decisions on the anti-deprivation rule. He explains that on the one hand the anti-deprivation rule is designed to invalidate any contractual stipulation which has the effect of diminishing the net asset value of a company in liquidation by any transfer to a third party who is not a creditor. On the other hand, a transfer or even a payment to a creditor upon winding up does not have the same effect. Rather a breach of the *pari passu* principle is condemnable as it has the effect of distorting the statutory scheme of distribution.

[141] Citing Lord Cotton LJ at p. 26 *Ex p Jay; Ex p Harrison* [1880] 14 (Ch D) 19.
[142] Roy Goode, *Principle of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 62, 99).
[143] Ibid. (No 117) 237.

Numerous agreements have over the years been scrutinised by English Courts to determine their legal validity measured against either the *pari passu* rule of distribution or the anti-deprivation rule. It is widely accepted that the anti-deprivation rule has rather older roots[144] and may safely be said that this rule came to real prominence in the decision delivered by the House of Lords in **British Eagle International Airlines Ltd v. Compagnie Nationale Air France**[145]. In brief, a group of airlines through the International Air Transport Association (IATA) had a netting system to deal with all the expenses they incurred to one another efficiently. A common fund was established and at the end of each month the sums were settled. British Eagle went insolvent and was a debtor but Air France owed it money. Air France argued that it should not have to pay British Eagle as it was bound to pay onto the netting scheme and have the sum cleared there. However the House of Lords rejected this argument and observed that this would have the effect of evading the insolvency regime. It did not matter that the dominant purpose of the IATA scheme was for sound business justification - it was nevertheless deemed to be void.

In **Belmont**[146] it was observed that the general principle is made up of two sub-rules: the anti-deprivation rule and the *pari passu* rule which are addressed to different company related issues. In borderline cases, a commercially sensible transaction entered into in good faith should not be taken as infringing the first rule. In brief this case dealt with the effect of security arrangements forming part of larger and more complex series of credit swap transactions whereby investors provided credit protection to Lehman Brothers using security which formed part of a high-grade investment purchased with funds subscribed by the note-holders and vested in a

[144] *Vide Borland's Trustee v Steel Brothers & Co Limited* [1901] Ch 279, were at p. 290 Farwell J stated that the principle in line with the *dicta* of James LJ in *Ex p Jay; In re Harrison* [1880] 14 (Ch D) 19 at p.25: *"The principle is 'that a simple stipulation that upon a man's becoming bankrupt that which was his property up to date of bankruptcy should go over to someone else and be taken away from his creditors, is void as being a violation of the policy of the bankrupt law."*

[145] [1975] 1 WLR 758. Its application and scope were moreover tested by a Court of Appeal decision in two cases, namely *Perpetual Trustee Company Limited v BNY Corporate Trustee Services Ltd* [on appeal from a decision of the Chancellor [2009] EWHC 1912 (Ch); [2009] 2 BCLC 400, [2009] BPIR 1093] and *Butters v BBC Worldwide Ltd* [on appeal from a decision of Peter Smith J, [2009] EWHC 1954 (Ch); [2009]; [2009] BPIR 1315].

[146] *Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc* [2011] UKSC38; [2011] W.L.R. 521.

trust corporation. In 2008, a series of events of default occurred. On 15 September 2008 and 3 October 2008, Lehman Brothers Holding Inc (LBHI) the parent company and Lehman Brothers Special Financing Inc (LBSF) a special purpose vehicle respectively filed for protections under Chapter 11 in the US Bankruptcy Court for the Southern District of New York. The note-holder opted to claim the flip clause so as to transfer priority over the collateral from LBSF to them. LBSF counter-argued that the flip clause was invalid under English law as breaching the anti-deprivation rule and formed part of a greater complex structure which was based on self-help. LBSF's argument was that, prior to its insolvency, it had property in the form of a present, future or contingent interest in the security, which secured a prior claim to cost due to it on termination of the agreement, that it was deprived of the claim and/or security upon or by reason of its insolvency, and that such a deprivation was invalid as contrary to the policy of the insolvency legislation. This argument was dismissed by the Court at every stage of the proceedings. Lord Collins affirmed that:

> *It would go well beyond the proper province of the judicial function to discard 200 years of authority, and to attempt to re-write the case law in the light of modern statutory developments. The anti-deprivation rule is too well-established to be discarded despite the detailed provisions set out in modern insolvency legislation, all of which must be taken to have been enacted against the background of the rule.*

According to him the anti-deprivation rule would be applicable *"in a commercially sensitive manner, taking into account the policy of party autonomy and the upholding of proper commercial bargains"* accompanied by further consideration that *"it is the substance rather than the form which should be the determinant."*

On appeal, the English Court once again found in favour of the note-holders on the basis that the complex commercial transaction had been entered into in good faith and there had never been any suggestion that its provisions were deliberately intended to evade insolvency law. This meant that the main provisions particularly the flip clause in favour of the note-holders were valid and enforceable.

To conclude, even though the anti-deprivation rule has its roots deeply set in corporate insolvency the trend adopted by English courts would be one that favoured restricting its application for two reasons:

1. In a corporate context, the increasingly sophisticated anti-avoidance provisions now in the Insolvency Act 1986 reduce the need for a general anti-avoidance principle originally developed to protect the much simpler bankruptcy legislation from evasion.

2. The uncertainties of the rule's boundaries risk coming into conflict with the countervailing public policy in favour of contractual certainty and party autonomy in *bona fide* commercial arrangements[147].

1.6 The Effect of Set-Off on the Application of the *Pari Passu* Principle as an Asset Distribution Mechanism

Insolvency set-off is a major exception to the application of the *pari passu* principle as an asset distribution mechanism[148]. In **Re Charge Card Services Ltd[149]** Millet J explains insolvency set-off as being triggered with regard to debts whose existence and amount were alike,

> *contingent at the date of the receiving order, and claims to damages for future breaches of contracts existing at that date, were capable of proof and, being capable of proof, could be set off under the section provided that they arose from mutual credits or mutual dealings. The only requirement was that they must in fact have resulted in quantified money claims by the time the claim to set off was made.*

Insolvency set-off diminishes the *pari passu* principle since if there are mutual debts, creditors are permitted to use their set-off rights to obtain priority over other

[147] See *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 [96] (Briggs J).
[148] Rory Derham, *Derham on the Law of Set-Off* (4th edn, Oxford University Press 2004).
[149] [1987] Ch 150.

creditors. The importance and significance of insolvency set-off on the applicability of *pari passu* cannot be overstated in view of the fact that it operates automatically from the date of any winding up order and does not require intervention by either party[150].

The Maltese Companies Act of 1995 does not deal with insolvency set-off[151]. The general principles of set-off are found in the Civil Code[152] which basically states that set-off takes place *ipso iure* where two persons are mutual debtors to one another. If these provisions were to be applied in an insolvency scenario once a creditor sets off his debt with the insolvent claim such creditor's claim is paid ahead of other creditors. This would seemingly disrupt the *pari passu* distribution of assets. However, these general provisions are to be applied and interpreted in light of the special law that is, the Set-off and Netting on Insolvency Act[153], which makes provision for the enforceability of set-off and netting on of bankruptcy or insolvency. In fact article 3(1) of the Set-off and Netting on Insolvency Act clearly states that *"notwithstanding the provisions of any other law"*, any close-out netting provision or any other provision in any contract providing for or relating to the set-off or netting of sums due from each party to the other in respect of mutual credits, mutual debts or other mutual dealings shall be enforceable in accordance with its terms, whether before or after bankruptcy or insolvency, in respect of mutual debts, mutual credits or mutual dealings which have arisen or occurred before the bankruptcy or insolvency of one of the parties.

[150] *Stein v Blake* [1995] UKHL 11.

[151] By contrast in England there are special provisions on set-off in the Insolvency Act and the Insolvency Rules. For example, Rule 14.25 of the Insolvency Rules 2016 provides that where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation, then an account must be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other. The balance, if any, once the account has been taken, is provable as a debt in the bankruptcy.

[152] *Vide* articles 1196- 1197, Chapter 16, Laws of Malta.

[153] Chapter 459, Laws of Malta which will be dealt with in more detail of Chapter 2.

The Set-off and Netting on Insolvency Act refers to contractual provisions and not to *ipso iure* set-off as provided for by the Civil Code. This issue was rarely discussed by our Court but one good example is **Dr Andrew Chetucti Ganado *et noe* vs Gollcher Company Limited[154],** wherein plaintiff company which was being wound up requested payment from defendant company. On its part defendant company submitted that the amount being vaunted by plaintiff company had been extinguished by the operation of set-off *ispo iure.* The Court observed that article 1196 of the Civil Code states that when there are mutual debtors then set-off operates *ipso iure.* Article 1197 of the Civil Code furthermore provides that set-off only occurs with respect to two debts that consist of a sum of money which is certain, liquidated and due. It has been affirmed by the Maltese Courts that when one of the parties pleads set-off he is in fact admitting to the debt. Such an admitted debt is extinguished by the operation of set-off[155]. In the case under review the defendant company had acknowledged its debt in favour of plaintiff company prior to the company entering into winding up proceedings. On its part, plaintiff company made reference to article 303 of the Companies Act dealing with fraudulent preferences[156].

However, the Court pointed out that the Companies Act is subject to the proviso contained in article 3(1) of the Set-Off and Netting on Insolvency Act which provides that: *"notwithstanding the provisions of any other law… in respect of mutual credits, mutual debts … which have arisen or occurred before the bankruptcy or insolvency of one of the parties, against: (a) the parties to the contract".*

[154] First Hall Civil Court, 16 November 2010.

[155] *Vide* Marianna Spiteri et vs Joseph Vella, (Vol. LXXVII.iii.128); Donald Orr *nomine* vs Edward Gingell Littlejohn *et* (LXVIII.ii.297); Stefan Zrinzo Azzopardi *nomine* vs Michael Vella *nomine* (LXXIX.iv.1371).

[156] Article 303 of the Companies expressly lays down that: *"Every privilege, hypothec or other charge, or transfer or other disposal of property or rights, and any payment, execution or other act relating to property or rights made or done by or against a company, and any obligation incurred by the company within six months before the dissolution of the company shall be deemed to be a fraudulent preference against its creditors whether it is of a gratuitous nature or an onerous nature if it constitutes a transaction at an undervalue or if a preference is given, unless the person in whose favour it is made, done or incurred, proves that he did not know and did not have reason to believe that the company was likely to be dissolved by reason of insolvency, and in the event of the company being so dissolved every such fraudulent preference shall be void."*

For this reason the First Court concluded that the provision dealing with fraudulent preferences contained in the Companies Act was inapplicable. The Court at First Instance adopted the approach that article 3 of the Set-off and Netting On Insolvency Act is to apply to *ipso iure* set-off as envisaged in the Civil Code. It is interesting to point out that the Court of Appeal[157] reversed the decision of the First Court since it pointed out that the Set-Off and Netting On Insolvency Act had not yet entered into force. However, it did so without entering into the merits of *ipso iure* insolvency subsequent to a company's date of deemed dissolution.

It is to be observed that article 3(1) of the Act[158] clearly refers to contracts and not to set-off by operation of law and can be deemed to exclude from its provisions other types of set-off governed by other laws. Clarity on this matter would be highly desirable and best achieved through timely legislative intervention. As things stand today the Companies Act is silent on insolvency set-off, the Civil Code sets out the general principles on set-off *ipso iure* whereas the Set-Off and Netting On Insolvency Act regulates set-off vis-à-vis contractual provisions. Thus insolvency set-off is not properly regulated and seeing that it is a serious exception to the applicability of *pari passu* this state of uncertainty should not be left to persist.

The European Insolvency Regulation[159] sets out the authority of EU Member States to open insolvency proceedings. It provides that, subject to certain exceptions, the law of the State that opens insolvency proceedings shall apply to those proceedings. It is expressly stated that set-off is an exception for the opening of insolvency proceedings and does not affect the rights of creditors to demand the set-off of their claims against the insolvent debtor. One of the main criticism levelled at the efficacy of the Regulation is that it fails to define what is meant by set-off[160]. Furthermore, it lacks clarity as to whether set-off rights under the law of a third country may be relied upon[161].

[157] Dr Andrew Chetucti Ganado *et noe* vs Gollcher Company Limited, Court of Appeal, 7 February 2012.
[158] Set-off and Netting On Insolvency Act, Chapter 459, Laws of Malta.
[159] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings OJ L 141, 5.6.2015, p. 19–72.
[160] G McCormack, 'Set-off under the European insolvency regulation (and English law)' [19 April 2020] International Insolvency Review.
[161] This European Insolvency Regulation will be discussed in further detail in Chapter 2.

Conclusions

In actual day-to-day business realities, those entrusted with the control of a company in distress may become tempted to favour certain particular non-preferential unsecured creditors over the general body of creditors of this class. This would be achieved by improving their positioning in the likelihood of an imminent insolvency. The power granted to the Court to quash such preferences is a significant weapon in the office-holder's armour to counter any circumventing of the fundamental *pari passu* principle and its ethos of sharing losses equally among the unsecured creditors[162]. Logically, the justification of the remedy should be, and ideally is, the restoration of the *status quo ante* to the benefit of the general body of creditors, with the Court given very wide powers to reach said goal.

However, the main stumbling block for the success of these actions appears to be that something more is required under English law, namely, the *'influenced by a desire'* motivation ingredient. In practice no jurisdiction to unwind the transactions arises under section 239 unless this requirement is satisfied. The rationale underpinning this ingredient is that it seeks to ensure that only where there is an improper motive behind the betterment, namely a sufficiently influencing *'positive wish to improve the creditor's position in the event of its own insolvent liquidation'*, will transactions be voidable. A motive consisting of proper commercial considerations and devoid of the improper betterment desire will not be at risk[163]. The determining factor is what the Court finds to have been the true motivation to commit the company to the course of action that resulted in the betterment.

The Maltese legislation has accorded a wider discretion to the domestic Courts in the determination of what would be tantamount to a fraudulent preference. This sensible approach in the local sphere has a definite impact on the practical

[162] Stephen Hill, 'Understanding s239 Preference under Insolvency Act 1986' (2014).Available at: < https://www.33bedfordrow.co.uk/insights/articles/understanding-s239-preference-under-insolvency-act-1986> accessed on 18 June 2019.
[163] Ibid.

application of the *pari passu* principle in the domestic insolvency regime. What remains to be discussed and evaluated is the effect that lawful causes of preferences is having on the practical application of the *pari passu* rule as an asset distribution mechanism.

Without any doubt and in light of the above, it remains a fact that a number of eminent text-writers have accepted that the *pari passu* principle is a fundamental concept in corporate insolvency law reflecting notions of basic fairness and equal treatment. The *pari passu* rule draws support both by the need for an orderly liquidation of insolvents' estates in addition to requirements of fairness[164]. This principle has been reaffirmed in a multiplicity of *fora* and advocated by several legal commentators. In fact, it has been argued that any deviation from the principle is a cause for great concern and that there is indeed a heavy burden of proving that deviation from this pervasive principle is 'warranted'[165]. In other words, in liquation proceedings the onus of proof rests upon those supporting differing priorities to justify their claim[166]. Where they fail to do so to the satisfaction of the Court, it would appear that the 'default principle' of 'equality' will be adhered to in the distribution of assets subsequent to liquidation.

This Chapter had the objective of providing the legal context in which the *pari passu* principle is expected to operate. It is now opportune to proceed to analyse the significant historical legislative antecedents that have culminated in the current Companies Act. This exercise will henceforth be undertaken comparatively with the position obtaining in the United Kingdom, Italy as well as the European Union. Two specific issues that need to be properly addressed are:

[164] Report of the Review Committee on Insolvency Law and Practice (1982) Cmnd 8558, para 1220.
[165] Andrew Keay & Paul Walton, 'The preferential debts regime in liquidation law: in the public interest?' [1999] C.f.i.L.R. 92.
[166] Jason Haynes, 'Has the doctrine of *pari passu* been rendered passé in the Commonwealth Caribbean?' [Spring 2013] Journal of Commonwealth Law and Legal Education.

- What effect is the absence in current Maltese corporate legislation of an *ad hoc* Insolvency Act and specific insolvency rules having on the financial return due to the general body of creditors?

- Regarding the role of the various office-holders in a winding up scenario – are the obligations and duties incumbent upon them being properly implemented and enforced?

All these vital aspects are set to be reviewed in the coming Chapters in order to lay the basis for a possible reformulation of the *pari passu* rule as an asset distribution mechanism.

Chapter 2 Significant Historical Antecedents Shaping the *Pari Passu* Principle

2.1 General Introduction

This Chapter traces the more significant stages of the *pari passu* principle throughout the centuries. A comparative exercise is undertaken by reviewing the salient legislative developments in this area of law that took place in Maltese law (a hybrid legal system), English law (a common law system), Italian law (a civil law jurisdiction) with additional reference to the harmonised rules laid down under European Union law and International Law. By highlighting a number of historical landmarks in the legislative process, one would be in a better position to appreciate the various aspects and relevance of this asset distribution mechanism. It is a well-known fact that the relationship of debtor and creditor has its darker aspects and in the absence of balanced and effective legal regulation there is a potential for hardship and oppression to be experienced on either side. This could in turn trigger serious social tensions, particularly in periods of economic recession when the incidence of financial failures tends to be at its height[167]. The overview will ultimately indicate that the trend on both domestic and European level is towards the promotion of corporate recovery. It may be safely said that the second half of the twentieth century witnessed the introduction of more "rescue focused" legislation in Western Europe by way of an economic benefit in contrast to other solutions such as piecemeal liquidation. It could well be that, economic and commercial factors apart, socio-political aspects and considerations have also influenced such a trend.

[167] Ian Fletcher, *The Law of Insolvency* (Sweet & Maxwell 2002).

2.2 Introduction to the Historical Legislative Developments in Maltese Corporate Legislation

The Maltese legal system is a mixed legal system.[168] In fact a comparative approach was adopted in the drafting of new corporate legislation. The following outline of the salient historical legislative developments in Maltese corporate legislation could serve as a solid basis to better attain a possible reformulation of the approach currently adopted with respect to the asset distribution mechanism.

A remarkable quantum leap, by way of substantial changes in the Maltese corporate system, has taken place post-1987[169] and which included legislation affecting insolvency proceedings. Furthermore, the recent global financial challenges have brought an increase of insolvency scenarios and this has led to necessary changes to the legislative framework in a number of jurisdictions including to Maltese corporate legislation. To this end, the final part of the Chapter deals with the impact Malta's accession to the European Union has left on our domestic law on insolvency. Bearing in mind Malta's deep rooted legal tradition, it has interestingly been pointed out that the symbiosis of Maltese law and European law offers a unique legal scenario.

The impetus towards domestic legislative development in corporate legislation could well be linked with the **Priceclub[170]** fiasco in 2003. It was genuinely felt at the

[168] Professor David J Attard tersely describes and presents the Maltese legal system as follows: *"The development of the Maltese legal system as a mixed legal system can therefore be described as follows. The Maltese legal system is based on the Civil law tradition. Its modern period dates back to the introduction (ironically) by the British colonial administration of codes largely based on Civil law sources. Decades of British rule exposed the Maltese legal system to English law; an influence which continued after Independence in 1964. This applies to many branches of contemporary Maltese Law ranging from Public Law to other branches of law, such as Company Law, Fiscal Law, and Maritime Law."* See David J Attard, *The Maltese Legal System Vol I* (Malta University Press 2012).

[169] *Vide* Andrew Muscat, *Principles of Maltese Company Law* (Vol I, Malta University Press 2019): *"Complex and far-reaching legislation – ranging from a new company and insolvency law, to a basket of statutes regulating the business of banking, financial institutions, investment services and insurance, to significant reforms in the tax regime – radically transformed the legal setting in which business activity had hitherto been carried out."*

[170] Dealt with in further detail in Chapter 4.

time that there was an urgent need for a complete overhaul and updating of Maltese corporate legislation. According to the Regulator (the Malta Financial Services Authority) a number of steps were undertaken, *"to develop a comprehensive and integrated set of laws for the financial services sector have involved the enactment of new laws as well as the enhancement, amendment and consolidation of existing legislation*[171]*".* This need for change was further necessitated by Malta's obligations under European Union legislation. In the areas of corporate insolvency and company law for example, the introduction of set-off and netting and the possibility of corporate reconstruction has had a significant impact on the development of the Maltese corporate system[172].

2.2.1 Significant Developments in Maltese Corporate Insolvency Law

What follows is an outline of the important legislative reforms that have occurred over the years and which have affected the manner in which the present Maltese insolvency law regime developed. These reforms are reflected in a number of legal areas and are quite extensive in nature and scope.

2.2.1.1 Distinction between Maltese Bankruptcy Law and Insolvency Law

Under Maltese law there is a distinction between the bankruptcy of the individual and partnerships *en nom commandite* and *en nom collectif* that are regulated by the Commercial Code and limited liability companies which are governed by the Companies Act of 1995[173]. However, the situation was very different prior to the

[171]<https://www.mfsa.com.mt/files/LegislationRegulation/legislation/MFSA/History%20&%20Overview%20MFSA.pdf> accessed 11 November 2019.

[172] Andrew Caruana Scicluna, "Legal Issues in Corporate Debt Restructuring", LL.D. Thesis, University of Malta, 2013.

[173] David Farrugia, "Procedures for the Adjudication of Company Insolvency: Selected Issues", LL.D. Thesis, University of Malta, 2013. On the distinction between the terms 'insolvency' and 'bankruptcy' the following he comments that: *"… unlike the situation regarding adjudication of company insolvency, the action for bankruptcy of a trader or partnership en nom collectif or en commandite is an action which is regulated by the Commercial Code. Thus, even though the term bankruptcy is mentioned in the Companies Act, (in fact, the partnerships en nom collectif and en commandite provisions from the Commercial Partnership Ordinance were reproduced virtually in the Act with only a few relatively minor modifications) its application and procedure are located separately in the Commercial Code under articles 477 to 540 whilst the adjudication and procedure with regard to the insolvency of companies is located solely in the Companies Act".*

enactment of the Companies Act of 1995. In fact the Commercial Partnership Ordinance regulated the dissolution and winding up of all three partnerships. But if a partnership was adjudged bankrupt then the detailed provisions in the Commercial Code on Bankruptcy[174] would apply. If the company was dissolved on grounds of bankruptcy then the bankruptcy proceedings would take the place of the usual liquidation. Furthermore, if the company was dissolved for some other cause, and in the course of its liquidation, it becomes insolvent, the liquidation process should be replaced by bankruptcy proceedings. A court judgment that is often cited to demonstrate this process is **Dr Victor Ragonesi *nomine* vs Dr Ian Refalo *nomine*[175].** In brief, the plaintiff submitted that defendant company went into liquidation on the 5 July 1978 and that it was a creditor of the company and was awarded judgment against the defendant company on the 13 November 1978. The plaintiff requested the Court that the company be declared bankrupt and that a curator in bankruptcy be appointed. The defendant rebutted that a company which is in liquidation cannot be declared bankrupt and undergo bankruptcy proceedings. Secondly, that even if a company is declared bankrupt, it can only be wound up in terms of the Commercial Partnership Ordinance and not in terms of the provisions of the Commercial Code relating to bankruptcy. With respect to the first defence the Court noted that even during liquidation the company retains its juridical personality and remains technically a trader and if its suspends the payments of its debt during this period, it may be declared bankrupt in terms of the Commercial Code. The Court stressed that the juridical effects of bankruptcy are clearly different from those of liquidation. Therefore, it follows that under bankruptcy law debts not fallen due become payable; interests no longer continue to accrue and the *massa dei creditori* as well as the *actio pauliana fallimentaris* are instituted. In its judgment, the court observed that these effects are of significant importance and once the Commercial Partnership Ordinance does not expressly exclude the possibility of a declaration of bankruptcy during liquidation proceedings, then these bankruptcy principles

[174] David Farrugia, "Procedures for the Adjudication of Company Insolvency: Selected Issues", LL.D. Thesis, University of Malta, 2013.
[175] Commercial Court, 4 December 1979.

should apply even to a company which has been dissolved. In respect of the second defence the Court referred to sections 151 to 161 of the Commercial Partnership Ordinance and concluded that liquidation takes place only in the interest and under the control of the General Meeting and that the liquidator is answerable to the General Meeting and may be removed by the General Meeting or by the Court. Even the liquidation accounts and the scheme of distribution must be approved by the General Meeting. The Court concluded that these provisions clearly demonstrate that creditors do not participate in liquidation proceedings and that the only right that each creditor has is an individual right to claim payment of what is due to him. Once a company had been declared bankrupt the proceedings that are to be utilized are those of bankruptcy. From all this it is amply clear that the Court opined that the procedure of liquidation is distinct from that of bankruptcy, where the control by the Court and by the curator, aims to ensure that the interests of both the general body of creditors and the bankrupt are protected.

New provisions were introduced in the Companies Act of 1995 which deal with the position where a company is in an insolvent liquidation. Interestingly however the bankruptcy provisions of the Commercial Code remain relevant in respect of individual traders, partnerships *en nom collectif* and partnerships *en commandite*. Thus, in terms of article 4 of the Commercial Code[176] a "trader" means any person who, by profession, exercises acts of trade in his own name, and includes any commercial partnership. For a time corporate insolvency was governed by the Commercial Code. The present position is that the provisions contained in the Commercial Code deal solely with bankruptcy of the individual trader whereas the articles in the Companies Act of 1995 regulated dissolution and winding up of insolvent companies.

[176] Chapter 13, Laws of Malta.

2.2.1.2 Commercial Partnership Ordinance, 1962

A Commission was set up in May 1954 in order,

> *to draft up to date bill concerning Commercial Partnerships and Companies, accompanied by a concise but comprehensive report on the main features in general of the draft bill and, in particular, on any principles new to our present system that would be introduced by the enactment of the bill, and containing also an indication of the changes, if any, that the enactment of the bill would render necessary in our main Codes or in any other one or more of our existing laws*[177]*.*

By and large, the Commercial Partnerships Ordinance of 1962 had originally introduced modern company law principles into Maltese law. By virtue of Legal Notice 5 of 1965 the Commercial Partnership Ordinance came into force on the 19 April 1965. The principal sources of the Commercial Partnership Ordinance were the English Companies Act 1948 applicable to a members' voluntary winding up and the Italian Civil Code of 1942. In its Report, the Commercial Partnerships Law Reform Commission[178] opted for a more straight forward mechanism than those contemplated in the English Companies Act 1948 because they opined that the provisions of this Act were: *"too complex and cumbersome to be extended to a trading community, such as ours, which is still largely made up of individual traders and which has not as yet sufficiently developed trading by companies. A simpler method has been considered to be more suitable to local conditions."*

The recommendations made by the Commission were carried out and accordingly the Commercial Partnership Ordinance provisions on dissolution and winding up were based on a combination of corresponding provisions in the Italian Civil Code and of some provisions of the English Companies Act, 1948.

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[177] Report of the Commercial Partnerships Law Reform Commission accompanying a Draft Commercial Partnerships Bill (1956) p.1, reproduced in Professor Joseph A. Micallef's notes entitled 'Commercial Law – Cases and Materials: The Enterprise Including Companies'.
[178] Ibid.

The Commercial Partnership Ordinance[179] brought in a number of important changes to Maltese company law modelled on common law. The Commercial Partnerships Law Reform Commission[180] expressly stated that insofar as companies were concerned the law was to a large extent based on English law. It is extremely relevant to point out that questions of dissolution and liquidation of companies were left to be patterned upon continental Roman Law models that were considered to be simpler and more adapted to the local scene at the time[181]. This position subsequently changed with the adoption of the 1995 Companies Act[182].

Although the Commercial Partnership Ordinance was revolutionary in nature certain *lacunae* were being noticed by practitioners at the time. The reigning position in Malta prior to the Companies Act in 1995, with regard to the legal notions of "bankruptcy" and insolvency was somewhat problematic[183]. This is due to the fact that article 150 of the Commercial Partnership Ordinance stipulated that company is dissolved if, *"(e) if the company is adjudged bankrupt[184]".*

The possibility of creditors to file a winding up application was not recognised under the Commercial Partnership Ordinance. This notwithstanding in **Daniel Cremona vs Joseph Lanfranco *noe*[185]** the Court expressly stated that any person who has an interest in the liquidation of the company has the right to institute proceedings or the dissolution of the company. Such an interested party would include a creditor who therefore would be entitled to file a winding up application. Thus the proactive approach taken Maltese Courts provided some effective redress to creditors. Today through the enactment of article 218 of the Companies Act expressly states that a

[179] Chapter 168, Laws of Malta.
[180] Report of the Commercial Partnerships Law Reform Commission accompanying a Draft Commercial Partnerships Bill (1956) p.1, reproduced in Professor Joseph A. Micallef's notes entitled "Commercial Law – Cases and Materials: The Enterprise Including Companies".
[181] Biagio Ando', Kevin Aquilina, Jotham Scerri-Diacono and David Zammit, *Malta" – "Mixed Jurisdictions Worldwide: The Third Legal Family* (2nd edn, Cambridge University Press 2012).
[182] Chapter 386, Laws of Malta.
[183] David Farrugia, "Procedures for the Adjudication of Company Insolvency: Selected Issues", LL.D. thesis, 2013.
[184] *Vide* Dr Ragonesi *noe* vs Dr Ian Refalo *noe*, Commercial Court, 4 December 1979.
[185] Commercial Court, 9 September 1975.

winding up application may be filed by: *"… either by the company following a decision of the general meeting or by its board of directors, or by any debenture holder, creditor or creditors, or by any contributory or contributories."*

In 1976 the Government declared itself in favour of a new law on dissolution. In fact the President of Malta in the inaugural speech on the opening of the House of Representative observed that:

> *There are still many laws, mostly commercial, that no longer adequately serve the needs of the country. As an example one need only mention the bankruptcy law and the law which regulates the liquidation of companies. Apart from being outdated, these laws give protection only to the creditors and shareholder and take no account of the employee who loses his job. For this reason, these will be revised not only for the purpose of updating but also with a view to protect deserving cases*[186].

2.2.1.3 The Companies Act, 1995 - Act XXV of 1995

The time was ripe for a major update of the prevailing system. In 1995, a complete overhaul of Maltese corporate legislation came into being. In fact Act XXV of 1995 commonly referred to as the Companies Act[187] repealed the Commercial Partnership Ordinance, 1962 which had served its purpose but had aged. By and large, the Companies Act is a hybrid piece of legislation. Its sources are derived from English, Italian, French and European law. The Act built on the existing rules and broad structures, improving and updating them to meet the needs of a more sophisticated and complex financial and commercial environment. It not only modernised and upgraded Maltese company law, but it also introduced the principles and standards established in the Company Law Harmonisation Directives of the European Union[188].

[186] Government Gazette no. 13,302 of the 26 November 1976 pg. 3858.
[187] Chapter 386, Laws of Malta.
[188] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law, OJ L 169, 30.6.2017, p. 46.

Maltese insolvency legislation was modelled on the UK Companies Act, 1985. This fact was explicitly recognised in **Brava Limited vs Sakaras Holding Limited**[189],

> *in the drafting of our new law governing companies, the chosen model was that the English Companies Act 1985. Under English law, dissolution and the consequent winding up of companies is governed by ad hoc legislation that is the Insolvency Act 1986. In 1995 when the new Companies Act was passed (today Chapter 386 of the Laws of Malta) it replaced the Commercial Partnership Ordinance 1962, the provisions dealing with dissolution and winding up were incorporated in the 1995 Act*[190]*.*

The Court here is explicitly reiterating the fact that when a model law was drafted for the new Maltese Companies Act, it was based on the English Companies Act, 1985. However, the position in relation to corporate insolvency legislation is not the same in the two jurisdictions since, under English law, dissolution and winding up of companies is dealt with by virtue of *ad hoc* legislation, namely the Insolvency Act, 1986. By contrast, when the new Companies Act[191] was enacted in Malta in 1995, it replaced the Commercial Partnership Ordinance and provisions dealing with the dissolution and winding up of companies were integrated in the same Act. In terms of the Companies Act, dissolution and consequential winding up of a company are regulated by article 214 *et sequitur* and this can take either the form of a winding up by the court or a voluntary winding up. Therefore in England special designed insolvency provisions are contained in a separate Act, that is the Insolvency Act of 1986 which are buttressed by the Insolvency Rules. Is it or is it not about time that we seriously consider taking on a more holistic approach in Malta? This possibility will be dealt with in further detail at a later stage[192].

[189] Brava Limited vs Sakaras Holding Limited, First Hall Civil Court, 4 July 2013.
[190] *Vide* also FIMBank vs Almeco Limited, First Hall Civil Court, 18 February 2013.
[191] Chapter 386, Laws of Malta.
[192] See Chapter 5.

2.2.1.4 Other Notable Amendments to the Companies Act

The European Commission's Annual Report for Small and Medium Enterprises (SMEs) for years 2014-2015[193] stressed that since a considerable of start-up companies were destined to fail while still in their infancy, it would be desirable that public policies be tailor made at offering a second chance would lead to an improvement of the business environment.

A highly critical report issued by the European Commission in 2016 concluded that Malta has the most inefficient insolvency proceedings of all the EU Member States. The Report[194] estimated that Malta could increase its SMEs by five per cent (5%) if it were to offer a discharge period of three years, creating 428 jobs. Second chance policies laid out in the Small Business Act[195] have been implemented in less than half the Member States – and has been the principle showing least progress since 2008 [196]. The bleak picture concerning the domestic position goes even further since according to the report only 40.7 per cent of secured creditors recover their debts following insolvency, compared to 65 per cent in the European Union. The report shows that the average length of insolvency proceedings in Malta is three years, compared to the European Union average of two years. Actually, considering that court case management in Malta in complicated proceedings is notoriously slow, the three-year period is comparatively good by Maltese standards.

Asked for comments by the Business Observer, Dr Conrad Portanier, a leading practitioner in this area of law, said that these statistics, although alarming, were not surprising,

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[193] European Commission Annual Report for Small and Medium Enterprises (SMEs) for years 2014/2015 published on 1 March 2016 (ISBN 978-92-79-52922-1). Available at: <https://publications.europa.eu/en/publication-detail/-/publication/7c9fbfe0-e044-11e5-8fea-01aa75ed71a1/language-en> accessed on 11 November 2019.

[194] Ibid.

[195] Chapter 512, Laws of Malta.

[196] Vanessa Macdonald, 'Malta last in Insolvency Rankings' *Times of Malta* (1 December 2016). Available at: <https://www.timesofmalta.com/articles/view/20161201/business-news/Malta-last-in-insolvency-rankings.632573> accessed 4 December 2019.

> *I will mention one case with significant commercial ramifications where the First Hall of the Civil Courts decided (swiftly and ably) that a large company owing millions to Maltese creditors is now insolvent since it was unable to pay its debts. The company has now appealed, as is its right under law, and the creditors need to wait for three to four years just for the Court of Appeal case to be appointed for the first hearing. I will not venture into proposing amendments. There are structural problems which necessitate a comprehensive national strategy to address the underlying problems in the medium term. Unfortunately, piecemeal tweaks to the system do not address the root of the issue. Lack of decisive action will lead to making Malta less attractive for investment, at a time when many other competing jurisdictions have made radical overhauls to their systems and laws*[197]*.*

His comments are definitely pertinent. The principle of fair hearing which incorporates within it the notion of proceedings to be tried and heard with a reasonable time holds true in all areas of law. However, its relevance is especially felt within the gamut of corporate insolvency law. The delay in proceedings inevitably leads to a dissipation of the assets of the company in liquidation to the detriment of the interests of the general body of creditors. Thus his recommendation for a holistic review of Maltese insolvency law are valid and ought to be actioned with immediate effect.

Similarly, insolvency expert Dr Louis Cassar Pullicino[198] observed that the number of insolvency cases is on the increase and they cut across commercial activity and added that, *"The moment that a company faces financial difficulties, it inevitably has implications for employees, suppliers, creditors and banks, for example. So the impact is quite widespread."*

It is for this reason that the effects of insolvency proceedings are described as being catastrophic. When a winding up process occurs, the financial outcome for creditors and contributories is largely dependent on honest administration.

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[197] Conrad Portanier, 'Justice Reform for Commercial Law' *Times of Malta* (28 January 2016). Available at: <https://www.timesofmalta.com/articles/view/20160128/business-news/Justice-reform-for-commercial-law.600398> accessed 28 January 2016.

[198] Louis Cassar Pullicino, 'Time for Companies Act Review' *Times of Malta* (6 October 2016). Available at: <https://www.timesofmalta.com/articles/view/20161006/business-news/Time-for-Companies-Act-review.627088> accessed on 6 October 2016.

Following the decision or order to wind up the directors are displaced by a liquidator, who takes control of the entire company with view to winding up. It is the trust which those persons are obliged to place in the liquidator to preserve the assets and act faithfully and fairly that defines the weight of the duties owed and the strictness with which his conduct must be considered by the Court. The law provides various procedures to be followed by persons occupying such offices and particular emphasis is laid on the interests of the general body of creditors.

He[199] also pointed out that since Malta has been attracting more companies with international shareholders, there was also an impact on foreign jurisdictions. Dr Cassar Pullicino[200] also rightly observed that insolvency should be the last resort for companies in trouble but lamented that the section of the Companies Act of 1995 relating to company reconstruction and company recovery procedure had, for some reason, rarely been picked up by practitioners and corporate entities,

> *It could well be a cultural problem but it is more likely that the particular requirements to qualify for this rescue procedure are too onerous as they require agreement between the creditors who hold more than half of the claims against the company. The possibility of actually engineering a corporate rescue becomes quite a tall order.*

The Report's publication coincided with new EU rules on business insolvency aimed at increasing the opportunities for companies in financial difficulties to restructure early on so as to prevent bankruptcy and avoid laying off staff. In May 2017 an

[199] Louis Cassar Pullicino, 'Time for Companies Act Review' *Times of Malta* (6 October 2016). Available at: <https://www.timesofmalta.com/articles/view/20161006/business-news/Time-for-Companies-Act-review.627088> accessed on 6 October 2016.
[200] Ibid.

Impact Assessment[201] of a Commission proposal for the Second Chance Directive[202] was published[203]. The identified regulatory failures related to:

(i) preventive restructuring;

(ii) stays of enforcement actions (moratoria);

(iii) debtor-in-possession;

(iv) restructuring plans;

(v) new financing in restructuring; and

(vi) debt restructuring for natural persons.

In order to address some of the issues raised, important amendments have been introduced by virtue of the Companies (Amendment) Act, 2017[204]. Of particular interest from our standpoint concerns a number of amendments that were introduced to the Court's general powers in a Court winding up. A case in point is article 258(2) of the Companies Act of 1995, dealing with a Court winding up has also been amended. As a result of various amendments, the legislator augmented the list of the general order of priority which the Court will give regard to in the event that the assets of the company are insufficient to satisfy its liabilities and the Court then makes an order as to the payment out of the assets of the costs, charges

[201] Impact Assessment (SWD(2016) 357, SWD(2016) 358 (summary) of a Commission proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU (COM(2016) 723), EPRS, May 2017. Available at: <http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/603236/EPRS_BRI(2017)603236_EN.pdf> accessed 10 March 2020.

[202] Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EUCOM(2016) 723.

[203] Ibid (no 176).

[204] Act No. XI of 2017.

and expenses incurred in the dissolution and winding up. These amendments refer to the special controller and company recovery procedure[205] that set out the order of payment namely:

- any necessary disbursements by the special controller appointed in such a company reconstruction procedure;

- the remuneration of the special controller;

- and any new financing granted to the company for the purpose of a company reconstruction.

2.2.1.5 Set-off and Netting on Insolvency Act, Chapter 459, Laws of Malta

The Set-off and Netting on Insolvency Act came into force on 1 June, 2003 and it was subsequently amended by Act I of 2004. Its aim was to regulate the enforceability of set-off and netting on bankruptcy and insolvency. Of particular note is article 3(8) of the Act which specifically provides that, *"Articles 303, 304 and 315 of the Companies Act and article 485 of the Commercial Code shall only be applicable in relation to a close-out netting provision where there is fraud on the part of the party to the agreement not being the insolvent party."*

In terms of general principles of Maltese law there is no automatic set-off provisions in the context of winding up proceedings. However the general rule found in the Civil Code is that where two persons are mutual debtors a set-off takes place between them. Dr Pisani Bencini observes that, *"it would appear from Maltese case law that courts are inclined to rule that automatic set-off, under general principles of law, will not apply in the context of insolvency[206]."* This argument is based primarily upon the application of the *pari passu* principle enshrined in article 287 of

[205] Article 329B, Companies Act.
[206] Kristina Pisani Bencini, *Malta - A Guide to Consumer Insolvency Proceedings in Europe* (EE Publishing Limited 2019).

the Companies Act of 1995 which mandates that upon the commencement of the winding up process, all creditors are to be treated equally with respect of their claims.

Through the application of this Act when a company is insolvent, its debtors and creditors were to be considered as debtors and creditors according to the net amounts involved. At the time of passing of this Act, the practice of netting was already mandatory in many countries. Its introduction in Malta followed extensive consultations and its objective was to reduce the exposure of creditors and risks for business thereby benefiting the economy.

The observations made during the debate in the House of Representatives on the Set-off and Netting on Insolvency Bill[207] are of particular interest since they reflect the Maltese Government's views and objectives on the subject. The then Finance Minister Hon. John Dalli observed that the Bill was intended to introduce into Maltese law new concepts in the business sector and amended the Companies Act of 1995. The main aim underpinning the Bill was to provide a level playing field for all whilst also giving better protection for consumers. Enforcement was a prime motivator – in that any country which wanted to promote international business had to show it was credible and that operators within it did not come here solely to escape law enforcement elsewhere. It was hoped that any possible loopholes would be removed through the proposed legislation. In amending the existing Companies Act of 1995, the Bill better defined the duties of directors and also introduced new recovery provisions for companies which ran into problems.

On his part the then Opposition spokesperson and Finance Shadow Minister, Hon. Leo Brincat, observed that in view of the **Priceclub Case[208]**, there were not enough

[207] 'New insolvency and bankruptcy procedures' *Times of Malta* (18 February, 2003). Available at: <https://timesofmalta.com/articles/view/new-insolvency-and-bankruptcy-procedures.156399> accessed on 2 March 2020.

[208] Dr Andrew Borg Cardona in his capacity of liquidator in the name of and in representation of Priceclub Operations Limited vs Victor Zammit, Christopher Gauci and Wallace Fino, Court of Appeal, 19 April 2010.

safeguards for creditors. Commenting on the case[209], Brincat stated that any remedial action taken appeared to have been too little, too late. Could the authorities have acted earlier, given the rumours that had been circulating well before the collapse? The lack of proper and timely action by the then Malta Financial Services Centre was unjustified. What had happened underlined the need for the regulatory authority to be continuously on the alert especially with respect to the operation of certain companies, particularly those which issued bonds. The Bill moreover lacked measures to boost the equities market. On the proposed company recovery procedure, he[210] asked, what would happen if the company in difficulty was not in a position to deposit the required sum of money to cover the costs of the special controller or if all its assets were used as collateral? What guarantees would there be that the special controller would have no conflict of interest? Once the company recovery procedure was terminated and the special controller submitted his proposed recovery plan, who would ensure that the plan was observed and that the recommendations made by the controller were implemented?

2.2.1.6 The Code of Organization and Civil Procedure (Amendment) Act

The Code of Organization and Civil Procedure (Amendment) Act[211] was published in on 19 January 2018 and came into force on 9 April 2018. The new Court was designated as the "Civil Court (Commercial Section)". This Court has now the competence and jurisdiction to hear and adjudicate cases relating to matters governed by the Companies Act of 1995, such as bankruptcy, insolvency proceedings, and winding-up proceedings. A need for the establishment of a Court dealing exclusively with commercial matters had long been felt[212].

[209] ibid (No 183).
[210] Hon. Leo Brincat MP.
[211] Act I of 2018.
[212] 'Commercial Court Section Set Up' *Times of Malta* (23 March 2018). Available at: <https://www.timesofmalta.com/articles/view/20180323/local/commercial-court-section-set-up.674248#.WrewLJnx0Xc.gmail> accessed on 23 March 2018.

During the parliamentary debate the then Minister for Justice, Culture and Local Government Hon. Owen Bonnici stressed the importance of this Court. The Government's objective through the setting up of this Commercial Section was committed to increase the efficiency and quality of the Maltese Courts. He[213] highlighted the fact that the setting up of a section tasked with company law issues clearly crystallises this commitment in that it provides a more specialised and accessible judicial service to citizens running a business as well as companies in commercial disputes adding that, *"this augurs extremely well with the various judicial reforms which this Government is principally implementing to revitalise the justice sector, with the purpose of ensuring that our country's citizens benefit from a stronger judiciary[214]."*

On his part the then Parliamentary Secretary for Financial Services, Digital Economy and Innovation Hon. Silvio Schembri said that establishing the Commercial Court would strengthen Malta's competitiveness. He[215] augured that this new Commercial Section would decrease bureaucratic procedures for companies and make Malta a natural choice for investors in that, *"it will create greater confidence in the commercial community in view that Malta is about to explore and develop new market, including the digital and financial technology sectors.[216]"*

A Commercial Court, albeit with a different jurisdiction, had previously existed in Malta. In its absence however an informal arrangement was put in place whereby the Court Registrar on the filing of court proceedings relating to matters of company law or the winding up companies would assign such cases to the same judge. Concerns were raised amongst several bodies and international credit agencies, since in many jurisdictions having a Commercial Court is the norm and not the exception. For this reason the Government ultimately decided to act and establish

[213] Hon. Owen Bonnici MP.
[214] "Another milestone achieved through the establishment of the Commercial Court" - https://mita.gov.mt/en/ict-features/Pages/2018/Another-milestone-achieved-through-the-establishment-of-the-Commercial-Court.aspx
[215] Hon. Silvio Schembri MP.
[216] ibid (No 189).

a new Commercial division, a Court which is now competent to hear and adjudicate cases relating to matters governed by the Companies Act of 1995.

It is interesting to point out that the Civil Court (Commercial Section) is not, strictly speaking, a Commercial Court separate from the Civil Court but rather a division or section of the Civil Court, like the Civil Court (Family Section). Moreover, the cases that are assigned to this new section do not depend at all on the notions of acts of trade[217] and trader[218]. The Civil Court (Commercial Section) hears those cases *"expressly assigned [to it] by law"* and the cases that have been assigned to it are presently cases *"which relate to matters regulated by company law."* In contrast, the competence of the 'old' Commercial Court depended on whether the case was of a commercial nature which in turn depended on the notions of acts of trade and trader. Cases involving companies and maritime law litigation was also deemed to be of a commercial nature.

2.2.1.7 Legislation dealing with Lawful Causes of Preferences

The Maltese legislator has chosen to adopt a piecemeal approach on the issue of the ranking of creditors in a winding up process. Generally, these so-called lawful causes of preferences can be divided into two broad categories:

(i) The lawful causes of preference that emanate from the Civil Code[219], that is privileges and hypothecs; and

[217] Articles 5,6 and 7, Commercial Code.
[218] Article 4, Commercial Code.
[219] Chapter 16, Laws of Malta.

(ii) The lawful causes of preference under the special laws, namely:

- Employment and Industrial Relations Act[220];
- Income Tax Management Act[221];
- Value Added Tax Act[222];
- the Social Security Act[223];
- Motor Vehicles Insurance (Third Party) Risks Ordinance[224];
- Commercial Code[225];
- Merchant Shipping Act[226];
- Civil Aviation Act[227];
- Duty on Documents and Transfers Act[228];
- Companies Act 1995[229]; and
- Customs Ordinance[230].

These lawful causes of preference and their interplay with the principle of *pari passu* will be discussed in more detail in a subsequent Chapter[231].

[220] Chapter 452, Laws of Malta.
[221] Chapter 372, Laws of Malta.
[222] Chapter 406, Laws of Malta.
[223] Chapter 318, Laws of Malta.
[224] Chapter 272, Laws of Malta.
[225] Chapter 13, Laws of Malta.
[226] Chapter 234, Laws of Malta.
[227] Chapter 232, Laws of Malta.
[228] Chapter 364, Laws of Malta.
[229] Chapter 386, Laws of Malta.
[230] Chapter 37, Laws of Malta.
[231] See Chapter 3.

2.3 Introduction to the Development of Insolvency Legislation Under English Law

2.3.1 Introduction

Due to the close connection between Maltese and English law on insolvency the first reference for comparative purpose on the subject under review, concerns the development of insolvency legislation under English law. The special and peculiar nature of present day insolvency law obtaining in England and Wales could only be properly understood in relation to the way it has evolved historically. It has been noted that *"… the statutory framework relating to companies has endured a series of upheavals which make it extremely difficult even to locate all the relevant provisions let alone to understand and assimilate them*[232]*."* One of the main characteristics of this branch of English law consists of a number of basic distinctions between insolvent individuals (the law of bankruptcy) and the insolvency of artificial legal persons, chiefly companies (corporate insolvency[233]). Despite attempts to gather together the disparate elements that have remained between the two for the sake of clarity and coherence, the division persists. The emphasis here is on the latter aspect, namely corporate insolvency. Although the greater part of corporate insolvency law is statutory, there are certain regimes governed wholly or partly by common law principles and by the inherent jurisdiction of the court. Until the passing of what is now the Insolvency Act 1986, the law relating to receivership of companies was almost wholly based on contract and on rules developed by the Courts. Though the powers and principal obligations of administrative receivers are now codified in the 1986 Act, much of receivership law continues to be based on common law principles.

[232] Geoffrey Morse, *Charlesworth's Company Law* (13th edn, Stevens & Sons 1987).
[233]Catherine Bridge, *Insolvency – A second chance? Why modern insolvency laws seek to promote business rescue* (Law in transition 2013) pp. 33-34.

2.3.2 The Impact of Legislative Developments on the *Pari Passu* Principle

The Bankruptcy Act 1542 introduced the modern principle of *pari passu* in England. The assets were to be sold to pay the creditors "a portion, rate and rate alike, according to the quantity of their debts". It has long been felt that the justification for the principle is its economic efficiency, in the sense that it reduces strategic costs and increases the aggregate pool of assets through the collectivity of dealings. In essence, bankruptcy law in England may be said to have begun as a debt-collection device for creditors and early English statutes were all directed at strengthening the hand of the creditors and increasing their chances of being paid, not at providing relief for debtors[234]. This said, the 1542 Act still reflected the ancient notion that people who could not pay their debts were criminals, and consequently required debtors to be imprisoned - *"a stigma which was to endure until relatively recent times and one which has not yet been totally relinquished[235]."*

Another key milestone in corporate insolvency is to be found in the nineteenth century developments in company law. In this respect, Mr Justice Briggs' comments on the development of the *pari passu* principle in **Bloom & Ors v. The Pensions Regulator**[236] are very apt,

> *since the mid-nineteenth century, a succession of Bankruptcy and Insolvency Acts have sought to establish a wide and inclusive definition of claims qualifying for pari passu treatment, by providing that provable debts and liabilities, and to extend to debts and liabilities which are, at the cut-off date, both present, future and contingent.*

The Court drew an important distinction between personal bankruptcy in contrast to corporate insolvency. In the case of personal bankruptcy, the underlying policy is not merely that creditors should be fairly treated *inter se*, but that the bankrupt should receive as full as possible a discharge from his debts. By contrast, in

[234] D G Baird, 'A World Without Bankruptcy' in J. Bhandari and L. Weiss (eds) Chapter 4 *Corporate Bankruptcy* (1996).
[235] Ian Fletcher, *The Law of Insolvency* (Sweet & Maxwell, 2002) pg. 6-8.
[236] [2013] UKSC 52.

corporate insolvency the requirement for the fair treatment of the company's creditors is sharpened by the fact that, save in exceptional cases, the company will be dissolved at the end of the insolvency process so that if a claim is not subjected to *pari passu* treatment it would not be paid out at all. The Court also outlined important criteria to be satisfied in order for a claim to qualify for *pari passu* treatment it must be a "provable debt" meaning one which arises from *"…matters which have occurred, or have begun to occur, prior to the cut-off date*[237]*."*

The notion of fair treatment of creditors tallies perfectly with the observations made by the First Court in the **Priceclub case**[238] with regard to the fiduciary duties owed by directors towards creditors. Mr Justice Mallia[239] quotes Andrew Keay who observes that,

> *unsecured creditors are protected only by contractual rights, but when companies are financially stressed there are, arguably, cogent arguments that their position warrants some form of fiduciary protection, whereby directors become accountable principally to creditors*[240]*.*

The reason given for this is that, if the company is insolvent or imminently likely to become so, the interests of the company are in reality the interests of existing creditors alone. At this point the creditors are considered to be the major stakeholders in the company because the company is effectively trading with the creditors money and as a result the directors have an obligation not to sacrifice creditor interests[241]. The Court concluded that the respondent directors had breached their duties owed to the creditors and were guilty of wrongful trading and fraudulent trading.

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[237] *Bloom & Ors v The Pensions Regulator* [2013] UKSC 52.

[238] Dr Andrew Borg Cardona in his capacity of liquidator in the name and in representation of Priceclub Operators Limited vs Victor Zammit, Christopher Gauci and Wallace Fino, Court of Appeal, 19 April 2010.

[239] Ibid (No 213).

[240] Andrew Keay, 'Directors Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over Protection of Creditors' (September 2003) MLR 66:5, pp. 665-699.

[241] Ibid (No 215).

2.3.3 The Joint Stock Act, 1844 up to the development of a Companies Act

The Joint Stock Act, 1844 established the company as a distinct legal entity but it still kept unlimited liability for the shareholders. From 1844 onwards corporate insolvency was dealt with by means of special statutory provisions. Among these we find the Companies Winding Up Act, 1844, the Joint Stock Companies Act, 1856, the Companies Act, 1862, the Companies (Consolidation) Act, 1908, and the Companies Act of 1929, 1948 and 1985. Only from 1855 onwards was the concept of the limited liability of members of the debts incurred by the company established in law. Members of incorporated companies could limit their personal liability, thus creating a distinction between corporate and individual insolvency.

Soon after the Companies Act of 1862, there followed company law enactments which *inter alia* provided for *pari passu* distribution[242]. But again there was a limitation in that the Companies Act, 1862 was restricted to voluntary winding up. It was apparently assumed that the court would exercise its powers to produce a similar result. Winding up expenses, including the remuneration due to the liquidator were made payable, from the very outset, in priority to the claims of other creditors – a rule which remained in practice to this day[243].

2.3.4 The Insolvency Act, 1986 and Insolvency Rules, 1986

The English Courts had the opportunity to provide an insightful and detailed analysis of the broad objectives of corporate insolvency in the **Lehman Brothers case**[244]. The 1986 Act and the 1986 Rules were introduced following the publication of the

[242] Section 133(1), Companies Act, 1862.

[243] Roy Goode, *Principles of Corporate Insolvency Law* (4th ed, Sweet & Maxwell 2011) p. 12.

[244] The Joint Administrators of LB Holdings Intermediate 2 Limited (Appellant) v The Joint Administrators of Lehman Brothers International (Europe) and others (Respondents) The Joint Administrators of Lehman Brothers Limited (Appellant) v Lehman Brothers International (Europe) (In Administration) and others (Respondents) Lehman Brothers Holdings Inc (Appellant) v The Joint Administrators of Lehman Brothers International (Europe) and others (Respondents) [2017] UKSC38, 17 May 2017.

"Report of the Review Committee on Insolvency Law and Practice"[245] in 1982. A Government White Paper[246] issued in 1984 outlined the main objectives of the reform as follows:

(i) to establish effective and straightforward procedures for dealing with and settling the affairs of corporate and personal insolvents in the interests of their creditors; and

(ii) to introduce a new insolvency mechanism, known as the administrator procedure, designed to facilitate the rehabilitation and re-organisation of companies faced by insolvency but where there are reasonable prospects for a return to profitability.

The 1986 legislation consolidated in a single statute and set of rules the legislative provisions regarding both personal insolvency and corporate insolvency. Until then they had been dealt with in separate legislation namely the Bankruptcy Act 1914 and the Bankruptcy Rules 1952[247] which covered personal insolvency and the Companies Act 1948 and the Companies (Winding-Up) Rules 1949[248], which applied to corporate insolvency. Nonetheless, the 1986 legislation contains almost entirely separate regimes for personal insolvency and corporate insolvency.

The Insolvency Act, 1986 and Insolvency Rules, 1986 represent a comprehensive overhaul of the insolvency legislation, adding new procedures and new rules and rewriting many of the established procedures and rules. It is relevant to point out that fundamental principles apply just as they always have done - the *pari passu* principle is an obvious example.

[245] (Cmnd 8558) (the Cork Report).
[246] Department of Industry and Trade, *A Revised Framework for Insolvency Law* (Cmnd 9175, 1984).
[247] (SI 1952/2113).
[248] (SI 1949/330).

It is an established fact that the doctrine of precedent has a significant part to play in this area of law too. Recently invoked examples include the anti-deprivation principle[249], the rule against double-proof[250], the rule in **Cherry v Boultbee**[251] regarding certain rules of fairness[252]. In **re Nortel GmbH**[253] the priorities in relation to such payments by a liquidator or by an administrator were summarised. Essentially it was stated that in a liquidation of a company, in accordance with insolvency legislation as interpreted and applied by the Courts, the order of priority for payment out of the company's assets is as follows:

(1) Fixed charge creditors;
(2) Expenses of the insolvency proceedings;
(3) Preferential creditors;
(4) Floating charge creditors;
(5) Unsecured provable debts;
(6) Statutory interest;
(7) Non-provable liabilities; and
(8) Shareholders.

The above hierarchy ranking of creditors is known as the waterfall and it can be taken as a generalised summary of the distribution priorities in insolvency procedures.

2.3.5 Rescue Focused Legislation

The second half of the twentieth century saw the introduction of more rescue focused legislation not only in England but throughout Western Europe. This development reflected widespread recognition of the economic benefits of corporate rescue, as compared to alternative strategies. Until 1986, corporate

[249] *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2012] 1 AC 383.
[250] *Re Kaupthing Singer & Friedlander Ltd (in administration) (No 2)* [2012] 1 AC 804, paras 8 to 12.
[251] (1839) 4 My & Cr 442.
[252] *Re Nortel GmbH* [2014] AC 209, para 122.
[253] [2014] AC 209, para 39.

insolvency was to remain governed mainly by successive Companies Acts, the last of these being the Companies Act of 1985. In that same year the new Insolvency Act was enacted. One of the reforms introduced by the 1986 legislation and foreshadowed by the White Paper concerned the administration procedure, as part of the so-called rescue culture which, in turn, has been described as *"a philosophy of reorganising companies so as to restore them to profitable trading and enable them to avoid liquidation*[254]*."*

The 1986 legislation brought into force two new corporate rescue procedures, namely the "company voluntary arrangement" and administration. Following the recommendations of the Insolvency Law Review Committee under the chairmanship of Sir Kenneth Cork, the Insolvency Act 1985 made substantial changes to insolvency provisions of the Companies Act of 1985. The 1982 Cork Report[255] had held that one of the aims of a good modern insolvency law was, *"to provide means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country".*

Nevertheless the take-up of the new corporate rescue procedures under the new regime was deemed by many as being disappointingly low[256]. The appointment of an out-of-court "receiver" to realize any security over the debtor and the debtor's property (including its business) continued to be used by secured creditors, as an alternative to liquidation. Although receivership was recognized as having facilitated the rescue of many businesses, the focus of the new regime had shifted to the broader platform of rescue of the company as a whole[257]. Once again, it is

[254] Roy Goode, *Principles of Corporate Insolvency Law* (4th ed., Sweet & Maxwell 2011) para 11-03.
[255] Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982).
[256] See Official Statistical, Companies Register Activity: 2019–2020, Company House published on 25 June 2020: Although take up of recovery procedures was low by contrast in the period 2019 to 2020, there were 536,934 dissolutions in the UK, a year on year increase of 5.5%. This is the largest number of dissolutions since 2009 to 2010. However, this was influenced by figures relating to the end of the financial year. During March 2020, the number of dissolutions increased considerably when compared with March 2019. The said increase in March 2020 coincides with the emergence of the coronavirus (Covid19) pandemic.
[257] Catherine Bridge, *Insolvency – A second chance? Why modern insolvency laws seek to promote business rescue* (Law in transition 2013) pp. 33-34.

evident that the "rehabilitative" aspect has in time gathered momentum and garnered more support by the powers that be. In 2001 the UK government issued a Report called "Productivity and Enterprise: Insolvency – A Second Chance[258]" wherein it argued that companies in financial difficulties should not be given a second chance while in the case of "honest individuals" these should be granted a fresh start.

The Insolvency Act 1986 was further amended by the Insolvency Act 2000, which introduced new provisions on voluntary arrangements and moratoria and amended the provisions of the Company Directors Disqualification Act 1986 on the disqualification of directors. Significantly, the Enterprise Act 2002 expanded the "administration" procedure, with the objective of making it the main collective corporate insolvency rescue procedure[259]. The series of reform proposals contained in the 2001 Report[260] formed the basis for the 2002 European Act, which sought to encourage productivity and entrepreneurship through changes to UK insolvency and competition law.

2.3.6 The Insolvency Rules, 1986

The Insolvency Rules 1986 and some free-standing provisions in the amending legislation complement the whole body of laws. The Rules were enacted to provide the procedural underpinning of the Insolvency Act. Due to the fact that the Act itself contains various procedural requirements whereas the Rules contain some substantive provisions, the division between Act and Rules is not clear-cut. Incidentally, this lack of clarity in rational structure in English insolvency has attracted adverse criticism. Goode[261] comments that whereas a number of provisions of the Insolvency Act, 1986 regulate procedural matters, such as the summoning of meetings and the contents of reports, other important substantive

[258] Insolvency Service, *Productivity and Enterprise: Insolvency – A Second Chance*? (Cm. 5234, July 2011).
[259] Ibid. (No 233).
[260] Ibid. (No 233).
[261] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011).

rights, such as what debts are provable, set-off in winding up and priority rules for the payment of liquidation expenses are delegated to the Insolvency Rules.

The new Insolvency Rules (England and Wales) 2016 were adopted on 6 April 2017, along with the insolvency parts of the Small Business, Enterprise and Employment Act 2015. In terms of the new rules the insolvency forms for the Registrar of Companies are no longer prescribed by insolvency legislation, instead their format, style and content are now under Companies House documents. This change resulted in Companies House producing brand new forms for all aspects of corporate insolvency. The trend adopted by successive UK governments is to promote business rescue[262]. Perhaps the most ground-breaking reform involved the removal of "crown preference" in 2003 and the introduction of the prescribed part fund. Before the enactment of the Enterprise Act 2002 the Crown recovered some GBP 60-90 million of preferential debt in insolvencies each year[263]. The benefits of abolishing the Crown preference towards unsecured creditors was ably summarized as follows, *"[a]t the time of the Enterprise Act 2002, the abolition of Crown Preference was one side of a balance between secured and unsecured creditor interests; the other was the introduction of the "prescribed part" (a reserved amount for unsecured creditors)[264]."* Other countries (for example, Germany, Austria, Canada and Australia) were ahead of the UK in either abolishing or severely restricting revenue authorities' priority[265].

The effect of this abolition in practice means that the government's preferential status for unpaid taxes of an insolvent company was removed. The main aim of this

[262] C Boyne, A J Davies, G Kittredge, P Volhard, 'European Funds Comment: Giving Priority to Tax in UK Insolvency Law' (27 September 2019): <https://www.debevoise.com/insights/publications/2019/09/tax-in-uk-insolvency-law> accessed on 19 October 2019.

[263] Insolvency Service, 'A Review of Company Rescue and Business Reconstruction Mechanisms' (DTI, London, September, 1999).

[264] 'Days of future past: the reintroduction of Crown Preference' (04 March 2019): < https://www.cms-lawnow.com/ealerts/2019/03/days-of-future-past-the-reintroduction-of-crown-preference?cc_lang=en> accessed on 20 March 2019.

[265] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press 2002).

reform was to ensure that as much as possible businesses remain afloat. This reform will be considered in further detail at a later stage. Such a measure is most definitely in line with the justifications underpinning the *pari passu* principle – as diminishing the lawful causes of preferences in turn increases the pool of assets available to the unsecured creditors. Put simply, the government now ranks together with the other unsecured creditors in the so called "prescribed part". Through this system a portion of the available assets of distribution are ring-fenced giving them priority over some secured creditors. The ceiling or maximum amount of ring-fenced assets is prescribed by law. This capping enables lenders to assess the impact it could have on their recovery.

However this small triumph for unsecured creditors was short-lived as the UK Government pledged to reintroduce an amended version of this rule. This is largely due to the fact that UK Government lost a significant amount of revenue from this change in the law. In view of a general feeling of uncertainty facing business in the UK, it is felt that the reintroduction of the crown preference, albeit an amended version of the original preference, is ill-timed.

The Government's secondary preferential creditor status will apply for debts relating to Pay As You Earn (PAYE), Value Added Tax, employee National Insurance Contributions and Construction Industry Scheme Deductions. The rationale is that this tax revenue, which has already been paid to, or reserved by, the company with the intention of it being paid to the Government (but for the insolvency), should be used as always intended, that is to fund public services. The rules concerning debts relating to Income Tax, Capital Gains Tax, Corporation Tax and Employer National Insurance Contributions remain unchanged under the new legislation.

The proposed re-introduction of the Crown privilege has raised a number of questions upon the control of insolvency processes. Under the system in place, that is pre-amendments, the unsecured creditors could control in general the approval of proposals and remuneration in administration and liquidation, unless (in administration) there will only be a return to secured and preferential creditors.

Secured creditors also have limited approval powers in liquidation. A burning question remains to be answered as to what will happen if there will be no return, other than to secured and preferential creditors, will this lead to the Crown having an enhanced level of oversight and control in the management of insolvency cases generally? The issue has always been that of trying to balance the competing interests in an insolvency scenario. This has always been a difficult predicament and the fact that a decision was made to abolish Crown Preference in 2003 does not mean that it can withstand the test of time.

2.3.7 Brexit and the development of Corporate Insolvency Law

The way forward with regard to the development of UK corporate insolvency and restructuring legislation is uncertain in view of the Withdrawal Agreement which formalized Brexit. Why is it relevant? Suffice it to say that London is an internationally recognized forum of excellence in restructuring. Thus the attractiveness offered by the UK corporate insolvency and reorganizing system ought to be preserved in a way that would ensure that benefits continue to exist post-Brexit, while working to make their insolvency and restructuring framework even more resilient and responsive.

During the duration of the agreed transition period ending on 31 December 2020 (which may be extended further), EU law will, subject to certain limited exceptions, continue to apply to the UK. However during this transition period the UK will not participate in EU institutions and decision-making. Having said this, the jurisdiction held by the Court of Justice of the European Union will subsist. But the UK will not be a Member State, international agreements between the EU and third countries will no longer apply to the UK. In respect to UK and EU cross-border restructuring and insolvency, the *status quo* is in effect retained throughout the transitional period. This effectively means that the EU Regulation[266] on insolvency proceedings

[266] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015.

continues to apply to the UK[267]. Similarly other related laws such as Brussels I (recast) on jurisdiction, the Rome Regulations on governing law and the Lugano Convention are still applicable. It will be most interesting to see what actually happens following the end of the transition period.

More importantly from our standpoint is the realization that, as MEP Alfred Sant pointed out, "a No-Deal Brexit would have a serious impact on EU member states like Malta"[268]. During a conference on the future of the Eurozone, Dr Sant said that a No-Deal Brexit, *'will likely have negative effects on Ireland, Holland, Malta and Belgium.*' He explained that at the current time, there are diverging opinions on where Europe goes from here: the first option being a federalised Europe favoured by Germany with the same rules for all EU member states. The second alternative is the necessity for a 'Europe of nations'. This latter approach, he states, is favoured by countries like Italy and France.

The fact that the UK will no longer be on the negotiating table with other Member States may have an impact on the future development of European Union Corporate Insolvency and Re-Organisation legislation. The truth of the matter is that previously Malta had an ally in the UK seeing that they both have a similar approach with respect to insolvency law and this position is set to change. It remains to be seen with the greater influence exercised by Germany and Italy how and in which direction this area of the law will develop.

[267] see Article 67(3) of the Withdrawal Agreement.

[268] Gordon Watson, 'No-Deal Brexit will have a serious impact on Malta – Sant' *Newsbook* (21 January 2019): <https://www.google.com.mt/search?q=malta+and+brexit&ei=6_ovXrj-C4PDwAL3y4Rw&start=10&sa=N&ved=2ahUKEwj4n93zaXnAhWDIVAKHfclAQ4Q8tMDegQIDBAx&biw=1280&bih=720> accessed on 4 March 2019.

2.4 Salient Legislative Milestones in Italian Bankruptcy Law with particular reference to the principle of *par condicio creditorum*

2.4.1 Introduction

Given the geographical proximity, close historical ties, cultural and commercial connections between Malta and Italy, it is hardly surprising that we find converging aspects in the legal sphere as well. In 1852 Sir Adrian Dingli, an eminent Maltese jurist, was instrumental in the enactment of a number of Codes which included the Code of Organisation and Civil Procedure, the Criminal Code and the Code of Criminal Procedure. Dingli drew extensively from other continental Codes, including those of neighbouring Italian States and in particular of the Kingdom of the two Sicilies. In 1907 another Maltese jurists Paolo DeBono published a set of notes[269] on the law of bankruptcy in Malta in Italian. Up to the mid-thirties the language used in the Maltese Courts and among members of the legal profession was Italian. The recent striking reforms undertaken in Italy in the law of bankruptcy and insolvency involved a complete overhaul of the Italian system. The strong commercial relations between the two countries makes Italy an obvious and ideal choice for the purpose of analysis and comparison.

2.4.2 Italian Bankruptcy Law of 1942 and the *par condicio creditorum*

For decades the legal framework embodying insolvency procedures in Italy was chiefly found in the Bankruptcy Law of 1942[270]. The enactment of this important piece of legislation during a war period is steeped in history. The year 1942 was an important landmark in the evolution of Italian law and in some respects the beginning of a new era[271]. Up to that date the main sources of Italian law, similarly to Malta, were the so-called "Five Codes" namely:

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[269] Paolo Debono, *Appunti di Lezioni sul Fallimentoi nel Diritto Maltese* (*Seconda Edizione Riveduta, Ampiata e Corretta* 1907).
[270] RD 267/2942.
[271] S A Riesenfeld, 'The Evolution of Modern Bankruptcy Law' (1947) Minn. Law Review, 2337, Vol. 31 p. 401.

i. the Civil Code of 1865;
ii. the Code of Commerce of 1882;
iii. the Code of Civil Procedure of 1865;
iv. the Penal Code of 1930; and
v. the Code of Criminal Procedure of 1930.

The need for reform especially with respect to the Codes dealing with private law had long been felt. A complete change occurred in 1942 wherein a new Civil Code and a new Code of Civil Procedure came into force. The Code of Commerce was abolished and instead two new bodies of law were enacted namely, the Code of Navigation and the Bankruptcy Act of 1942.

The Italian bankruptcy law before the reform was contained in Book III, Titles 1-6 of the Commercial Code of 31 October, 1882, which was modelled on French law. In 1903 a statute was enacted which provided for compositions to prevent bankruptcy and for special bankruptcy proceedings applicable to small merchants. The complete overhaul of the Commercial Code continued until the First World War and was resumed with greater energy after peace was restored. Reform of the bankruptcy law was again commenced with fresh vigour. It resulted that bankruptcy law was the only remaining portion of the old Commercial Code not to be allocated to some specialised legislation. Thus the Italian legislator opted not to include it in the Civil Code or the Code of Civil Procedure. Instead it was decided that it was best to design a separate act covering the whole law pertaining to the financial crisis of an enterprise as dictated by the exigencies of the national economy. This led to the adoption of the Bankruptcy Law of 1942 which has withstood the test of time and will only be subject to major changes in 2020.

A key principle found in Italian Bankruptcy Law is the *par condicio creditorum*, commonly known as the equal treatment of all creditors[272]. This is manifested in practice principally in those provisions blocking the executive and precautionary actions (art. 51 and art. 168). Additionally, by virtue of a so-called *concordato con riserva*, which essentially is an arrangement with the creditors, it is now possible to further safeguard the debtor company's assets from the individual creditor enforcement action in the interest of all the creditors and through which the latter could have their claims paid out. In the same vein, reference is to be made article 44 which serves to render ineffective those acts and payments made by the bankrupt person following a declaration of bankruptcy.

2.4.3 A complete overhaul of Italian Insolvency Law: "Crisis and Insolvency Code"

After almost eighty years from the Bankruptcy Law of 1942 it was felt that the time was ripe for Italy to replace its Bankruptcy Law which was past its date. As a result, a comprehensive reform of Italian insolvency law was carried out. The truly significant amendments include *inter alia* provisions on early warning mechanisms, pre-insolvency and insolvency out-of-court procedures and plan proceedings, moratoria, liquidation proceedings, group insolvencies and debtors' over-indebtedness[273].

In 2019 the Crisis and Insolvency Code[274] was launched into the Italian Legal system in lieu of the previous Bankruptcy Law[275]. Initially set for August 2020 the new Italian law on insolvency and pre-insolvency proceedings entitled Code of Enterprise Crisis and Insolvency is now scheduled to come into force on 1 September 2021. The date has been postponed due to the outbreak of the Covid19 pandemic.

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[272] Gaetano Fiorelli and Eliana Maria Fruncillo, *Insolvency Law, Policy and Procedure, Italy* (5th edn, Insolvency Review 2017).

[273] Renato Mangano, 'A comprehensive reform of insolvency law in Italy' (1 April 2019) Oxford University Business Law Blog - <https://www.law.ox.ac.uk/business-law-blog/blog/2019/04/comprehensive-reform-insolvency-law-italy> accessed 5 May 2019.

[274] Legislative Decree n. 14/2019

[275] RD 267/2942.

However, the articles concerning the changes of the Italian Civil Code related to directors' liabilities is already in force[276]. The main objective of the New Insolvency Code is to move away from the dissolution and winding up of failed or failing enterprises from the market towards the maintenance of goodwill and avoidance of the loss of value that results from liquidation. In general therefore, the new legislation seeks to prevent insolvencies by providing support to companies in financial distress. One way of achieving this is by promoting sound business principles to the management of the company in a state of "crisis". The term "crisis" is legally defined for the first time as a flexible concept: the state of being in a dire financial situation which will in all probability lead to a state of insolvency.

An important new duty incumbent on a director is the responsibility to ensure that the company has an accounting and administrative structure in place that will enable any potential financial crisis or issues to be flagged early enough so that the situation may be effectively addressed. This means that directors that are entrusted with management-related responsibilities will have to take on certain responsibilities beyond pure management, including duties relating to active participation in activities of a corporate compliance nature and others relating to control and supervision. The reforms provide for a number non-judicial procedures aimed at facilitating the handling of negotiations between the business in distress and its creditors[277].

2.4.4 Criticism of the Italian insolvency law which gave rise to significant developments in the field

Critics of the prevailing law in Italy highlighted the fact that *"the discipline presently in force evidences a lack of sensibility to the social and economic effects that the winding up of an entrepreneurial activity might trigger (for example, risks of*

[276] Massimo Di Terlizzi, *Corporate Recovery and Insolvency – Italy* (International Company Legal Guide, 2018).

[277] Cecilia Buresti & Piermaurizio Tafuni, 'New Italian insolvency law will impact D&O coverage' (November 2019) - <https://www.nortonrosefulbright.com/en-pk/knowledge/publications/bebe1bdb/02-new-italian-insolvency-law-will-impact-d-o-coverage> accessed 25 January 2020.

propagation of the bankruptcy in the financial system, negative impacts on connected enterprises, social problems originated by the employees' lay-off etc.[278])" Indeed it has been observed that with the first Italian Bankruptcy Law, bankruptcy in Italy was considered *"an indelible social stain and the returning in bonis was considered difficult to implement and socially unacceptable[279]."* This resulted in a legal system that was not particularly interested in the recovery of the debtor.

During the past decade some additional alternatives were introduced such as out-of-court arrangements with the aim of assisting companies in financial distress. These alternative methods contrasted with the traditional arrangements in Italy which were formal in that they required judicial proceedings or the intervention of other competent public authorities[280].

2.4.4.1 Italian Law Decree no. 347/2003 known as the Marzano Law

In 2003 the so-called Marzano law[281] was enacted in the aftermath of the **Parmalat[282]** collapse and later amended in order to address the insolvency status of certain **Alitalia** group companies[283]. The Parmalat scandal is an important insolvency case study in Italy with liabilities amounting to billions of Euros and thousands of creditors. Basically Parmalat, a major Italian company "discovered" that it had a fourteen billion euro (€14bn) black hole in its books. It collapsed virtually overnight. The Parmalat scandal sent shock waves throughout the financial world.

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[278] 'Bankruptcy and a fresh start: stigma or failures and legal consequences of bankruptcy – Italy' International Insolvency Institute, - <https://www.iiiglobal.org/sites/default/files/report_ita.pdf> accessed 8 April 2020.

[279] Massimo Di Terlizzi, *Corporate Recovery and Insolvency – Italy* (International Company Legal Guide, 2018).

[280] Gaetano Fiorelli and Eliana Maria Fruncillo, "Insolvency Law, Policy and Procedure, Italy", (Insolvency Review Edition 5th edn, Insolvency Review published November 2017).

[281] Law Decree no. 347/2003.

[282] P Manganelli, *'Da Parmalat ad Alitalia: strumenti di gestione della crisi d'impresa'*(DPS, 2008, n. 23, 24).

[283] That is, Alitalia – Linee Aeree Italiane S.p.A., Alitalia Express S.p.A., Volare S.p.A., Alitalia Servizi S.p.A. and Alitalia Airport S.p.A; See Gianni, Origoni, Grippo & Partners, "The new extraordinary administration proceedings for large insolvent companies in Italy" - <http://www.gop.it/doc_pubblicazioni/19_kdnktppfn9_ita.pdf>.

The devastating effects of the Parmalat fiasco were felt mostly in Parma with many pensioners losing virtually all their money but its effects rippled across the globe. It transpired that the company was the victim of a vast fraud. A complex web of worldwide transactions were involved that misled the market and investors about the true value of the company and its share price. The company was founded in the 1960s. It had operation base spread all over the world and reported revenues of €7.5bn in the months before it collapsed. However, the management of Parmalat entangled its business in an array of borrowings, false accounting and misleading reports to investors and regulators. This was merely a smoke screen to conceal accumulating losses that were the result of a series of expensive acquisitions after Parmalat went on a buying spree in the 1990s. A significant number of acquisitions were financed by bond issues underwritten by the leading investment banks. Within a few years it came crashing down[284]. Its ramifications were also felt in Malta since Parmalat SpA set up three companies, Parmalat Malta Holding Limited, Parmalat Trading Limited, which were Maltese companies and Parmalat Capital Finance Limited, which was registered in Malta and was the owner of a subsidiary in the Cayman Islands[285]. Parmalat has since reinvented itself. An Italian government as administrator has now been appointed to run the company's affairs. The saga of its collapse and the repercussions of the biggest fraud scandal at a European company continue to baffle and fascinate in equal measure.

The handling of the case was heavily criticized by a number of law experts. Essentially, the *lacunae* found in Italian Bankruptcy Law at the time were threefold[286]. Firstly, the creditors were deprived of their rights to pursue their claims. Secondly, the creditors could not participate in the extraordinary administration of the company. Thirdly, the *modus operandi* as provided by law was deemed to be too bureaucratic, too complex and expensive for the creditors.

[284] Vincent Boland, 'The saga of Parmalat's collapse' *Financial Times* (19 December, 2008) - <https://www.ft.com/content/c275dc7c-cd3a-11dd-9905-000077b07658> accessed 8 April 2020.
[285] Julian Manduca, 'Directors of Malta based Parmalat companies arrested' *Malta Today* (4 January 2004).
[286] Lucio Ghia, 'The Italian legislation provided for the Parmalat case under a critic point of view' International Insolvency Institute) - < https://www.iiiglobal.org/sites/default/files/7-_parmalat.pdf>.

Through a series of substantive and procedural reforms starting from 2003 there has been a shift of focus of the legislator towards the recovery of the debtor by emulating the mechanism of the so-called "second chance" which originated in the United States. The subsequent reforms until 2012 had as their aim the recovery of the debtor's productive capacity through composition with creditor also "in blank[287]", which facilitated the continuation of the business activity with the further possibility, through these composition, to split the debtors into classes. In addition, the legislation implemented the so-called "certified" restructuring plans and debt restructuring agreements that are independent of court intervention during the formation phase. The reforms enacted from 2013 to 2015 introduced instruments aimed at the interests of the creditors in the context of the composition with creditors, such as minimum payment thresholds, "concurrent bids" and specific informational obligations, in particular in the "blank arrangements". The law now seems to provide a more flexible regime for companies under extraordinary administration and wider powers to the extraordinary commissioner in order to meet the needs of the reorganization and restructuring of the insolvent companies[288].

2.4.4.2 Law 155/2017 for the reform of business crisis and insolvency regulations

In light of another reform of 2017, the system in its complexity seems to have reached a point of balance between the protection of the interests of creditors and interests of the debtor in the continuation of the business activity[289]. As a result of Law 155/2017, a process of reforms of insolvency and business crisis was initiated with respect to the Italian Law on Bankruptcy with particular reference to corporate

[287] "concordato preventivo in bianco" which may be explained as the proposal of a plan to the creditors, but with reservation of filing the documents and declaration by a deadline which the Court will assign. The debtor may assess and negotiate a plan by said deadline, possibly also converting the same into a debt restructuring agreement.
[288] International Comparative Legal Guide (ICLG), 'The International Comparative Guide to Corporate Recovery and Insolvency 2019 – Italy' (13th edn 2019).
[289] Massimo Di Terlizzi, '*Corporate Recovery and Insolvency – Italy* (International Company Legal Guide 2018).

rescue and insolvency regimes. Some of the key elements of the proposed reform consist of the following[290]:

1. The term "bankruptcy" was replaced by the phrase "judicial liquidation";
2. The novel notion of "state of crisis" was introduced and defined as the probability of future insolvency;
3. The state of crisis or insolvency was made applicable to every category of debtor namely, a natural or legal person, a collective body, a consumer and any company, with the exclusion of public bodies only regulating the different possible outcomes separately;
4. The concept of the debtor's "centre of main interests" derived from European Union law was incorporated;
5. The notion of group of companies was introduced;
6. The promotion of debt restructuring agreements and recovery plans was improved;
7. The provisions dealing with compositions with creditors and the "new" bankruptcy were changed; and
8. Finally, some additional changes to the compulsory administrative liquidation were made.

In order to restructure a company in distress, the Italian system provides a number of options:

1. Pre-bankruptcy proceedings: a certified restructuring plan ("*piano di risanamento"* – art. 67 of the Bankruptcy Law) and a debt restructuring agreement – art. 182).

[290] Ibid (No 263).

2. Procedures that are yet to go bankrupt: agreements with creditors (*"concordato preventivo"* – art. 160 *et seq.)* aimed at rescuing or winding up the company; and

3. Bankruptcy (*fallimento* – art 5 *et seq.* of the Bankruptcy Law), bankruptcy agreement (*concordato fallimentare* – art. 124) and compulsory administrative liquidation ("*liquidazione coatta"* – art. 124 *et seq.*).

A Certified Restructuring Plan ("*piano di risanamento"* – art. 67) is a private agreement between the debtor and the creditors and is so named because it has to be certified by an independent expert, who guarantees the feasibility and truthfulness of the plan. In this process the Court is not involved. Only the payments and, in general the transactions made in accordance with the certified plan, are not subject to claw back actions.

Debt Restructuring Agreements ("*accordo di ristrutturazione del debito"* – art. 182 *bis*) are agreements aimed at allowing a debtor in financial difficulties to restructure his debts and obtain protection against creditors, through the validation by the Court of an agreement made at least with sixty percent (60%) of the creditors. This is a private negotiation between the debtor and its (in the case of a company) creditors. The competent Court is involved only at the end of the negotiation process to obtain the validation of the restructuring agreement. The application for the validation must include a fairness opinion by an independent expert concerning, among others, the reasonableness of the restructuring agreement in order to ensure full payment of any creditor who is not a party to the agreement. The said creditors have to be paid within (i) 120 days from the validation of the agreement in case of expired credits; or (ii) 120 days from the expiration of the credits in case these credits have not expired at the date of the validation of the agreement. For companies that have, debts with banks and/or other financial operators, it is possible to enter an agreement with part of such creditors in order to delay the

payment of their credits; such agreements are also binding for those creditors that have not entered into them (so-called “stand-still agreements”).

Before a restructuring agreement is signed, it is always possible for the company to block any individual action by the creditors by filing an application with the Court including (1) the proposal of the restructuring agreement; (2) an affidavit certifying the ongoing negotiations with creditors; and (3) fairness opinion by an independent expert confirming the suitability of the proposed agreement. After the validation of the agreement any dissenting stakeholder that has not entered into the agreement may file an opposition against the agreement.

2.4.5 Conclusions

In conclusion, one could safely say that the radical change undertaken in Italy of its bankruptcy law is impressive. More especially when one keeps in mind that the new law truly embraces the ethos predominant in modern insolvency law that promotes a culture of business rescue. How does all this impact on the *pari passu* principle? The fact that businesses will effectively be given a second chance it is probable that the number of creditors will possibly decrease. In turn if there is an insolvent liquidation at a later stage the pool of assets available to unsecured creditors will most likely increase.

Nonetheless the efficacy in practice of the new Italian insolvency regime is yet to be fully tested over the years. In any case, it should definitely serve as an inspiration to the Maltese legislator when embarking on a much needed reform of Maltese corporate insolvency law.

2.5 Harmonisation with European Union Law

Having gone through the position in Malta, England and Italy, we now pass on to consider Malta's position within the European Union. Although we have highlighted the importance given to decisions taken by the English Courts in the matter of insolvency, at the same time Malta must still fulfil its obligation as a Member State of the European Union with regard *inter alia* to insolvency and restructuring of companies. With Malta's accession to the European Union on 1 May, 2004 it became necessary to take an active consideration of existing of European Union legislation in order to fall in line with it as much as possible and within a reasonable time period. Moreover, the evident and, I would say necessary interaction between Maltese and EU legislation, beckons for an examination of the impact that EU law was going to have on domestic insolvency law.

At present, there is no codified European company law as such. What this means in practice is that Member States continue to operate with separate corporate legislation, which are to be amended in order to comply with EU directives and regulations on the subject. The chief objective of the European Union harmonisation of company law legislation is to establish a *"modern and efficient company law and corporate governance framework for European undertakings, investors and employees aim to improve the business environment in the EU."*[291]

The nature of European insolvency law is such as to raise a considerable number of issues – including priorities of creditors and social security matters[292]. What the process integration of the internal market on a European Union level requires, *"a coherent, harmonised body of insolvency law, capable of addressing the cross-border implications of corporate insolvencies[293]".* Manfred Balz, who is one of the

[291] European Parliament, Fact Sheets on the European Union: http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuId=FTU_2.1.11.html> accessed 2 June 2020.
[292] Emilie Ghio, 'Case Study on Cross-border Insolvency and Rescue Law: an Analysis of the Future of European Integration' [2017] 20 (1) IJEL.
[293] Ibid.

drafters of what is now the European Insolvency Regulation 2000[294], observed that a ‘*‘functioning bankruptcy system is essential to any economy that aspires to achieve the freedoms of establishment of business and the free flow of goods, services and capital, and to integrate national markets into a unitary internal market[295].”*

One also finds some important European legal entities operating within this sector that co-exist with the national ones. Among these, mention may be made on the following entities:

(i) The European Company (SE): the two operative legislative instruments for the establishment of a European company are Regulation (EC) No 2157/2001 on the Statute for a European company and Directive 2001/86/EC supplementing the Statute with regard to the involvement of employees in the European company. It enables a company to be set up within the territory of the European Union in the form of a public limited liability company.

(ii) The European Co-operative Society (SCE): by virtue of Regulation (EC) No 1435/2003 enables a cooperative to be established by persons resident in different Member States or by legal entities established under the laws of different Member States.

(iii) European Economic Interest Grouping (EEIG)[296]: allows a company in one Member State to cooperate in a joint venture with companies or natural persons in another Member State. It is vested with legal capacity.

[294] Council Regulation 1346/2000/EC of 29 May 2000 on insolvency proceedings, OJ L160/1, 29 May 2000.
[295] Manfred Balz, ‘The European Union Convention on Insolvency Proceedings’ (1996) 70 American Bankruptcy Law Journal 485, 490.
[296] Council Regulation (EEC) No 2137/85.

(iv) Single-member private limited liability company (SUP): the aim of the proposal is to facilitate to set up a single-member private limited liability company in the European Union across borders between Member States.

in general, most insolvency regimes respect pre-insolvency entitlements privately negotiated by the debtor and the creditors (*par condicio creditorum*)[297]. However, a closer analysis of Member States insolvency rules, it would easily appear that *'national regimes often provide for an intricate web of creditor priorities, which do not respect the pre-insolvency entitlements deriving from bargains between private parties*[298]*.'* Such priorities protect specific classes of creditors, such as employees, certain contractual partners on the treasury. These exceptions to the *par condicio creditorum* largely vary across EU Member States and reflect underlying practical options and values. A case in point for example is the protection of employees' claims for wages and unpaid contributions by the insolvent employer. In this regard, no common denominator exists across Member States. Some countries, like Austria and Germany, creditors' priorities have been totally repealed; whereas, in most jurisdictions, employees' claims rank in priority over other claims. In this latter case, however, the extensions of such privileges varies across insolvency regimes. In this complex scenario, the principle of *par condicio creditorum* can be considered as a common standard following by most jurisdictions, yet its nature of a true general principle is questionable. In his assessment of the position of insolvency law in EU States, concerning the harmonisation of insolvency law in the EU, which he dubs as 'a highly sensitive subject[299]', Mucciarelli states that the reason for Member Sates idiosyncrasies depends *'on fundamental political choices, whose legitimacy is rooted in the relationship between citizens and the legislatives bodies representing their interests*[300]*.'*

[297] Federico M Mucciarelli, 'General Principles of EU Corporate and Insolvency Law' (February 2021) <https://ecgi.global/content/working-papers> accessed on 5 March 2021.
[298] See also Jose' M Garrido, 'The Distributional Question in Insolvency Comparative Aspects' (1995) 4 International Insolvency Review 25, 31.
[299] Federico M Mucciarelli, 'General Principles of EU Corporate and Insolvency Law' (February 2021) <https://ecgi.global/content/working-papers> accessed on 5 March 2021.
[300] Ibid.

The European Commission's 2014 Recommendation on a new approach to business fortune and insolvency[301]. Mucciarelli writes that this Directive fails to address creditors' ranking and priorities, including those protecting secured debts which fall wholly within Member States' competence. He also believes that eventually both notions of 'insolvency' and 'likelihood of insolvency' should be defined by national laws. By not providing common definitions of EU law, the Directive runs the risk of generating conflicts of jurisdiction and creating loopholes[302].

2.5.1 Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings

This Regulation operates between Member States and focuses upon creating a framework for the commencement of proceedings and for the automatic recognition and co-operation between Member States. Thus it is essentially a conflict of laws enactment mainly intended to determine which EU courts have jurisdiction to open insolvency proceedings.

The Maltese insolvency proceedings which fall within the ambit of this regulation are: (i) dissolution, (ii) administration, (iii) members' or creditors' voluntary winding up, (iv) Court winding up and (v) trader bankruptcy. By and large, this Regulation has an important impact on the Maltese insolvency regime especially so with respect to private international law issues relating to insolvency. In essence the Regulation provides that with the application of the *"centre of main interests"* rule, the fact that a company is incorporated or governed by the laws of Malta does not mean that Maltese insolvency laws would automatically apply, since Malta may not be the centre of main interests of such a company.

Furthermore, even if the main proceedings are opened outside Malta, where the debtor has an "establishment" in Malta meaning the place of operations where the

[301] European Commission Recommendation 12 March 2014, COM (2014) 1500 final.
[302] Ibid.

debtor carries out a non-transitory economic activity with human means and goods, then it may also be possible for secondary proceedings to be opened in Malta. The effects of these secondary winding up proceedings shall however be restricted to the assets of the debtor situated in Malta. The winding-up proceedings are restricted to winding up by the court and voluntary winding up, as well as bankruptcy including, where a warrant of seizure is issued by a curator in the case of a bankrupt trader.

In analyzing Malta's transposition of the said Regulation[303] it has been observed that certain inclusions or exclusions in the ambit of the regulation may however appear somewhat anomalous within the context of Maltese company law. One pertinent aspect that was flagged was that it was not clear why dissolution and administration have been listed as insolvency proceedings. In terms of the Maltese company law, dissolution marks the commencement of liquidation proceedings which then ends with the striking off of a company. In addition, as part of members' voluntary winding up a declaration of solvency is made by the directors of the company, which *ictu occuli* runs counter to the notion of "insolvency proceedings" envisaged by the Regulation. Similarly, the notion of administration is not identical to the that existing under English law. What the Maltese Companies Act of 1995 does envisage is the possibility of the appointment of a provisional administrator in a compulsory winding up to generally oversee the general administration of the company being wound up. It is unclear how this is tantamount to "insolvency proceedings" in terms of the Regulation.

Still, despite these incongruities, the EU Insolvency Regulation has provided a framework for the resolution of conflict of laws issues arising in relation to insolvencies. This Regulation does not however apply to insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings

[303] Kristina Pisani Bencini, 'The European Union Insolvency Regulation … and Malta?' *Times of Malta* (25 June 2009). Available at: <the-european-union-insolvency-regulation-and-malta.262454> accessed 12 January 2018.

which provide services involving the holding of funds or securities for third parties, or collective investment undertakings.

2.5.2 The Recast Regulation[304]

Although the first EU Regulation[305] aims at providing a harmonised position among Member States, nonetheless the legal framework was criticised for its narrow personal scope of application. The criticism was largely aimed at the fact that only professionals and not courts were subject to provisions[306]. In addition, in terms of the structure of the regulation, the main proceeding may be directed towards rescuing the company whereas the secondary proceedings were only winding up in nature. Thus in order to promote better harmonised application of cross-border insolvency proceedings, the Regulation has been recast and co-operation duties have been extended by virtue of Regulation (EU) of the European Parliament and the Council of 20 May 2015 on insolvency proceedings[307]. The importance of accountability is of pivotal in this sphere of law since certainty and accountability of the Centre of Main Interest (COMI) are indispensable for creditors in order to make a reasonable risk assessment of their investments. In the Virgos-Schmit Report[308] dealing with insolvency proceedings it is stated as a fact that insolvency is a "foreseeable risk". What this means in practice is that barring a few exceptions, no business is immune from insolvency. It is of the utmost importance that the insolvency jurisdiction is a place known to the debtor's actual and potential creditors. Why is this so importance? Since as we have seen the creditor's bargaining position changes drastically pre and post-liquidation. Since in general a contractual obligation parties may regulate their relationship "ex ante" or "ex post". However, this is not the case with insolvency legislation, which limits party

[304] Recast Regulation on Insolvency Proceedings (Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015.
[305] Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings in OJ L.60, 30.6.2000, p.1
[306] Vesna Lazić, *Recasting the Insolvency Regulation: Improvements and Missed Opportunities* (Asser Press 2020).
[307] [2015] OJ L 141, 5.6, p. 19.
[308] M Virgos and E Schmit, 'Report on the Convention on Insolvency Proceedings' (EU Document No. Council 6500/1996, 1996).

autonomy to provide for collective debt enforcement and *pari passu* distribution among creditors. All the above highlights the importance that in the realm of cross-border insolvencies predictability and suitability must always be guaranteed by the existing regulatory system.

The main limitation of the Recast Regulation is that its scope is limited to provisions that govern jurisdiction of insolvency proceedings and judgments that are delivered directly on the basis of insolvency proceedings and are closely connected with such proceedings. What this means in practice is that if an action is not closely connected with insolvency proceedings different regimes may apply. This holds true even where proceedings are brought by an insolvency office holder or against an insolvent company. By way of example of the diverse pieces of legislation that may be applicable one may mention, the Regulation on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Regulation of the European Parliament and the Council No. 1215/2012 (the Brussels Regulation) which is a recast of Council Regulation (EC) No. 44/2001) and came into effect on 10 January 2015[309].

2.5.3 The Restructuring Directive[310]

The Restructuring Directive adopted on 20 June 2019 and subsequently came into force on the 17 July 2019. It is of central importance as it shines a light of the future direction to be taken by the European Union on matters relating to insolvency and restructuring. The time limit set by the Directive for implementation of its measures by the member states is of two years. However, the Directive includes a significant proviso in that if a member state finds it too difficult to implement the measures included in the directive then it may be given a further extension.

[309] The Recast Regulation and the Brussels Regulation are designed to complement each other meaning that insolvency proceedings being specifically excluded from the ambit of the Brussels Regulation.

[310] Directive (EU 2019/2015) of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.

There are three crucial objectives underpinning the Restructuring Directive namely:

- to make it incumbent upon each member state to have a preventive restructuring framework. The said framework must include a restructuring plan;

- secondly, it offers a second chance to businesses through an effective debt discharge mechanism; and

- finally, it promotes the necessity that each member states put in place measures to raise the efficiency of restructuring, insolvency and discharge of debt procedures more widely.

These pivotal objectives enshrined in the Directive are intended to ensure the proper functioning of the internal market and to remove obstacles to the exercise of fundamental freedoms. It aims to ensure that viable business concerns and in financial difficulties have access to effective national preventive restructuring frameworks that enable them to continue operating. It can be safely be said that the Restructuring Directive is trying to be the European Union's answer to the US Chapter 11 procedure. Put simply, Chapter 11 of the US Bankruptcy Code Chapter 11 is designed in order to ensure the preservation of reorganization or going concern value over liquidation value. Thus as a natural corollary through the application of Chapter 11 measures it is assumed that the most efficacious way to achieve that result is to retain management and enable multiple outcomes either through a plan of reorganization, a series of going concern sales and even a liquidating plan[311].

[311] 'Comparison of Chapter 11 of the United States Bankruptcy Code and the System of Administration in the United Kingdom':<https://www.jonesday.com/files/Publication/1ec093d4-66fb-42a6-8115-be0694c59443/Presentation/PublicationAttachment/e5b46572-7aeb-4c34-ab2e-bee2f8f3d3c2/Comparison%20of%20Chapter%2011%20(A4).pdf> accessed on 2 March 2020.

The major drawback of the Restructuring Directive is that it merely provides for a framework with a range of options. A lot will depend on how member states implement the restructuring plan regime. By and large, it will be up to each member state to make the provisions 'fit' with national law and, in doing so, member states can also choose how far reaching they will go. Malta has up to 2021 to transpose this Directive. It will be interesting to see what restructuring framework Malta will choose to adopt – in the sense will it limit itself to provisions on the Companies Act of 1995 or will it take the opportunity to revamp the whole regime?

2.5.4 Insurance Business (Reorganisation and Winding up of Insurance Undertakings) Regulations, 2004

A special regime governs the reorganisation and winding up of insurance business. When dealing with insurance undertakings, reference must be made to the Insurance Business (Reorganisation and Winding Up of insurance Undertakings) Regulations, 2004 which transposed Directive 2001/17/EC on the reorganisation and winding up of insurance undertakings. The Regulations apply to Member States of the European Union and to countries within the European Economic Area. Generally, the Regulations provide that it is the "home" Member State of an insurance undertaking which will have exclusive jurisdiction to open winding up proceedings and reorganisation measures in relation to an insurance undertaking.

The most significant aspect of this legislation is that it has the effect of distorting the effect of the *pari passu* principle in that its broad effect in the winding up of a Maltese insurance undertaking priority is given to insurance claims over all other debt claims.

2.5.5 Credit Institutions (Reorganisation and Winding up) Regulations, 2004

Mention needs to be made here of the obtaining position in the EU with regard to credit institutions, where a set of specific EU Regulations exists. These Regulations transpose Directive 2001/24/EC on the reorganisation and winding up of credit

institutions. They are applicable to Member States of the European Union and to countries within the European Economic Area. Again in a general sense, the Regulations provide that it is the "home" Member State of a credit institution which will have exclusive jurisdiction to open winding up proceedings and reorganisation measures in relation to a credit institution.

2.5.6 Financial Collateral Arrangements Regulations, 2004

Certain entities are excluded from the general insolvency regime due to the specific nature of their business. This special regime has an impact on the application of the *pari passu* rule since it is displaced in favour of a special set of rules. The European Parliament and Council Directive on financial collateral arrangements[312] was transposed into our law by virtue of Legal Notice 177 of 2004 as amended. The said Financial Collateral Regulations were issued under the Set Off Act. The Regulations specifically state that,

> *The purpose of these regulations is, in part, to implement the provisions of Directive 2002/47/EC on financial collateral arrangements and Directive 2009/44/ EC of the European Parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC, as currently in force and as may be amended from time to time, including any implementing measures that have been issued or may be issued thereunder and to provide for other matters relating to financial collateral arrangements and they shall be interpreted and applied accordingly.*

The Regulation aims to simplify the process of taking and enforcing financial collateral across the European Union.

[312] Directive 2002/47/EC of the 6 June 2002.

2.6 International Insolvency

A final aspect that would be pertinent to consider are the international initiatives on insolvency. It is important to keep abreast with these initiatives as they provide a global framework within which the various jurisdiction of the world need to operate. There has been increased activity with respect to cross-border insolvency at the international level. In fact the United Commission on International Trade Law (UNCITRAL) has been of significant importance in this area of law[313]. Suffice it to say that a growing number of countries have adopted the 1997 UNCITRAL Model Law on cross-border insolvency[314].

The UNCITRAL Legislative Guide on Insolvency Law[315] was also adopted by a number of State parties. The Legislative Guide, divided into four parts, was adopted gradually. The Guide enters into specific detail on the main tenants present in any insolvency regime. By and large, each Part of the Guide addresses key substantial and procedural matters prevalent in any insolvency regime. In fact, Part One of the Guide outlines the primary objectives of an insolvency regime as well as structural issues such as the relationship between insolvency law and other law. It also contains an overview of the types of mechanisms available for resolving a debtor's financial difficulties and the institutional framework required to support an effective insolvency regime. Part Two focuses on the key features present in any effective insolvency law. The Guide emphasises that efficiency is achieved by following the various stages of an insolvency proceedings from their commencement to the discharge of the debtor and closure of the proceedings. Pivotal elements are identified, as including standardized commencement criteria; a stay to protect the assets of the insolvency estate that includes actions by secured creditors; post-commencement finance; participation of creditors; provision for expedited reorganization proceedings; simplified requirements for submission and verification of claims; conversion of reorganization to liquidation when

[313] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011).
[314] < http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html> accessed 30 October 2019.
[315] Ibid. (No 281).

reorganization fails; and clear rules for discharge of the debtor and closure of insolvency proceedings. Part Three deals with the treatment of "enterprise groups" in insolvency, both nationally and internationally. Finally Part Four provides some insight into the obligations that might be imposed upon those responsible for making decisions with respect to the management of an enterprise when that enterprise faces imminent insolvency or insolvency becomes unavoidable.

The UNCITRAL Guide describes one of the nine key objectives of a strong insolvency regime to be ensuring equitable treatment of similarly situated creditors. This is a clear recognition of the central importance of the *pari passu* principle. Interestingly, the notion of "equitable treatment of similarly situated creditors" in accordance with the UNCITRAL Guide is not to be understood as meaning that all creditors must be treated identically, but rather that creditor treatment should reflect the bargains the creditors have struck with the debtor. In addition, another central objectives is the recognition of existing creditor rights and the establishment of clear rules for the ranking of priority claims. What this means in practice is that a clear and predictable ranking system is to be in place in order to ensure that creditors are certain of their rights at the time of entering into commercial arrangements with the debtor. Malta has notably integrated many of the key elements provided for in the Legislative Guide on Insolvency Law. Foremost among these are the stay of proceedings against the assets of the insolvent company and creditor participation in insolvency proceedings. However, a lurking doubt remain in this respect with respect to the rules of ranking scattered around various pieces of legislation. Is it about time to set aside this piecemeal approach in favour of a holistic unitary compendium of ranking of creditors? The UNCITRAL Guide identifies two main categories of claims afforded priority namely employee compensation and tax claims.

2.7 Conclusions

As has been highlighted throughout this Chapter, this area of law is steeped in outstanding legislative development as a result of which it has undergone significant changes over the years. One of the main purposes of this comparative analysis of the significant historical legislative developments in these jurisdictions had the objective of flagging out possible *lacunae* in the Maltese insolvency system and identify possible alternatives found in other legal systems. From among those areas that beckon the need for reform the following standout as the most conspicuous:

2.7.1 The need for a Special Law dealing with Insolvency

The Maltese legislator has consistently referred to English law on the subject and most provisions have been mirrored in domestic law. It comes as no surprise therefore that many judgments delivered by the Maltese Courts contain ample reference to English precedents on company law[316]. Maltese law on insolvency is far from perfect and a number of areas need to be revisited and where necessary, reformed, amplified or ameliorated as the case may be. One glaring omission that still persists today is that under prevailing Maltese law the rules on ranking are scattered in various pieces of separate special laws. This situation is far from ideal. Legal certainty is the cornerstone of any developed legal system.

Considering the legal heritage found in the Maltese legal system it is a shame that to date there is no comprehensive legal instrument that holistically regulates all matters relating to insolvency under Maltese law. A system akin to that prevalent under English law – where one finds a comprehensive Insolvency Act buttressed by detailed Insolvency Rules outlining the procedure – would be far more apt to cater for insolvency proceedings in Malta. Since insolvency proceedings have of late become increasingly more complex owing largely to the increased presence of a

[316] *Vide* for example The Accountant General and The Permanent Secretary, Ministry for Education and Employment vs Master Builders Ltd (C-38756) *et* decided by the Civil Court (Commercial Section) on 27 September 2018, in Chapter 4.

foreign element in the winding up process this fragmentation of laws needs to be seen to and remedied. At present most practitioners rely on the interpretation and application of the various ranking rules found in the special laws in order to determine the hierarchy of claims. The enactment of an *ad hoc* piece of legislation would definitely augment the prestige of the Maltese insolvency regime.

2.7.2 Primacy of Corporate Rescue Provisions

What is equally apparent from the analysis of the comparative legislative development outlined throughout this Chapter is that the focus of all emerging legislation is chiefly on restructuring. In fact today a lot of emphasis is placed on reorganization procedures. Suffice it to say that restructuring is at the heart of the European Commission's growth program. Likewise, the UK Enterprise Act, 2002 introduced radical changes to corporate insolvency. The over-all intention was to trigger a change in culture, which highlighted the importance of company rescue and rehabilitation, fairness for all creditors and making it tougher for delinquent directors. Also in Italy, in the new insolvency framework, the liquidation of the company is considered to be the final option, to be activated only once all other alternative procedures prove to be unfeasible.

It is significant to note that the European Commission stated that *"[t]he objective [was] to shift the focus away from liquidation towards encouraging viable businesses to restructure at an early stage so as to prevent insolvency*[317]*."* The success of an early rescue process have been well-documented at European level, for example it has been stated that, *"[t]he benefits of business rescue can be summarised as follows: maximisation of asset value … [b]etter recovery rates for creditors … [s]aving jobs … [l]ower costs … [a]voidance of reputational risks and directors' liability [and] [e]ncouraging entrepreneurship*[318]*."* The basic tenet of the

[317] European Commission Press Release, 'Insolvency: Commission recommends new approach to rescue businesses and give honest entrepreneurs a second chance' (12 March 2014) Brussels. Available at:
<http://europa.eu/rapid/press-release_IP-14-254_en.htm> accessed 04 December 2017.
[318] SWD(2012) 416 final, para 3.2.1.

Recommendation is the rescue of viable businesses which the Commission defines as *"changing the composition, conditions, or structure of assets and liabilities of debtors, or a combination of those elements, with the objective of enabling the continuation, in whole or in part, of the debtors' activities*[319]*."* A fair question would be: how does all this connect with the application of the *pari passu* principle? Since both the *pari passu* principle and reorganisation proceedings have the best interests of the general body of creditors at heard the development of advanced restructuring proceedings would definitely be important for the continued relevance of the *pari passu* principle in practice. The relationship between dissolution and consequential winding up, on the one hand, and reorganisation proceedings will be examined in greater detail in a subsequent Chapter[320].

2.7.3 Abolition of Crown Preference

The Crown Preference may be seen as the equivalent to the various tax privileges granted to various government authorities for the collection of dues under a proliferation of special laws. One relevant aspect that deserves to be considered when we come to examine ranking of creditors has to do with the issue of tax privileges. It is of central importance since in practice any available assets for distribution are snatched up by different tax authorities in execution of their legal preferences to the detriment of the unsecured creditors. Put very simply the time is ripe for a serious review of their validity since in the first place these tax privileges complicate and inevitably delay the insolvency proceedings. Secondly, they disrupt the entire concept of *pari passu* at the same time, one must recognise the fact that privileges created by law have to be respected. Otherwise there will be no legal certainty and commercial obligations might be jeopardised in the process.

Is it about time that we draw inspiration from the English insolvency system and remove this tax privilege? Would removing this special class create a fairer and more efficient system in line with the principle? Could a fund be introduced into

[319] Restructuring Recommendation, Recital 1.
[320] See Chapter 5.

the Maltese insolvency system which would benefit the unsecured creditors? On numerous occasions liquidators and our courts are faced with intricate problems relating to the myriad of preferences that emerge from numerous special tax law. The delay in determining the proper ranking and validity of tax privileges naturally means a further dissipation of the assets of the insolvent company. This will of course negatively impact any possible application of the *pari passu* principle. This tax privilege may be seen to represent a particular example of the interests of the state being preferred over certain creditors who stand to correspondingly lose out.

2.7.4 Professional Insolvency Practitioners

The introduction of professional insolvency practitioners in Malta as found under English law should be seriously considered. Although the qualifications and disqualifications to act as a liquidator are included in the Maltese Companies Act of 1995 - could we go a step further? The English insolvency system provides for professional insolvency practitioners who must obtain an insolvency license from the recognized professional board. Amongst other criteria, license holders must have passed examinations, have practical experience, show that they are a fit and proper person to be in this position of trust and also have a general insolvency bond and professional indemnity insurance policy in place. Ensuring that liquidators act to the highest standards is of the utmost importance since their action or inaction may have a direct impact on the final outcome and distributions to the creditors.

One pivotal function of the liquidator is to investigate the action of the company pre-liquidation. The sections dealing with fraudulent and wrongful trading are of particular importance[321]. In this context and by way of example reference is made to **Official Receiver in his capacity of liquidator of Smart Malta ICT Limited [C-41884] in accordance with a decree dated 30 of March 2010 vs i. Steve Alamango and ii. Geoffrey Farrugia[322]**, wherein the timely investigative action taken by the liquidator for wrongful trading resulted in the increase in the disposable assets to

[321] Articles 315 and 316, Companies Act, Chapter 386, Laws of Malta.
[322] First Hall Civil Court (Commercial Section), 30 May 2019.

be distribute *pro rata* among the creditors. The Court in this case observed that article 316(2) of Chapter 386 was analogous to that found in English law. Thus the same principles are to apply. It was in the Court's full discretion what amount to liquidate. The amount to be liquidated is to be calculated according to the loss suffered by the company and not by the creditors. The Court stated that it was worth noting that the amount to be liquidated is to be distributed *pari passu* between all the creditors. In insolvency proceedings the liquidator is acting in the best interests of the general body of creditors and therefore no one creditor of the company is to benefit from some priority over the other creditors. This principle applies with regard to privileged creditors. The timely action of the liquidator in this case benefited the general body of creditors.

At times, liquidators need to go great pains to delineate their powers and functions which may prove a hindrance to the proper execution of their duties. However, in the same vein having professional body set up will provide a specialized monitoring board ensuring that standards are being held and thereby ensuring best possible practice in relation with the interests of the general body of creditors. Therefore, should we introduce provisions in Maltese law bolstering the standards to be met by liquidators?

2.7.5 The Effect of Cross-Border Insolvency Legislation on *Pari Passu* Principle

We have seen that there is a smorgasbord of legislation dealing with cross-border insolvency legislation. Put simply, a cross-border insolvency is a transnational insolvency meaning insolvency proceedings in one country while the creditors are to found in a different country[323]. It is a fact that complex international insolvencies are on the increase in the line with the growth of global business[324]. How does this impact on the application of the *pari passu* principle? There could be a displacement of the application of the principle in cross-border insolvencies since a

[323] Look Chan Ho, *Cross-Border Insolvency: Principles and Practice* (Sweet & Maxwell 2016).
[324] Look Chan Ho, 'Anti-Suit Injunctions in Cross-Border Insolvency: A Restatement' [July 2003] ICLQ vol 52, pp 697-736.

creditor may be actively interested to take their claims to fora that are not subject to collective insolvency proceedings in order to gain property over other creditors. Once an international company conducts its business on a transnational level its creditors may seek to pursue their claims against the insolvent company in their own domestic courts even though the company is already subject to separate insolvency proceedings in another jurisdiction for example in the jurisdiction of the company. For example, the case of **Mercato Uno** a hypermarket chain in Italy held by a Maltese company was declared bankrupt by a Milanese tribunal in Italy[325]. Thousands of employees and other creditors opted for proceedings in Italy even though the company owning the business was registered in Malta. It has also been argued that there could even be the flexible application of the *pari passu* principle in the case of cross-border insolvencies[326]. Commenting on this novel flexible application of the principle Look Chan Ho observes that, "*the Court's application of the pari passu principle is as much pragmatic as it is intellectually sound – pragmatic because it enables the 20-year old liquidation to progress to closure in the best interests of all creditors, and intellectually sound because it gives effect to choice of law principles applicable to the Mainland balance (the lex situs being mainland law).*" To demonstrate the intricacies faced in cross-border insolvency one could refer to **Re Arena Corporation Ltd**[327]. The English Court found that a company incorporated in the Isle of Man with its centre of main interest in Denmark had sufficient connection with England (in the form of assets located in England) to enable it to exercise its jurisdiction under section 221 of the Insolvency Act 1986 to wind up the company.

Fletcher[328] notes that the interaction of two or more legal systems in a cross-border insolvency provokes a diversity on *"fundamental matters of principle"* which is *"usually intense, even by standards of private international law."* Professor

[325] http://www.fallimentoshernon.it/

[326] See *Re Guangdong International Trust & Investment Corporation Hong Kong (Holdings) Ltd* [2018] HKCFI 2498, wherein the Court held that the principle of *pari passu* distribution may be applied flexibly to distribute the insolvent estate's assets in Hong Kong and abroad; Also *Beluga Chartering v Beluga Projects (Singapore)* [2013] SGHC 60; [2013] 2 SLR 1035.

[327] [2003] All ER (D) 277.

[328] Ian Fletcher, *Insolvency in Private International Law* (Oxford University Press 2005) para 1.11.

Worthington explains that in a state of insolvency there is inevitably a shortfall of the assets of a company against creditors and it follows therefore that differences between jurisdictions on questions of priority create incentives to litigate for creditors of a multinational company[329]. This has been recognized by LoPucki[330] as a noxious type of forum shopping. In an attempt to limit this practice the UNCITRAL Model Law on Cross-Border Insolvency stands out as an importance instrument in facilitating co-operation[331]. It is crucial to understand therefore that the principle of *pari passu* is neither as opaque nor as impassable even in cross-border insolvencies due to the realities of forum shopping.

2.7.6 Possible Procedural Reforms

Although we have seen that Malta has indeed adopted many of the recommendations included in Legislative Guide on Insolvency Law such as the stay of proceedings against the assets of a company in liquidation, there still is room for improvement. The need for further reforms with the aim of improving existing insolvency legislation is clearly felt and comes to the fore whenever insolvency proceedings occurring domestically from time to time are put under scrutiny. Some of the suggested reforms are put forward or implied in the judgment itself. In **Panta Contracting Limited vs D.A. Holdings Limited[332]** the Court carried out an extremely interesting analysis of the notion of "stay of proceedings" found under Maltese law which is different to the "sisting of proceedings" found under English law. This is defined as the Court order which either stops or suspends proceedings. These are all part and parcel of the concept of judicial shielding and which form an integral part of the *pari passu* principle. This aspect will be dealt with in greater detail in a subsequent Chapter[333].

[329] Sarah Worthington, *Equity* (2nd edn, Oxford University Press 2003) pp. 53.
[330] Lynn M. LoPucki, 'Co-operation in International Bankruptcy: A Post-Universalist Approach' (1998) 85, Cornell Law Review 696, 721.
[331] J Townsend, 'International Co-operation in Cross-Border Insolvency: HIH Insolvency' (Sep 2008) The Modern Law Review, Vol 71, No 5 p.811-822.
[332] Panta Contracting Limited vs D.A. Holdings Limited *et,* First Hall Civil Court, 17 March 2016.
[333] See Chapter 5.

Chapter 3 The Application of the *Pari Passu* Principle: A Critical Analysis and Appraisal

3.1 General Introduction

A significant number of text writers and sundry judicial pronouncements in the form of decrees and decisions reiterate the centrality of the *pari passu* principle in any insolvency regime. The resulting effect of the application of this principle is that unless a creditor can clearly show that he truly deserves some priority in the liquidation distribution, the liquidator will treat all creditors as equals and try to maximize the assets available for distribution among the general body of creditors. What this means in practice is that, by treating all unsecured creditors the same, available assets will be distributed among them *pro rata*. The above serves to reinforce the objective of insolvency proceedings which is that of striving for equality among unsecured creditors. However, in this area of law there seems to be a misguided tendency to equate equity with equality[334].

The *pari passu* principle is deemed to be so pivotal that it is not even possible for parties to an agreement to contract out of it. In fact, since a liquidation is a form of collective insolvency proceeding which has as its primary objective the distribution of assets among the general body of creditors in accordance with a statutory *pari passu* rule it cannot be excluded by contract. This rule has long been established by the English Courts most notably in ***ex parte* Mackay[335]** wherein the Court reinforced the mandatory character of the principle which cannot be excluded by contract in that, *"a man is not allowed, by stipulation with a creditor, to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides."* It is truly remarkable that this principle is deemed to be so important that it even overrides on the basic notion of law namely the freedom to contract.

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[334] Daniel J Bussel & David A Skeel, Jr., *Bankruptcy* (10th edn, University Casebook Series 2015).
[335] [1873] LR 8 Ch App 643.

It is also true however that Courts often uphold arrangements that give one group of unsecured creditors significantly different treatment than other groups. One pertinent example illustrating this point is the **Chrysler's Bankruptcy**[336] where Chrysler filed a petition for bankruptcy on 30 April, 2009 and managed to complete its bankruptcy run in the span of forty two (42) days making it one of the fastest major industrial bankruptcies in living memory. The apparent advantage of compensation in favour of priority creditors raised concerns in capital markets. It was argued that the Chrysler bankruptcy cannot be understood as complying with good bankruptcy practice. So much so that some commentators have been lead to observe that,

> *… it resurrected discredited practices long thought interred in the nineteenth and early twentieth century equity receiverships, and that its potential for disrupting financial markets surrounding troubled companies in difficult economic times is more than small*[337]*.*

In this instance, Chrysler's retirees, trade creditors, tort creditors and the unsecured portion of its senior bondholders' claims all had general unsecured claims. If the equality of creditors principle were truly and effectively applied they should have received the same recovery. However, it was not so. In reality there was a significant disparity in compensation. Suffice it to say that whereas on the one hand the retirees and trade creditors were paid in full, or nearly so, by contrast, tort creditors and the bondholders' deficiency claims received almost nothing. The resulting effect of all these unsavoury manoeuvres gave way to a scenario wherein the recoveries of seemingly similar creditors were widely divergent.[338] Commenting on the treatment of creditors in particular in the **Chrysler's Bankruptcy**, Roe and Skeel[339] observe that,

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[336] In Re Chrysler LLC United States Courts of Appeal, Second Circuit (5 June 2009) 576 F.3d 108; See also 'Chrysler Bankruptcy Filings- petition for bankruptcy' *The New York Times* [April 30, 2009] accessible at: https://www.nytimes.com/interactive/projects/documents/chrysler-bankruptcy-filing

[337] Mark J Roe & David A Skeel, Jr., 'Assessing the Chrysler Bankruptcy' (2010)108 Mich. L. Rev. 727.

[338] Daniel J Bussel & David A Skeel, Jr., *Bankruptcy* (10th edn, University Casebook Series 2015).

[339] Mark J Roe & David A Skeel, Jr., 'Assessing the Chrysler Bankruptcy' (2010) 108 Mich. L. Rev. 727.

> *It entered as a company widely thought to be ripe for liquidation if left on its own, obtained massive funding from the United States Treasury, and exited through a pseudo-sale of its main assets to a new government-funded entity. Most creditors were picked up by the purchasing entity, but some were not.*

The disparity in the compensation made to prior creditors raised considerable concern since in this case certain classes of secured creditors were unceremoniously cut off and received no payments with their priorities being unjustifiably set aside which meant that,

> *Contrary to the received wisdom regarding the implications of Chrysler and GM, their combined effect foretells the literal death of the fundamental distributive principles that are the essence of bankruptcy law and that have been the bedrock of bankruptcy reorganizations for at least a century*[340]*.*

In practice, if we take a good look at current winding up practice, a rateable distribution among creditors is rarely achieved. But there are some notable exceptions. There are three major factors underlying deviations to the rule:

1. The principle is in general confined to assets of the company and does not affect creditors having a right *in rem*[341]*.* Thus the *pari passu* principle applies only to the general unsecured creditor*;*

2. The liquidator takes the assets subject to the burdens and securities that affect them;

[340] Ralph Brubaker & Charles J Tabb, 'Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM' (2010) Illinois Law Review: <https://illinoislawreview.org/wp-content/ilr-content/articles/2010/5/Brubaker.pdf> accessed 15 January 2019.

[341] Any security created by virtue of a provision of national law, by which real property of a person owing real property taxes is subject to a public charge, constitutes a right *in rem* within the meaning of Article 5(1) Insolvency Regulation (Regulation 1346/2000) as interpreted by the Court of Justice of the European Union in C-195/15.

3. A considerable portion of what free assets remain have to be applied to meet claims ranking in priority to those of ordinary unsecured creditors. The effect is largely to frustrate a primary objective of the insolvency proceedings and to deprive the general body of creditors of any significant interest in winding up.

Despite these significant deviations, Goode[342] is quick to point out that nevertheless the *pari passu* principle retains some practical importance, if only in a negative sense, in that it might have the effect of invalidating pre-liquidation transactions by which a creditor hopes to secure an advantage over his competitors, and where it does have this effect it may result in an expansion of the assets available for distribution. In reality, this approach to the *pari passu* principle is truly practical and effective. It is better to have the protection offered by the principle *inter alia* through the avoidance of transactions rather than discard it completely.

It is an uncontested fact moreover that the principle is subject to numerous exceptions. Various theories have been floated in order to justify the above described deviations to the rule. At the heart of the issue is whether the time is ripe to set aside a number of these lawful causes of preference or privileged claims in favour of a system which is fairer to the unsecured creditor. It will be shown that many commentators are critical of the prevalent position that the *pari passu* principle is of fundamental importance. The detractors argue that often-time the principle is confused and misapplied.

The above preamble sets the tone to what will be discussed in this Chapter. The manner in which the principle is reflected in law will be analysed. The manifestations of the principle will be demonstrated by reference to those provisions found in the Companies Act of 1995 that are intended to shield the company in liquidation from the onslaught of individual enforcement actions by creditors. It will be shown that these provisions represent some of the most positive effects of the application of the

[342] Roy Goode, *Principles of Corporate Insolvency* (4th edn, Sweet & Maxwell 2011).

pari passu principle. What is aimed at is an overview of the exceptions to the principle. In other words, the central issue is whether - in view of the many exceptions and modes of by-passing the operation of the *pari passu* principle – it can still be said that the principle is really all-pervasive. From a domestic standpoint, it will become apparent that the statutory regime in Malta, like its counterpart in the United Kingdom shares similar defects which cannot be simply overlooked. Finally, a critique of the principle will be undertaken by conducting an overview of negative reviews of the principle put forward by a number of commentators and divergent approaches taken in the context of international insolvencies. At this level one can well observe that there is an emerging trend both regionally through the European Union (EU) efforts as well as international initiatives such as the United Nations Commission on International Trade Law (UNCITRAL) to incorporate within company rescue procedures the objectives of the *pari passu* principle. In doing so it is hoped that insolvency proceedings are only commenced as a last resort. It is precisely for this reason that it is of significant importance to consider the novel way the *pari passu* principle is being effectively applied in the realm of corporate reconstructions.

3.2 The *Pari Passu* Principle as reflected in the Law of Insolvency

3.2.1 The *Pari Passu* Principle Under Maltese law: An Overview

The principle of *pari passu* distribution requires that all creditors of a certain class within the statutory scheme should be treated equally in the distribution. Thus, once a company is dissolved and is being wound up all the company's property shall fall into the custody of the liquidator. It would be of great interest to analyse at the outset the manner in which this principle has been reflected in law and more importantly to examine its effectiveness in achieving its intended legislative goals. If the principle is found not to be reaching the intended objective or its desired effect, it is pertinent to examine whether the existing legislation can be improved upon. If mere amendments are not enough, its whole *raison d'etre* should be thoroughly examined and then a decision be taken whether to debunk it entirely or at least eliminate certain aspects that have proven to be unpractical or redundant. In the

first place a logical starting point would be to systematically analyse the legal provisions that are currently in Maltese law.

In a general manner, article 302 of the Companies Act deals with the application of the rules of ranking and provides that, *"In the winding up of a company the assets of which are insufficient to meet the liabilities, the rights of secured and unsecured creditors and the priority and ranking of their debts shall be regulated by the law for the time being in force."*

The above is in line with the general principles of Maltese law in that, *"whosoever has bound himself personally, is obliged to fulfil his obligations with all his property, present and future*[343]*."* Once this principle is applied to the realm of corporate insolvency, the effect would be that of subjecting the company's property – movable and immovable, corporeal and incorporeal, present and future – to be considered as a common guarantee for all the debtor's company's debts[344]. Furthermore, in terms of article 1995 of the Civil Code the *"property of a debtor is the common guarantee of his creditors, all of whom have an equal right over such property, unless there exist between them lawful causes of preference."* These lawful causes of preference are privileges, hypothecs and the benefit of separation of estates[345]. In addition, in terms of article 1964 of the Civil Code, a pledge amounts to a contract created as preference for an obligation. Privileges and hypothecs being real rights are constituted over the property of the debtor[346]. Besides the lawful causes of preferences created in terms of the Civil Code, other specific privileges are created by a variety of special laws as will be amply seen at a later stage.

[343] Article 1994, Civil Code, Chapter 16, Laws of Malta.
[344] This in furtherance of the Latin maxim *bona non intelliguntur nisi deducto aere aliene. Vide* Paolo Debono, *Bankruptcy in Malta* p.37.
[345] Article 1996, Civil Code, Chapter 16, Laws of Malta.
[346] In accordance with article 303, Companies Act, unless the person in whose favour the privilege, hypothec or any other charge was constituted proves that he did not know and did not have reason to believe that the company was likely to be dissolved by reason of insolvency, any charge constituted by the company within six months before its dissolution shall be void if such constitution was proved to be at a significant undervalue or by way of preference to a creditor.

It is then the liquidator's function to realise all the assets of the company being wound up and pay creditors according to their ranking in law in terms of article 287 of the Companies Act of 1995[347]. This article provides that:

> *subject to the provisions of this Act and of any other law as to preferential debts or payments, the property of a company shall, on its winding up, be applied in satisfaction of its liabilities pari passu, and, subject to such application, shall, unless the articles otherwise provide, be distributed among the members according to their rights and interests in the company.*

The above-cited provision is found in Chapter IV of Sub-Title II of the Companies Act of 1995 which contains specific provisions relating to voluntary winding up. The application of this principle in the instance of voluntary winding up is directly and specifically provided for in Maltese law. By contrast, in the case of a compulsory winding up by the Court, its application can be inferred through a thorough reading of article 238(1)(c) of the Companies Act of 1995 dealing with the functions and powers of the liquidator and which states that *"the liquidator in a winding up by the court shall pay creditors according to their ranking at law."*

The applicability of the *pari passu* principle is implied in this provision. This means that, through its application the liquidator is provided with a point of departure in the exercise of the ranking of creditors. The most obvious starting point in this context would be to treat all creditors equally at the outset and thereby applying the principle.

There is a marked difference in approach to the *pari passu* principle between Maltese and English law (to be discussed below) in that the latter is more direct and specific. A legislative amendment in the Maltese Companies Act of 1995 specifically expressing the applicability of the *pari passu* principle in the cases of winding up by the court would be advisable and commendable and this is also in line with the Latin maxim *ubi lex voluit dixit.*

[347] Chapter 386, Laws of Malta.

An amendment introduced in the Companies Act by virtue of Act No. XI of 2017[348] provides for the priority of certain debts in the winding up. Article 258(1), applicable with regard to a winding up by a Court, states that, *"the court may, in the event of the assets being insufficient to satisfy the liabilities, make an order as to the payment out of the assets of the costs, charges and expense incurred in the dissolution and the winding up in such order of priority as the court thinks fit."*

Furthermore, article 258(2) provides that the Court in exercising the above discretion is to have due regard to the following order of priority:

a) expenses properly chargeable or incurred by the official receiver or the liquidator in preserving, realising or collecting any of the assets of the company;

b) any other expenses incurred or disbursements made by the official receiver or under his authority, including those incurred or made in carrying on the business of the company;

c) the remuneration of the provisional administrator, if any;

d) any necessary disbursements by the special controller in the course of his office in terms of article 329A and 329B;

e) the remuneration of the special controller;

f) the costs of the applicant, and of any person appearing on the application whose costs are allowed by the court;

[348] The Companies (Amendment) Act, 2017.

g) the remuneration of the special manager, if any;

h) any amount payable to a person employed or authorised to assist in preparation of a statement of affairs or of account;

i) any allowance made by order of the court, towards costs on an application or release from the obligation to submit a statement of affairs, or for an extension of time for submitting such a statement;

j) any necessary disbursements by the liquidator in the course of his administration, including any expenses incurred by members of the liquidation committee or their representatives and allowed by the liquidator;

k) the remuneration of any person employed by the liquidator to perform any services for the company, as required or authorised by the provisions of this Act;

l) the remuneration of the official receiver and of the liquidator;

m) any new financing granted to the company for the purpose of a recovery procedure in terms of articles 329A and 329B.

This means that the Court has a certain measure of discretionary power with respect to the ranking of costs, charges and expenses. These were clarifying amendments to article 258(2) dealing with a court winding up scenario. There were moreover some other additions to the list of the general order of priority. The new priorities include the following,

- any necessary disbursements by the special controller appointed in such a company reconstruction procedure;

- the remuneration of the special controller; and

- any new financing granted to the company for the purpose of a company reconstruction[349].

Moreover, article 293 dealing with a voluntary winding up provides that, *"all costs, charges and expenses properly incurred in the winding up, including the remuneration of the liquidator, shall be payable out of the assets of the company in priority to all other claims."*

3.2.2 The *Pari Passu* Principle under English law

English insolvency law contains specific and express provisions with respect to both compulsory and voluntary winding up:

- Rule 4.181 of the Insolvency Rules, 1986[350]; and
- Section 107 of the Insolvency Act, 1986.

If, as is not usually the case, company's creditors have been paid, the remaining funds are to be returned to the members of the company.

In the case of a voluntary winding up, section 107 of the Insolvency Act 1986, explicitly states that:

> *subject to the provisions of this Act as to preferential payments, the company's property in a voluntary winding up shall on the winding up be applied in satisfaction of the company's liabilities pari passu and, subject to that application, shall (unless the articles otherwise provide) be distributed among the members according to their rights and interests in the company.*

[349] Stephanie J Coppini, 'Recent 2017 Amendments to the Companies Act' (26 April 2017). Available at: < https://ganadoadvocates.com/resources/publications/recent-2017-amendments-to-the-companies-act/> accessed on 20 November 2019.
[350] SI 1986/1925.

Furthermore in the case of a compulsory winding up, rule 4.181(1) of the UK Insolvency Rules[351] specifically states that: *"debts other than preferential debts rank equally between themselves in the winding up and, after the preferential debts, shall be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves."*

Unlike the obtaining situation under Maltese law, the applicability of the *pari passu* principle to both modes of winding up, is expressly stated in English corporate insolvency legislation. This clarity in legislative style is to be lauded and is to be replicated in our domestic law.

3.2.3 Treatment of Creditors and the *Par Condicio Creditorum* under Italian law

For comparative purposes it is opportune at this juncture to examine the position in Italy on the issue of equal treatments among creditors. In terms of the Italian Royal Decree of March 16 1942 number 267, the issue of equal treatment between creditors was indirectly regulated by article 111. This provision provided that the assets to be allocated to creditors were to be distributed in a ranking order between expenses, debts contracted for the administration of the procedure and unsecured debts. Therefore, the application of the principle of a level playing field is derived from the importation of the rule referred to in article 2741 of the Italian Civil Code. Historically, most of the causes of preference, mortgage, pledge and privilege were located precisely in the civil code. Over a period of time there developed a proliferation of new causes of pre-emption: new special and general privileges. The privileges that the legislator wanted to introduce over the years have overlapped those already in force with the result of progressively eliminating the unsecured creditors. Unfortunately one has to note that the increase in special privileges and preference is at the expense of unsecured creditors.

There are two groups of creditors that enjoy preferential treatment:

[351] SI 1986/1925.

1. creditors who hold a security interest (*creditori ipotecari* and *creditori pignoratizi* – so called "secured creditors"); and

2. preferred creditors (*creditori privilegiati*).

According to Italian Law, the principal categories of secured creditors are:

- creditors who hold a mortgage on immovables of the debtor; and

- creditors who hold a pledge on movable assets of the debtor or on claims of the debtor against third parties.

A preferred creditor (*creditore privilegiato in senso stretto*) is one whose claim is given statutory preferential treatment over other creditors. No priority lien may be created contractually. Such liens may apply to all of the debtor's property or solely to a specific property. The Italian Civil Code contains very detailed rules[352] regulating priority conflicts between secured and preferred creditors. As a general principle, creditors holding a security interest are paid to the exclusion of all other creditors, including secured creditors having a lower rank. Unsecured creditors (*creditori chirografari*) have no preference and will therefore be paid only if any proceeds of the estate remain after all other creditors have received payment. Accordingly, unsecured creditors will share equally in the estate, in proportion to the size of their claims. Therefore the equality principle only applies to those creditors who have an unsecured claim and are not preferred creditors. They share *pro rata* in the amount available to them.

[352] Art. 2745 of the Italian Civil Code.

With respect to the legal phenomenon of lawful causes of preferences Italian insolvency practitioner Fabiani[353] recognises the fact that the creation of privileges is the result of a discretionary choice by the legislator who, due to the quality of the credit, believes that position is particularly worthy and such as to justify the distortion of the level playing field. Nevertheless, the legislator was always prone to adding and never removing any priorities. The resultant effect of increasing these lawful causes of preference is that the more certain privileges are placed in a high-ranking order, the more the others slide down and are marginalized.

3.3 Lawful Causes of Preference

Put simply, a lawful cause of preference creates a priority in favour of certain creditors. These preferences have the effect of dissipating the assets available for distribution *pari passu.*

3.3.1 Lawful Causes of Preference

Judge Paolo DeBono clearly elaborates that it is only once all the lawful causes of preferences have been paid out that the unsecured creditors can be paid out *pari passu,*

> *once the judicial costs and of the administration of bankruptcy have been deducted and the relief granted to the bankrupt and his family… the privileged and mortgage creditors will be paid according to their ranking, and then unsecured creditors are paid out of the residual assets in proportion to their verified credits[354].*

Furthermore, creditors whose claims exceed the amount which is covered by their privilege or hypothec, *"… rank in the distribution of the remaining assets, up to the*

[353] Massimo Fabiani, 'La *par condicio creditorum* al tempo del codice della crisi' *Questione Giustizia, Fascicolo* 2/2019.
[354] Paolo Debono, *Appunti di Lezioni sul Fallimento nel Diritto Maltese* (*Seconda edizione riveduta, ampliata e corretta* 1907).

amount that is due to them[355]*."* In **Francesco Pace vs Antonio Galea**[356] delivered by the Maltese Court of Appeal ample reference is made to eminent French jurist Laurent[357] who explains that the legal basis of a privilege is *its* utility and augmentation of the common debtor's estate*, whether the thing itself or its price the advantage in favour of the creditor is always there".* And for this reason

> *it is justified that also on the price to have a privilege ... because the creditor who has seized the thing on which he has the privilege does not act except for asking for its sale to be able to exercise the privilege over the price. Therefore this interpretation is not wide either, but it is an interpretation in accordance with the spirit of the law and the justification underlying the privilege.*

3.3.2 Lawful Causes of Preferences under Italian Law

The justification for these lawful causes of preference found in Italian law is lucidly explained by one Italian author[358] writing on the *par condicio creditorum*. He opines that equality between creditors does not necessarily mean that all creditors are equal[359]. The differences between them do not depend on the creditor's identity but on the nature of the credit. Melotto[360] explains that the law establishes an order of preference of credits according to their nature, that is, according to whether they are credits for supplies, services, financing or taxes. The law of preferences is explained through the use of the following example, if Tizio boasts a credit that the law considers more important than Caio's credit, then Tizio will be paid before Caio not because it is better but only because his credit comes first in the order established by law.

The flexibility offered by the new Italian insolvency legislation has served to provide a measure of added support for the protection of the *par condicio creditorum.*

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[355] Paolo DeBono, *Appunti di Lezioni sul Fallimento nel Diritto Maltese* (*Seconda edizione riveduta, ampliata e corretta* 1907).
[356] Court of Appeal, Vol. XXX.i.746 (1939).
[357] Francois Laurent, *Principi di Diritto Civile* Vol. XXIX no.480.
[358] Albert Melotto, 'Cos'è la "par condicio creditorum"', *La Legge per Tutti*, 17 November 2018.
[359] Article 2741 of the Italian Civil Code and article 52 of Italian Insolvency Law.
[360] Ibid (No 325).

Reference can be made to the **CMC[361] Ravenna Cooperative Case**[362] which was faced with six requests for bankruptcy. The situation became critical on 9 November 2018, when the Cooperative informed the creditors that it would not be able to pay instalments on the bonds to the tune of 9.7 million euro falling due on 15 November 2018. The Cooperative CMC Ravenna was considered to be among the third largest construction group in Italy with a turnover of 1,118 million euro in 2017 alone. After making public its state of default with regard to payment, numerous injunctions were filed against it on the part of suppliers, bondholders and creditors. On 21 November 2018, Unicredit, as agent bank, and as a result of the non-payment of the coupon that was due, notified the Cooperative of the activation of the cross default (cross insolvency extended to all current debts). In the meantime, all its clients stopped payments meaning that a total of 136.7 million euro of arrears that the company expected to collect did not materialise. This was also due to the sharp deterioration of the net financial position that already featured in the Cooperative's half-yearly report June 2018. Consequently, a group of advisors appointed on 9 November 2018, led by Mediobanca, to review the overall financial situation of the Cooperative came to the conclusion that there was no room for carrying out any further negotiations with banks. At this point there grew the real risk of going towards a bankruptcy procedure. This led to a dramatic meeting of the board of directors, held on 2 December 2018, that ended with an unanimous decision to request the *concordato in bianco* ("composition with creditors with rights reserved/ in blank"), as the only way identified, *"to protect the Cooperative's assets which would be depleted by the foreclosures of the quickest creditors … and therefore [protect] the par condicio creditorum."*

In so doing, CMC Ravenna opened the path to a debt restructuring process under Italian insolvency law before a court in the jurisdiction of its home city, Ravenna.

[361] "Cooperativa Muratori e Cementisti" (CMC)

[362] 'Cmc, creditori alla porta e mancati incassi: perché è in concordato' *Corriere della Sera/ Economia* (24 December 2018).

Thereby choosing *"the most effective process in order to secure company's assets and protect, in this way, all the stakeholders*[363]*".*

On 4 March 2020, during the bondholders' meeting, those present approved the company's plan for credit agreements which had to be examined by the creditors' meeting in order to determine the way forward. The possibility of offering further security to unsecured creditors was floated for further consideration[364]. In May 2020 the Court in Ravenna issued a decree approving the proposed restructuring plan[365].

In terms of Italian law, the order of the distribution of assets as regards general claims namely assets which are not secured by special privileges, charges, or other forms of security, is as follows[366]:

1. The costs of bankruptcy proceedings, which have priority even over secured claims such as mortgages and pledges;

2. Employment compensation, including, without limitation, termination benefits;

3. Claims of independent professional contractors who performed services for the insolvent company/individual entrepreneur during the twelve month period prior to the insolvency order;

4. Commissions due within the previous twelve (12) months pursuant to agency agreements and compensation for the termination of an agency;
5. Taxes on real property;

[363] Victor Jimenez, 'Distressed CMC Ravenna stokes HY's Italian fear' GlobalCapital, 4 December 2018.
[364] Valentina Magri, 'Crisi CMC di Ravenna, via libera degli obbligazionisti al piano concordatario, ora al vaglio di tutti i creditori' 10 March 2020.
[365] Press Release by CMC di Ravenna dated 29 May 2020 – available at: https://cmcgruppo.com/cmc/en/press/press-releases/
[366] A P Scarso, *Debt Restructuring in the "new" Italian Insolvency Law* (Studia Iuridica Toruniensia,Tom V 2009).

6. Claims of farmers;

7. Claims of suppliers of production plants and equipment, and claims of banks which financed the purchase thereof;

8. The debtor's expenses for food, clothing, lodgings, medical treatment or funeral arrangements, incurred within a period of six months prior to the insolvency order, as well as the expenses relating to the support of the debtor's family within the previous three months.

9. Income taxes (subject to certain limitations);

10. Local taxes, social security payments and insurance premiums.

Any sum due in a foreign currency will be converted into Euro as of the date of the insolvency order according to the rate of exchange then in force.

3.3.3 Lawful Causes of Preference under English law

We now come to consider the position obtaining under English law. The Insolvency Act 1986 and the Insolvency (England & Wales) Rules 2016[367] provide a statutory scheme setting out the manner the insolvency practitioner must distribute assets to meet creditor claims. The ranking order set out by law puts creditors into different classes and the insolvency practitioner distributes available assets according to the order of priority. The insolvency practitioner is prohibited from distributing assets to a class of creditors until he has repaid in full the claims of all creditors in the prior

[367] See the Insolvency (England & Wales) Rules 2016 (SI 1986/1925) in particular Chapter 2 "Creditors' claims in administration, winding up and bankruptcy" and Chapter 3 "Distribution to creditors in administration, winding up and bankruptcy".

ranking class. For this exercise to be accomplished a ranking order must first be established in terms of law. Accordingly, the ranking order should be as follows:

1. First ranking claims are holders of fixed charges and creditors with a proprietary interest in assets. A creditor that holds a valid fixed charge over a company's assets is entitled to the proceeds of the realisation of those assets in satisfaction of the liability due to it from the company.

2. Second ranking claims are the expenses of the insolvent estate. Therefore the insolvency practitioner pays the expenses of the insolvent estate before paying any other claims.

3. Third ranking are the preferential creditors. The majority of preferential debts rank equally in the distribution. However, it is significant to point out that some claims of unsecured creditors' debts are given "preferential" status, for example deposits made to an insolvent bank or building society that are insured under the Financial Services Compensation Scheme[368].

4. Fourth ranking are the holders of floating charges. As soon as the insolvent practitioner has paid all the expenses of the insolvent estate and preferential debts in full, any remaining assets subject to floating charges can be paid according to the priority of their security. The way a floating charge works is that it will automatically crystallise on the insolvency date and convert from being a generic charge over a class of assets to a fixed charge over the specific assets within that class. A floating charge created in the twelve (12) months before insolvency is void on the appointment of the insolvency practitioner except where new lending to the company takes place. This is extended to two (2) years in the case of floating

[368] The Financial Services Compensation Scheme (FSCS) the UK's statutory Deposit Insurance investors compensation scheme for customers of authorised financial services firms. This means that FSCS can pay compensation if a firm is unable, or likely to be unable, to pay claims against it.

charges in favour of "connected parties" (for example a director or associate of the director).

5. Fifth ranking are the unsecured creditors. The insolvency practitioner is to pay unsecured creditors, on a *pari passu* basis from any remaining assets. An unsecured creditor who has no security over any of the insolvent company's assets must have a provable debt. A secured creditor having a provable debt which was not paid in full from the realisation of assets subject to its security can claim any shortfall as an unsecured claim, but these claims can only be paid from unsecured assets.

6. Sixth ranking claims are the shareholders. It is a standard rule that after the repayment of all unsecured creditors in full, any surplus is to be distributed among the shareholders of the company according to their shareholding.

3.3.4 Special Law granting Special Tax Privileges under Maltese Law

As stated above, it is article 302 of the Companies Act of 1995 that provides for the application of the rules of ranking. The law makes it abundantly clear that in the winding up process of an insolvent company, *"… the rights of secured and unsecured creditors and the priority and ranking of their debts shall be regulated by the law for the time being in force."*

Rather unfortunately one has to look at different pieces of legislation in order to rank the creditors, thus rendering the exercise cumbersome and at times confusing and fragmented. The most pertinent areas of local legislation to be considered in this context are the following:

1. Title XXIII of the Civil Code[369] which deals with privileges and hypothecs. Article 1996 of the Civil Code provides that, *"the lawful causes of preferences are privilege, hypothecs and the benefit of the separation of estates."* The lawful causes of preference create a priority of payment to the creditor so secured in preference of post-ranking creditors or unsecured creditors.

2. Article 20 of the Employment and Industrial Relations Act[370] commences with the important proviso that this privileged claim is operative "*notwithstanding the provisions of any other law".* It then proceeds to state that any claim by any employee in respect of:

    - the current wage by the employer to the employee;
    - compensation for leave to which the employee is entitled; and
    - any compensation due to the employee in consideration of the termination of employment, or for any notice period;

    shall constitute a privileged claim over the assets of the employer and shall be paid in preference to all other claims whether privileged or hypothecary. The law itself sets out an important capping provision in that the privileged claim is limited to a maximum of three (3) months. What this means is that in accordance with this provision of law the compensation due in preference to employees shall be paid before any other claim of preference, even before any privilege or hypothec.

3. Article 116(3) of the Social Security Act[371] also contains the proviso that this legal provision is to come into effect *"notwithstanding the provisions of any other law".* By virtue of this provision the claim of the Director of Social Services for any amount due by way of any Class One or Class Two

[369] Chapter 16, Laws of Malta.
[370] Chapter 452, Laws of Malta.
[371] Chapter 318, Laws of Malta.

contribution under this article shall constitute a privileged claim. The privileged claim is to operate as follows:

(i) in the case of a Class One contribution, ranking equally with wages of employees over the assets of the employer; and

(ii) in the case of Class Two contribution, over the estate of the self-employed or self-occupied person concerned.

Such a privileged claim is to be paid in preference to all other claims (excluding wages) whether privileged or hypothecary. Here again the law is providing for a privileged claim over the assets of the employer and the self-employed for the Social Security contributions which they are bound by law to pay.

4. The provisions of article 23(11) of Income Tax Management Act[372] is to apply *"notwithstanding the provisions of any other law".* It provides that the amount due to be paid under this article constitutes a privileged claim over the assets of the employer. It is to be ranked immediately after the wages of employees and is to be paid after such wages and claims in preference to all other claims whether privileged or hypothecary. This privileged claims ranks immediately after the privileged claims emanating from the Employment and Industrial Relations Act[373] and the Social Security Act[374].

5. In terms of article 62 of the Value Added Tax[375] the Commissioner has a special privilege over the assets forming part of the economic activity of a person in respect of any tax due by that person. The said tax is to be paid, notwithstanding anything contained in any other law, in preference to a debt

[372] Chapter 372, Laws of Malta.
[373] In terms of article 20 of the Employment and Industrial Relations Act.
[374] Relating to claims of the Director of Social Security for any amounts due by way of contribution under article 116 of the Social Security Act
[375] Chapter 406, Laws of Malta.

having any other privilege, except for a debt having a general privilege and a debt mentioned in article 2009(a)[376] or (b)[377] of the Civil Code. There is a whole compendium of judgments delivered by the Maltese Courts dealing with this particular provision. These will be dealt with in greater detail in Chapter 4.

6. In terms of article 49(b) of the Duty on Documents and Transfers Act[378], a special privilege is created in favour of notaries for the duty payable or paid by him on transfer of property *inter vivos.* This special privilege has to be registered and shall rank together with the privilege contemplated under article 2010(c) of the Civil Code. Moreover the same Act, under Article 66(4) creates a special privilege in favour of the Government of Malta for the duty payable over all property transferred *causa mortis.*

There are numerous other special laws that create special privileges. However, I have chosen to focus particularly on tax privileges. The main reason for this choice is due to the fact that in practice tax privileges "take-over" the whole exercise concerning the ranking of creditors. The privileges that derive from the Employment and Industrial Relations Act[379] in favour of employees as well as those in the Civil Code[380] are also discussed in order to demonstrate the complexities involved in ranking creditors and to show the different legal status of varying secured creditors.

A pertinent practical example illustrating the manner in which the privileges granted by virtue of a number of special laws tend to become quite complex and also nearly always dissipate any possible assets distributable on a *pari passu* method is best illustrated in the Court case that follows. In **Unibuild Company Limited (C19011)**[381]**,** the Maltese Civil Court had occasion to decide upon the pre-ranking of creditors in the case of competing creditors with regard to their debtor company. In short, the

[376] The article deals with the privilege of pledge.
[377] It provides for the privilege of the hotel-keeper respectively.
[378] Chapter 364, Laws of Malta.
[379] Chapter 452, Laws of Malta.
[380] Chapter 16, Laws of Malta.
[381] Civil Court (Commercial Section), 31 January 2019.

background to these proceedings was as follows. On 30 October 2017, the Civil Court ordered the winding up of Unibuild Company Limited. A liquidator was appointed by the Court who submitted two reports establishing the creditor ranking. The competing creditors, among whom there were some claiming preferential rights, were the following: Andre Hugo, Ballut Blocks Services Limited, Bank of Valletta plc, Buz Dov Development Limited, HSBC plc, Juanafil Consultants Limited, The Commissioner of Inland Revenue, Nisso Company Limited, The Registrar of Companies.

Upon examining the liquidator's reports, the Court passed on to make its own deliberations in light of submissions made by the creditors. One major issue concerned a complaint raised by Ballut Blocks Services Ltd that not all the credit claims were backed by proof in terms of law and this was a very relevant point since the debtor company's assets were not sufficient to meet the various claims. The Court made specific reference to article 301 of Chapter 386. The complainant Company submitted that the Commissioner of Inland Revenue representing all Government tax units failed to prove as to whether the procedure contemplated by law in order to render a credit into an executive title by operation of the law were followed. Reference was made to article 116(2) Chapter 318 insofar as a judicial letter has to be notified for a claim for payment in connection with social security contributions. It did not result from the acts of the proceedings that such a judicial letter had in fact been issued and that it was up to the Commissioner to furnish such evidence. The Court concurred with this submission and opined that the legal privilege claimed by the Commissioner of Inland Revenue would only arise once a demand for payment was made according to law. Unless this results from the acts of the case, no privileged amount would subsist meaning that this amount cannot pre-rank other creditor claims enjoying a hypothec.

Another objection raised by Ballut Blocks Services Limited concerned a debt claimed by the Commissioner of Inland Revenue as Value Added Tax. According to the Company, no proof on this debt resulted in terms of law. It made reference to article 59 of Chapter 406 to maintain that the amount claimed was not proven in terms of

law and that therefore it should not pre-rank and put in the fifth place in the creditors' ranking as submitted by the liquidator.

In his Report the liquidator had considered the VAT debt to be privileged in virtue of article 62 of Chapter 406 which specifies that the Commissioner shall have a special privilege on those active assets forming part of the economic activity of a person on all tax that is due by that person in terms of the Act. Irrespective of whatever is stated under any other law, this section states that any VAT due takes preference over a debt which has any other kind of privilege, except for a debt enjoying a general privilege or a type of debt mentioned in article 2009 (a) or (b) of the Civil Code[382].

With the above-mentioned legal complexities in mind one rightly asks whether it is about time to seriously rethink these governmental privileges in the context of ranking of creditors. Is it fair and just that tax authorities grab most if not all of the available assets for distribution? Can these tax preferences be justified on grounds of public policy? Having regard to the above-mentioned factual and legal elements surrounding the case in question, is it not a ripe time to reconsider whether these tax privilege have had an adverse impact upon the course insolvency proceedings by way of additional complications and unnecessary delay? The arguments for and against will be discussed in detail in another Chapter accompanied by proposals for possible reform.

[382] In order to arrive at its final decision, the Court cited a number of locally decided cases namely:
- Ranking of Creditors of Carmelo Gauci Limited (Rik. Nru 53/06);
- Ranking of Creditors of Christopher Gauci (921/10/2013);
- Ranking of Creditors of Victor Zammit *et* (26/05/2015);

which will be dealt with in further detail in Chapter 4.

3.4 Avoidance of Transactions

3.4.1 Introduction

At this juncture, it would be opportune to discuss the law of avoidance of transactions. This is generally aimed at securing collectivity and the principle of *pari passu* distribution and to guard against unjust enrichment by one party to the detriment of the general body of creditors[383]. Why should this aspect be considered at this point? One good reason is that the law prohibiting preferences is an important area of corporate insolvency law. It is designed to counter attempts to undermine or circumvent the proper application of the *pari passu* principle in the case of a company's insolvency.

All anti-avoidance rules, however, are subject to the very large exception that creditors remain able to jump up the priority queue, through the creation of a security interest. Security avoids the effects of *pari passu* distribution by creating rights that have priority over the claims of unsecured creditors[384]. Thus, once again, a conflict seems to arise between two fundamental principles of law, that of freedom of contract which allows one to bargain for priority and the mandatory character of the *pari passu* principle[385].

Therefore, in contrast to the prevailing notion that the *pari passu* principle is sacrosanct and that its inherent characteristics of fairness and equality of treatment are unquestionable, several commentators have over the years expressed a fundamentally different view citing several examples where the doctrine may be deemed to be rendered passé. The fact remains that there are so many exceptions to the rule that at the end of the day they serve to stultify what should have been a

[383] *Vide* Daniel D Prentice, 'Some Observations on the Law relating to Preferences in R. Cranston (ed.), *Making Commercial Law* (Clarendon Press, Oxford 1997); Andrew Keay, 'The Recovery of Voidable Preferences: Aspects of Restoration' (2000) 1 CFILR.
[384] Vanessa Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 M.L.R. 633, 634.
[385] Michael Bridge, 'The *Quistclose* Trust in a world of secured transactions' (1992) 12 O.J.L.S. 222, 340.

practical application of the *pari passu* principle in the distribution of competing claims.

There exists an inevitable temptation on the part of some directors or persons involved in a company to try to circumvent or undermine the application of the *pari passu* principle during the company's twilight. This would be achieved by placing a particular existing creditor into a far better ranking once the inevitable insolvency comes to pass. Therefore the preferred creditor would be in a much more advantageous position in comparison to what that particular creditor would otherwise have been entitled to, standing alongside the other creditors *pari passu*. The uplift or improvement gained would have caused a corresponding detriment to the general body of creditors – distorting the 'equal treatment' ethos and frustrating the proper distribution of the general pool of assets to that body.

3.4.2 Fraudulent Preferences Under Maltese Law

3.4.2.1 "Qualifying Preferences"

The relevant provision is article 303(1) of the Companies Act of 1995 which states that:

- every privilege, hypothec or other charge; or
- transfer or other disposal of property or rights; or
- any payment, execution or other act relating to property or rights made or done by or against a company; and
- any obligation incurred by the company

made within six (6) months before the dissolution of the company shall be deemed to be a fraudulent preference against its creditors. It is irrelevant whether it is of a gratuitous or an onerous nature if it constitutes a transaction at an undervalue or if a preference is given. The burden of proof is on the person in whose favour it is made to prove that he did not know and did not have reason to believe that the company was likely to be dissolved by reason of insolvency. Any fraudulent preference shall

be void. Two important requirements set out by law for a preference to be deemed fraudulent are that:

- it is done by a company within six (6) months prior to the dissolution of the company; and
- while the company is insolvent.

3.4.2.2 What Transactions Are Preferences?

The Maltese Companies Act in article 303(2) distinguishes between two categories of fraudulent preferences:

(i) Transactions at an undervalue; and
(ii) Preferences.

In terms of article 303(2)(a)(i) and (ii) of the Companies Act, a company enters into a transaction at an undervalue if the company:

(i) makes a gift or otherwise enters into a transaction on terms that provide for the company to receive no consideration; or

(ii) enters into a transaction for a consideration the value of which, in money or money's worth, is significantly less than the value in money or money's worth of the consideration provided by the company.

Examples of what would be deemed to be a transaction at an undervalue are the following:

(i) Donation of property;
(ii) Undertaking a gratuitous obligation;
(iii) Purchasing any object not at its true value;

(iv) Leasing a property not at its true market value;

(v) Paying for service not at its true value;

(vi) Accepting an amount in order to extinguish a debt which is much less than its recoverable value.

3.4.2.3 Preferences

We now come to review the obtaining position under Maltese law with regard to preferences relating to companies being wound up and compare it with the English[386] and Italian[387] position. In accordance with article 303(2)(b)(i) and (ii) of the Companies Act, a company gives a preference to a person if:

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

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

3.4.2.4 Consequences of a Transaction being a Preference

By application of article 304 of the Maltese Companies Act, anything made or done after the appointed day is void under article 303 as a fraudulent preference and without prejudice to any rights or liabilities arising apart from the provisions of this article, the person preferred shall be subject to the same liabilities and shall have the same rights as if he had undertaken to be personally liable as surety for the debt to the extent of the charge on the property or the value of his interest, whichever is the less. Furthermore, the value of the preferred person's interest shall be determined

[386] See paragraph 3.4.3 below.
[387] See paragraph 3.4.4 below.

as at the date of the transaction constituting the fraudulent preference, and shall be determined as if the interest were free of all encumbrances or burdens other than those to which the charge for the company's debt was then subject[388].

On any application made to the Court regarding a payment alleging it was a fraudulent preference of a surety or guarantor, the Court may determine any such requests and issue any relief orders necessary[389]. There are a number of obstacles that must be overcome in order for an action for the avoidance of pre-liquidation transaction to be successful. The first among these is that the transaction being disputed must fall within the legal definition of a "qualifying preference." Besides, the law provides for a number of circumstances of transactions that are considered to be fraudulent preferences. If the transaction falls within these categories then the law provides for the consequences of such transaction being deemed to be a fraudulent preference. The effect of such an avoidance of a fraudulent preference may well qualify as a triumph for the legitimate application of the *pari passu* principle.

3.4.3 Avoidance of Transaction under English law

On a similar vein, section 239 of the English Insolvency Act 1986 has proved an effective weapon in a liquidator or administrator's hand. In practice, its continuing practical appeal to day-to-day insolvencies in the United Kingdom is evinced by the steady stream of reported cases in this area. Section 239 of Insolvency Act 1986 only permits applications to Court to be made in respect of an allegedly voidable preference that has occurred within the 'relevant time'. 'Relevant time' is defined, for the purposes of section 239, by section 240(1) as being either:

a. In the case of a preference given to a person who is 'connected with' the company, any time in the period of two (2) years ending with the 'onset of insolvency'; or

[388] article 304(2) of the Maltese Companies Act.
[389] article 304(2) of the Maltese Companies Act.

b. In any other case, any time in the period of six (6) months ending with the 'onset of insolvency'.

The 'onset of insolvency' is defined in section 240 (3) which lists different scenarios all relating to the company either entered into administration or going into liquidation. This may be the date of presentation of the petition for the making of an administration order, or in the case of an out-of-court appointment of an administrator the date on which the notice of intention to appoint is filed. In the case of a company going into liquidation following conversion of administration into winding up the onset of insolvency is the date on which the company entered administration. But in all other cases under which the company goes into liquidation the onset of insolvency is the date of the commencement of the winding-up.

In addition, the issue of whether the recipient of the preference was a person 'connected with' the company at the time the preference occurred, has an impact on two aspects of the application of section 239:

a. On the length of the 'relevant time' – as outlined above; and

b. It triggers a presumption created by in s239 (6) in respect to the ingredient 'influenced by a desire' – this will be considered below.

Persons 'connected with' a company is defined in a combination of section 249 and section 435. In fact, section 249 stipulates as follows:

For the purposes of any provision in, a person is connected with a company if-

(a) he is a director or shadow director of the company or an associate of such a director or shadow director, or
(b) he is an associate of the company

> *and "associate" has the meaning given by section 435 in Part XVIII of this Act.*

The rationale explaining the manner in which those *'connected with'* the company are singled out, is well brought out by Prentice as follows: *"The reason for singling out connected parties (e.g. directors) for special treatment is that they will more likely than other creditors to know of the company's insolvency and will also be in a position to pressurize the company to make a preferred payment*[390]*."* In other words, if the solvency of the company at the moment the alleged preference was given is in issue, then the Court would need to consider evidence of the company's accounts at that time.

Under English law, a Court cannot make an order setting aside a preference unless another condition, contained in section 239 (5), is satisfied, namely: *"…unless the company which gave the preference was influenced in deciding to give it by a desire to produce in relation to that person the effect mentioned in …*".

In **M C Bacon Ltd**[391], Millett J observes that *"...desire is subjective… Under the new regime a transaction will not be set aside as a voidable preference until the company positively wished to improve the creditor's position in the event of its own insolvent liquidation."* In **Fairway Magazines**[392], Mummery J elaborates even further in that:

> *…it does not follow that, because there was a desire to grant the debenture or to make the payment, there was a desire to prefer the creditor in the event of insolvency. If the company is influenced by 'proper commercial considerations' and not by a 'positive wish to improve the creditor's position in the event of its insolvent liquidation', then the debenture is valid.*

It is important to note that the crucial date is, *'…when the decision to grant [the preference] was made'.* In other words, it is not the date when:

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[390] Daniel D Prentice, 'Some Observations on the Law Relating to Preferences' Cranston(ed), *Making Commercial Law: Essays in Honour of Roy Goode* (Clarendon Press Oxford 1997) 439.
[391] *Re MC Bacon Ltd* [1990] BCLC 324.
[392] *Re Fairway Magazines Ltd* [1993] BCLC 643.

a. the transaction putting into effect the preference was executed; or

b. the underlying contractual or other obligations were created.

Where contractual obligations provide for the company to make a payment by a certain date, the relevant date is the date of the decision as to whether the company will honour its already existing contractual obligations. On this issue, in **Wills v Corfe Joinery Ltd (In Liquidation)**[393] Stealth J holds that:

> *Most preferences involve the payment of some debts in preference to others. All debts stem from an enforceable obligation to make the payment. If the decision to incur the debt, rather than the later decision to pay it, was the relevant time at which the company's desire was to be judged, the payment of debts would rarely constitute a preference under s. 239.*

This crucial date when the motivation is judged, applies equally to whether the company should honour its pre-existing obligation to grant a security or not. As Stealth J stated, there is no *"…distinction between the payment of debts on the one hand and other obligations, such as an obligation to grant a security, on the other*." It is the decision to comply with an obligation that is the key decision date and not the date when the obligation to later grant the security was created.

The ingredient here is only in respect to the company director's state of mind or conduct. As stated by Stealth J, *"this is entirely an issue of the thought processes of the directors of the company…Section 239 focuses not on the conduct or state of mind of the creditor concerned, but on that of the directors or others acting for the company.*" In this sense, this issue may be described as company-centric. A particular state of mind or conduct from the recipient is not required for the statutory power of set aside to be available to the Court. The statutory power is not dependent on any finding by the Court that the recipient has acted in any way improperly. The

[393] *Wills v Corfe Joinery Ltd* [1997] BCC 511.

Court found that the recipient had received a voidable preference but wanted to make it clear that *"the result in this case implies no criticism of [the recipient] at all"*. It can here be remarked that a statutory power founded on mere betterment, without this motivation ingredient, would be unworkable in practice. Companies in distress would struggle to interact with their creditors because individual creditors would be concerned that any betterment received due to the company's actions or omissions under the company's control or influence, would be vulnerable to being unwound later in insolvency. As the distressed company's position deteriorated, refinancing would be increasingly impossible, as individual creditors would become more and more concerned about the unwinding risk.

Where a transaction falls foul of section 239 of the Insolvency Act 1986, the transaction is voidable at the instance of the office-holder. Power is vested in the office-holder to bring proceedings to seek an order for it to be set aside. Upon a preference being established, the Court is required to *'make such order as it thinks fit for restoring the position to what it would have been if the company had not given that preference',* that is the *status quo ante*.

There are two parts to the remedy likely to be sought by the office-holder[394]:

a. An order setting aside the transaction (or 'avoiding', the phrases can be used for present purposes interchangeably). From the date of the Court order onwards, the transaction is null and void (the 'setting aside order'); and

b. An order reversing the betterment by unwinding the improvement, thereby removing the corresponding detriment to the general body of creditors (the 'restorative order').

[394] Stephen Hill, 'Understanding s239 Preference under Insolvency Act 1986' (2014). Available at: < https://www.33bedfordrow.co.uk/insights/articles/understanding-s239-preference-under-insolvency-act-1986> accessed on 18 June 2019.

Without contradicting the generality of the 'as it thinks fit' provision, section 241 (1) sets out seven orders the Court may decide to make. The Court will tailor the order so as to best achieve restoration in the particular circumstances of the case. Section 241(1) sets out that:

> *…an order ... with respect to a ... preference entered into or given by a company may—*
> *(a) require any property transferred as part of the transaction, or in connection with the giving of the preference, to be vested in the company ...*
> *(c) release or discharge ... any security given by the company*
> *(d) require any person to pay, in respect of benefits received by him from the company, such sum to the office-holder as the court may direct ...*

Where an asset is to be returned to the company, and that asset has been improved during the interim, allowance can be made for the expenditure incurred by the recipient. Guarantees or sureties released or discharged following linked debt being paid off contrary to s239, can be ordered to *'be under such new or revived obligations …as the court thinks appropriate'*.

The 'fruits' of the litigation, the sum recovered pursuant to the restorative order, is vested in the office-holder. It is money arising from the power he or she has exercised. As stated in **Re Yagerphone**[395]:

> *The right to recover a sum of money from a creditor who has been preferred is conferred for the purpose of benefiting the general body of creditors…the sum of money…did not become part of the general assets of, but was a sum of money received by the liquidator … with a trust for those creditors amongst whom they had to distribute the assets of the company.*

Such restored sums cannot therefore be subject to any floating charge granted over the company's assets.

[395] *Re Yagerphone* [1935] Ch 392.

3.4.4 "Claw Back" Action under Italian Law

Even in terms of Italian Insolvency legislation, the official receiver is empowered to apply to the court in order to bring the so-called "claw back" action[396] (*azione revocatoria*). The main objectives of these provisions have been to balance the needs of creditors to an adequate protection against certain "suspect" transactions in the run up to insolvency with the interests of debtors in financial distress to boost their assets[397]. Of particular note is article 67(1) of the Italian Insolvency Code which permits the court appointed official receiver to file a "claw back" action in order to have the following types of transactions set aside:

- gratuitous transactions entered into by the insolvent company or individual businessman in the year before the insolvency order;

- any transaction at an undervalue carried out by the insolvent company or individual businessman in the year before the insolvency order[398];

- any discharge of due and payable obligations performed in the year before the insolvency order[399];

- any security[400] granted by the insolvent company or individual businessman in the year before the insolvency order to secure pre-existing debts not yet due at the time the relevant security was granted;

- any security granted by the insolvent company or individual businessman in the six (6) months prior to the insolvency order to secure pre-existing debts that were due and payable at the time the relevant security was granted.

[396] That is, an action to set aside a wide range of transactions entered into before the opening of insolvency proceedings.
[397] A P Scarso, *Debt Restructuring in the "new" Italian Insolvency Law* (Studia Iuridica Toruniensia,Tom V 2009).
[398] A transaction is assumed to be "undervalue" when the actual value of the consideration paid to the debtor is less than one quarter in comparison to the value of the counterparty's consideration.
[399] Such as, for example, the transfer of goods to a creditor to discharge a payment obligation.
[400] pledge and mortgage.

With reference to the above-mentioned transactions, the official receiver does not have to demonstrate any intention by the distressed company/individual businessman to defraud or cause a prejudice to the creditors, or that the beneficiary was aware of the debtor's "state of crisis" at the time of the transaction.

The beneficiary can resist the claw back action by rebutting the burden of proof, by proving that, at the time when the transaction under scrutiny took place, he was not aware of the debtor's "state of crisis". The term debtor's "state of crisis" is to be understood as meaning that it was no longer possible for the debtor company to perform its obligations regularly at the time in which the relevant transaction was performed. In order to have the following transactions set aside, the official receiver has to prove that the beneficiary was aware of the debtor's "state of crisis" at the time when the transaction took place, provided it occurred within six months of the bankruptcy order:

- any repayment of debt already due and enforceable made through normal means;

- any pledge or mortgage granted by the debtor as security for debts arising simultaneously with the grant of the security; and

- any other transaction for consideration.

Finally, according to Art. 67(3) of the Italian Insolvency Code, the following transactions are unchallengeable by the official receiver[401]:

- payments for goods and services made in the debtor's ordinary course of business and in accordance with customary terms and conditions;

[401] A P Scarso, *Debt Restructuring in the "new" Italian Insolvency Law* (Studia Iuridica Toruniensia,Tom V 2009).

- sale of land to be used by the purchaser for their or their close relative's living purposes;

- transactions, payments and guarantees over the debtor's assets carried out or granted:

a) according to a reorganisation plan agreed upon with creditors, aimed at reducing the company's liabilities and rebalancing its financial position, "validated" by a favourable opinion of an independent expert;

b) pursuant to a voluntary restructuring arrangement or a debt restructuring plan;

    - any payment made to the employees and consultants;

    - any payment of receivables due to obtain services required for the admission to the voluntary arrangement with creditors.

Fabiani[402] analyses the relevance of investigating acts done by the Board of Directors which adversely affect the level playing field of creditors, that can expose the perpetrator to one of the liability actions provided for in the Italian Civil Code. He argues that the company has an interest in ensuring that the managerial team exercise their powers in compliance with the law. In a case of a breach of duty by a director a prejudice can be suffered by the creditors by way of a diminution of its patrimony, to be understood also as a lower profit. If no damage has arisen from the unlawful conduct of the directors, there is no room for an action of liability. When a director acts for personal interests or to damage certain shareholders, he certainly

[402] Massimo Fabiani, 'La *par condicio creditorum* al tempo del codice della crisi' (Questione Giustizia, Fascicolo 2/2019).

exposes himself to a series of repercussions. If a company has sold a company asset at a very low price (a transaction at an undervalue) then the provisions of article 166, paragraph 1, of the *Codice della Crisi d'Impresa e dell'Insolvenza* are triggered. In this case, the act on the part of the management to give away an asset for a small sum diminished the corporate patrimony.

3.5 Judicial Shielding

Since the objective of the *pari passu* principle is to render inoperative all agreements which would give unfair preference to particular creditors, it would be opportune to introduce at this point the legislative provisions which freeze the pursuit of individual debt enforcement remedies against the insolvent company being wound up in favour of collective actions by the creditors as one collective body. By and large, the operative provisions that matter in this particular context are articles 220,221, 222, 224(2) and 292 of the Companies Act. In terms of article 220 of the Maltese Companies Act,

> *at any time after the filing of a winding up application, and before a winding up order has been made, the company, or any creditor or contributory, may apply to the court for a stay of judicial proceedings pending against the company, and the court may stay those proceedings accordingly on such terms as it thinks fit.*

In the period between the filing of the application for the company to be wound up by the court and the court's decision, the court may order a stay of proceedings on the application of the company, creditor or contributory. The purpose of staying judicial proceedings is to ensure that the collective interests of the general body of creditors are protected, since no asset would be dissipated from the debtor company's estate and thus creditors would be in an equal position at the start of the ranking exercise.

Furthermore, Article 292(1) goes on to stipulate that,

> *the liquidator or any member, contributory or creditor may apply to the court to determine any question arising in the course of winding up of a company, or to exercise, as respects the enforcement of calls or any other matter, all or any of the powers which the court might exercise if the company were being wound up by the court.*

Through the application of this provision the protection afforded in a winding up by a court is extended to a voluntary winding up.

In **Dr. Edward Gatt *nomine* vs TRM Limited Malta**[403], it was held that when a Court is faced with an application based on article 220[404], the Court's hands are not tied and it can exercise its discretion as to whether to accept or reject such a request. The defendant company had also requested for a stay of proceedings in terms of article 220. The main objective of this provision of law was to avoid a scenario where creditors are unfairly prejudiced in the ranking of creditors because of individual enforcement actions against the insolvent company. The legislator wanted to ensure that the available assets of the insolvent company for distribution by the liquidator rateably to the creditors was in accordance with the principle of *pari passu,* which was the fundamental aim of article 220. The legislator wanted to avoid that a creditor obtains a judgment before all the other creditors in such a manner that there would be a race before the Courts. The law therefore offers the possibility to the Court to stay new proceedings that are initiated for the recovery of a debt in the course of the winding up proceedings. Once a company is wound up it is the function of the liquidator to realise the assets and to distribute them in accordance with the principle of *pari passu.* A company which still is a viable concern must act in the best interests of the shareholders.

[403] First Hall Civil Court, 10 October, 2007.
[404] Chapter 386, Laws of Malta.

As Davies explains,

> *the traditional answer of the common law has been the classical one that the duties are owed to the members of the company as a whole, the members being the persons who created it or who have subsequently become members, normally by buying shares in it. The usual justification for this way of defining 'the company' is that the shareholders stand last in line to receive the economic benefits of the company's activities and therefore have the strongest incentive of all the groups involved with the company to monitor the board effectively*[405].

Once winding up proceedings commence, the interests of the shareholders are no longer paramount. Rather it is the interests of the general body of creditors, as a collective entity, which become important. In **Kinsela v Russell Kinsela Pty Ltd**[406] it was held that, *"in a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise …"* But where a company is insolvent *, "…the interests of the creditors intrude."* In such a situation, the creditors,

> *…become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.*

Also in **Colin Gwyer & Associates Limited v London Wharf (Limehouse) Limited**[407] it was stated that, *"in relation to an insolvent company, the directors when considering the company's interests must have regards to the interests of the creditors".*

[405] Paul Davies, *Gower and Davies: The Principles of Modern Company Law* (4th edn, Sweet & Maxwell 2008).
[406] (1986) 4 NSWLR 722.
[407] [2003] BCC 885

Article 220 of the Companies Act affords a discretion to the Court, in order to preserve the fundamental principle of *pari passu* and also in the interests of the general body of creditors, to stay proceedings. However, it is important that this discretion is exercised reasonably[408]. It is interesting at this point to make reference to Fletcher's observation that,

> *in exercising their discretionary powers … the courts have evolved an approach which aspires to balance the collective interest against the relative hardship and injustice, which may be experienced by the individual creditor, under circumstances where it is inevitable that any mitigation of that person's loss will be at the expense of the general body of creditors, and hence will amount to a judicially-sanctioned exception to the pari passu principle[409].*

It seems logical, therefore, to maintain that in the course of winding up proceedings, the Court does not allow fresh concurrent proceedings to commence, unless there are substantial reasons permitting such action. The main purpose of these provisions is the collection and distribution of the assets of companies for the general benefit of their creditors and amongst the creditors *pari passu*. The exercise of this discretion by the Court must not be for the benefit of any particular creditor or creditors but for the benefit of the general body of creditors[410].

Coming back to the position obtaining under Maltese law, in **Saviour Cutajar vs All Invest Company Limited[411]**, the Court highlighted the fact that it is abundantly clear that article 220 of the Companies Act gives a discretion to the Court in order to protect the fundamental principle of *par condicio creditorum.* This decision is of particular note since it also involved the Malta Financial Services Authority and to this end the Court concluded that the request for the proceedings to be stayed should be rejected. The Court opined that the allegation of mis-selling of a financial product and the allegation of fraud were in themselves serious and grave reason. The Court also pointed out that additionally due note was to be taken of another

[408] See Dr. Edward Gatt *nomine* vs TRM Limited Malta, First Hall Civil Court, 10 December 2007.
[409] I Fletcher, "The Law of Insolvency", Third Edition, page 957.
[410] See the judgment in *Re Redman (Builders) Limited* [1964] 1 All E. R. 851.
[411] First Hall Civil Court, 28 May 2014.

important factor and that is the objection lodged by the Malta Financial Services Authority to the requests made by defendant company, All Invest in the winding up proceedings being heard before another Court. This is due to the supervisory role afforded to the Malta Financial Services Authority by law over companies carrying out financial services. Furthermore, the Malta Financial Services Authority was empowered to commence winding up proceedings on its own initiative. Thus the Court concluded that there were sufficient reasons of a serious nature for the Court to exercise its discretion in order to reject the application for a stay of proceedings. Additionally, article 221 provides that, *"in a winding up by the court, any disposition of the property of the company, including any rights of action, and any transfer of shares, or alteration of the status of the members of the company, made after the date of its deemed dissolution, shall be void, unless the court otherwise orders."*

The effect of this provision is that it ensures that all creditors remain on an equal footing in that no benefit or advantage is granted to them beyond that which is permissible by law and thus the principle of equality is preserved.

Article 222 of the Companies Act expressly states that when a company is being wound up by the court, any act or warrant, whether precautionary or executive, other than a warrant of prohibitory injunction, issued or carried into effect against the company after the date of its deemed dissolution, shall be void.

Finally, in terms of art 224(2) of the Companies Act, *"where a winding up order has been made or a provisional administrator has been appointed in accordance with the provisions of article 228, no action or proceeding shall be proceeded with or commenced against the company or its property except by the leave of the court and subject to such terms as the court may impose."*

In **Mediterranean Flower Products Limited vs Flower Power (Sales) Limited *et***[412], the appellate court drew a distinction between a scenario where a provisional administrator is appointed for plaintiff company as opposed to a case where a provisional administrator was appointed for defendant company. The appellate court observed that article 224(2) referred to judicial actions taken against a company in a winding up process and not to instances where an action is brought by a company party to such proceedings. In this regard the Court opined that the words of the law were self-evident and made it abundantly clear that the aim of this article was intended to safeguard companies undergoing winding up proceedings (even if before the winding up order is actually deliver) against multiple court actions being brought against it.

In interpreting this provision to the facts of the case at hand, the Court observed that the intervenor in the proceedings made it amply clear that its purpose for filing an application was in order to have the debt owed to it confirmed by a court judgment both against the defendant as well as its guarantor. It was argued that the guarantor is obliged *in solidum* with the defendant. However, in the circumstances the court highlighted the fact that the intervenor had other remedies at law against the guarantor and proceeded to reject the intervenor's request against the guarantor.

The intention of the Maltese legislator in enacting articles 222 and 224(2) of the Companies Act is manifest and encapsulates the ethos of our corporate insolvency regime. The domestic corporate insolvency legislation is focused on preserving the best interests of the general body of creditors. The above-cited Court of Appeal judgment recognises and confirms this overriding principle. It is my firm belief that it is only through the strict application of the judicial shielding provisions that the underlying objectives of the applicable winding up legal provisions are best applied and implemented in practice[413].

[412] Court of Appeal, 30 July 2010.
[413] Further judgments delivered by the Maltese courts on this point will be analysed in further detail in Chapter 4.

In **Panta Contracting Limited vs D.A. Holding Limited[414],** one finds a detailed analysis of article 224(2) of the Companies Act together with a comparative analysis between the Maltese and English texts of the same provision of law. Whereas Article 224(2) of the Companies Act reads as follows,

> *Meta jkun sar ordni għal stralc jew ikun inħatar amministratur provvizorju, skont id-disposizzjonijiet tal-artikolu 228, ma tista' tittieħed ebda azzjoni jew jinbdew xi proceduri kontra l-kumpannija jew il-proprjetà tagħha ħlief bil-permess tal-qorti u taħt dawk il-kondizzjonijiet li tista' timponi l-qorti.*

Its English translation equivalent reads as follows,

> *Where a winding up order has been made or a provisional administrator has been appointed in accordance with the provisions of article 228, no action or proceeding shall be proceeded with or commenced against the company or its property except by leave of the court and subject to such terms as the court may impose.*

There is no doubt that this provision was modelled on section 130(2) of the Insolvency Act, 1986 which states that,

> *when a winding-up order has been made or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company or its property, except by leave of the court and subject to such terms as the court may impose.*

[414] First Hall Civil Court, 26 February 2015.

It is quite evident that the text that appears in the Maltese Companies Act is almost identical to its counterpart under English law. The Court cited Keay and Walton[415] on the interpretation of Section 130(2) of the Insolvency Act 1986 who argue that,

> *the rationale for this is that it is not appropriate for the liquidator to be harassed by litigants, which would diminish the estate of the company; rather the liquidator is to preserve the limited assets of the company for distribution among all the persons who have claims upon them[416].*

The Court also pointed that this article of law was intended to diminish litigation costs as it obliges all the creditors to take part in the same procedural scheme established in the winding up. Adopting such a collective action renders the whole process less expensive and more orderly "*if any claims against the company can be dealt with in the usual way that is used for the proving of claims.[417]"* In other words, the objective underpinning this provision was to avoid the inconvenience and expense of litigation by imposing collective proceedings.

Leave of court is not granted where the applicant's claim is unfounded in fact and in law[418]. In determining whether to grant leave or not, the Courts have an absolute discretion, and an appellate court will not readily interfere with the exercise of a discretion[419]. The Courts are not bound by a set of guidelines in the exercise of the discretion. It is presumed that the Courts are to do what is right and fair in all circumstances[420]. There are other factors that are deemed to be also significant in establishing whether leave should be granted such as, *"the amount and seriousness of the claim, the degree of complexity of the legal and factual issues involves, and the stage to which the proceedings, if already commenced, may have progressed[421]."*

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[415] Andrew Keay and Peter Walton,*Insolvency Law* (Longman, Pearson Education Limited 2003) 248-251.
[416] *Re David Lloyd & Co* [1877] 6 Ch D 339 [344].
[417] *Ogilvie Grant v East* [1983] 7 ACLR 669 [672].
[418] *Vagrant Pty Ltd (in liq.) v Fielding* [1993] 11 ACLC 411.
[419] *Thomas Plate Glass Co v Land & Sea Telegraph Construction Co* [1871] 6 Ch App 643; *Re Pacaya Rubber & Produce Co* [1913] 1 Ch 218 CA.
[420] *Re Aro Co Ltd* [1980] Ch 196; *Re Exchange Securities & Commodities Ltd* [1983] BCLC 186 at 195.
[421] *OgilvieGrant v East* [1983], 7 ACLR 669.

When a Court is examining an application to see if there is a good cause of action it will consider whether the action will affect the orderly winding up of the company and if any such action would prejudice the other creditors[422]. It is possible for the court to extend leave to a creditor to prosecute or initiate legal proceedings and impose conditions, such as the usual requirement that the creditor will not attempt to enforce against the company any judgement obtained without the leave of the court[423].

In general, the cases where leave has been granted can be divided into two broad categories. Firstly, where the nature of plaintiff`s claim requests leave and secondly, where the balance of convenience and the requirements of justice demand that leave be given. The question would have to be fundamentally one of expedience and convenience. This means that leave will not be granted where the proposed action raises issues which are able to be dealt with in the liquidation proceedings with equal convenience and less delay and expense.[424] By contrast, any claims which are likely to be more difficult or more expensive to settle in winding up rather than by action at law are usually allowed to proceed.

It is worthwhile to remark regarding this issue that in terms of the new Italian *Codice della Crisi d'Impresa e dell'Insolvenza* there are signs that lead to postulate that the protection of the level playing field has not been weakened on a procedural level. Articles 150 and 54 of the *Codice della Crisi d'Impresa e dell'Insolvenza* have in fact expanded the judicial acts that remain subject to judicial shielding. In the past, the prohibition concerned executive and not precautionary actions. It is true that, by way of interpretation, there was a tendency to extend the ban also to precautionary initiatives[425], but one can only take note that the legislator considered it important to transform what was previously only an interpretation into positive law[426].

[422] *Re Gordon Grant and Grant Pty Ltd* [1982] 1 ACLC 196.
[423] *Re Gordon Grant and Grant Pty Ltd* [1982] 1 ACLC 1996.
[424] *Re Exchange Securities & Commodities Ltd* [1983] BCLC 186 at 196.
[425] See Cass., 18 gennaio 1995, n. 520, in *Fallimento*, 1995, p. 837.
[426] See Cass., 5 aprile 2013, n. 8425, in *Foro it*., rep. 2013, voce *Fallimento*, n. 329.

3.6 A Critique of the *Pari Passu* Principle

3.6.1 Introduction

The impression may have been given so far that the *pari passu* principle has been unequivocally accepted and applied by one and all whenever insolvency proceedings are set in motion. But in reality there has been a fair amount of valid criticism of the entire principle to a varying degree ranging from one of cautious doubt to downright scepticism. This principle was first introduced into English Law by the Statute of Bankruptcy in 1542. However, not everyone is happy or that much convinced with its practicality, applicability or even supposed fairness. Some would even consider it as a flawed procedure. According to these critics the application of the *pari passu* principle is limited in practice. These critical views stem from the fact that in applying the *pari passu* principle, it should follow that all creditors of a particular type are to be treated the same post-insolvency. In theory, the creditors are supposed to share the assets of the insolvent company on a *pro rata* basis[427]. However, there are different layers of priority among creditors. The various exceptions to the orthodox definition of the *pari passu* rule have tended to distort, or rather create misconceptions about its practical application. The existence of preferential and subordinated creditors is a case in point. For this reason, these commentators would argue, that the principle could be salvaged by adopting a multi-lateral approach. Rather than operating in a comprehensive manner with respect to every type of claim or liability, the actual distributional scheme *"is essentially one in which the pari passu principle is applied sequentially in relation to certain discreet groups of claims, ranked into categories according to a fixed system of priorities[428]".*

[427] *Re Smith, Knight & Co, ex p. Ashbury* [1868] LR 5 Eq. 233, at [226].,
[428] Look Chan Ho, '*Pari Passu* Distribution and Post-Petition Disposition: A Rationalisation of Re Tain Construction' (SSRN, 21 November 2005).

3.6.2 The *Pari Passu* Principle Debunked?

Two divergent schools of thought have emerged regarding the validity of a true functioning of the *pari passu* principle. The academic analysis conducted by Mokal[429] on the function of *pari passu* in English insolvency law and Ho's[430] review of Goode's approach to the subject highlight a marked division between two schools of thought regarding the efficacy of the principle in practice. There are those who view *pari passu* as being 'fundamental' or 'a cornerstone', and those who view the role and reality of *pari passu* as being merely one of a number of priority rules. Despite the above, both the evolution and application of insolvency law, as well as the operation of common commercial principles have led to a number of situations where creditors can either side step the *pari passu* rule altogether or, at the very least turn it on its head. So whittled down has the *pari passu* rule become that it was stated by Mokal that *"pari passu is not a rule or a restriction or a standard. It neither imposes a requirement which insolvency must fulfil nor does it shape that law in any way[431]".*

Mokal has engaged in numerous academic studies examining the *pari passu* principle. He is highly critical of those who regard it as "the foremost principle in the law of insolvency around the world." He goes as far as to refer to the principle as a "myth". He argues that the *pari passu* principle does not constitute an accurate description of how the assets of insolvent companies are in fact distributed, has no role to play in ensuring an orderly winding up of such companies, does not explain or justify distinctive features of the formal insolvency regime, and has little to do with fairness in liquidation[432]. Mokal states that the true purpose of the principle is to provide a low expense way of dealing with those classes of claims which both the Parliament and commercial entities have decided should receive little or nothing at the end of the insolvency proceedings. He asserts that, rather than being the pillar

[429]Rizwaan Jameel Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60(3) Cambridge Law Journal 581.
[430] Look Chan Ho, 'Goode's swan song to corporate insolvency law' [2006] EBLR 1727.
[431] Andrew Keay *et*, *McPherson & Keay's Law of Company Liquidation* (4th edn, Sweet & Maxwell 2017) quoting R Mokal.
[432] Rizwaan Jameel Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60(3) Cambridge Law Journal 581. .

of any asset distributional system, it is the antithesis of this and it is to be understood as a principle of non-distribution. This hard stance is explained as follows, *"to the extent that these arguments succeed, the initial onus of justifying their position shifts from those arguing in favour of the priority of secured credit, to those who support a more 'equal' distribution of the insolvent's estate.*[433]*"*

3.6.3 The Creditors' Bargain Model

Mokal is likewise critical of those who try to justify the so-called "Creditors' Bargain Model" of insolvency law. He explain that according to this model the vital characteristics of any insolvency regime are best explained *"as reflecting the notional agreement the creditors of a company themselves would strike if given the chance to bargain with each other before anyone lends anything*[434]*".* This school of thought is based on the principle that a corporate insolvency regime ought to be centred upon the perspective of the *ex ante* bargaining powers of creditors. In order to dispute the validity of this approach, Mokal uses the principles underlying the stay on unsecured claims to show that model has no explanatory or justificatory force. He asserts that it is more a question of self-interest of creditors. He argues that the effects of the application of this model is that it is, *"oppressive of weaker parties, would be strongly anti-egalitarian, and therefore would have no normative appeal. It follows that principles which can be argued for within the model have nothing to do with autonomy. Nor would they necessarily be efficient*[435]*".* In another scholarly article, Mokal revisits the so-called Creditors Bargain Model and again is highly critical of it:

> *Within the Creditors' Bargain Model, well-diversified repeat players do not care about what is "collectively undesirable!" They are motivated, let us recall, solely by their own self-interest, and so appeals to the collective weal should not be regarded as holding any sway with them. Nor would they be moved by the fact that the switch-over to a*

[433] Ibid (No 399).
[434] Rizwaan Jameel Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press 2005).
[435] Rizwaan Jameel Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005).

collective system is likely to preserve the most value in the debtor's estate[436].

According to him,

Self-interested repeat players would prefer a larger slice of a smaller pie to a smaller slice of a larger pie. And while the collective regime would usually lead to a larger pie, winning an individualistic race might lead to a larger slice[437].

The priority of secured creditors has often been criticised for tolerating the *"exploitation of certain types of unsecured creditor. It has also been blamed for creating inefficiencies[438]."* Three distinguishing features are said to differentiate secured from unsecured creditors[439]:

1. The secured creditor obtains priority, that is he gains the right to have collateral to be applied to the satisfaction of his debts in a particular order with respect to other creditors;

2. The collateral is encumbered meaning that the debtor loses the right to convey to third parties rights inconsistent with those of the secured creditor; and

3. The said security in itself provides a remedy in enforcing the secured debt which is swifter and less costly. These features make it superior when compared to that afforded to unsecured creditors. This is especially true in the instance when a company is on the door-step of insolvency in that the existence of a security takes on the greatest significance.

[436] Rizwaan Jameel Mokal, 'Contractarianism, and the Law of Corporate Insolvency' (July 2007) Singapore Journal of Legal Studies, 51-95.
[437] Ibid (No 403).
[438] Rizwaan Jameel Mokal, 'The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit' (December 2002) 22 Oxford Journal of Legal Studies, Issue 4.,.
[439] Lynn M. LoPucki, 'The unsecured creditor's bargain' (1994) 80 Virginia LR 1887, 1921.

The privileged position enjoyed by secured creditors was ably described by Mokal as follows:

> *There has always been some feeling – at least among some academic commentators – that the balance is tilted too far in favour of those holding security[440]. The Report of the Insolvency Law Review Committee proposed certain restrictions on the secured creditors' ability to enforce their security[441]. Famously, it suggested that 10% of the value of the assets subject to a floating charge be set aside in a company's insolvency for distribution to unsecured creditors[442].*

Regarding the appointment of a receiver he goes on to state that,

> *The ability of secured creditors to appoint a receiver to manage assets subject to their security was also considered, and the Committee proposed a suspension of the security holder's right to enforce that security for twelve months, should a receiver or administrator be appointed[443]. Neither of these proposals was reflected in the Insolvency Act 1986, enacted in response to the Cork Report.*

There are others who comment that unsecured creditors are "uninformed" and thus in an apparent disadvantage. In his experience as a practising commercial and bankruptcy lawyer, LoPucki, remarked that,

> *substantial proportion of the unsecured creditors who had showed up on bankruptcy schedules were not creditors who had knowingly assumed the risk of the debtor's business. They were creditors who, had they known the true state of the law and the debtor's finances when they made the fatal decision to extend credit (or not to withdraw from an extension already made), would have decided differently[444].*

Finch[445] describes a strong version of *pari passu* as one which operates so *"that unsecured creditors as a whole, are paid pro rata to the extent of pre-insolvency claims."* Her weak version is one where *pari passu* operates so that *"…such unsecured*

[440] See generally, Roy Goode, 'The death of insolvency law' (1980) 1 Company Law 123.
[441] "Insolvency Law and Practice" (Cmnd. 8558, 1982).
[442] Ibid. (No 408).
[443] Ibid. (No 408).
[444] Lynn M LoPucki, 'The Unsecured Creditor's Bargain' (1994) 80 VA. L. Rxv. 1887, 1924-47.
[445] Vanessa Finch, *Corporate insolvency law: perspectives and principles* (Cambridge University Press 2009).

creditors share rateably within the particular ranking that draws distinctions between different classes of unsecured creditors (e.g. preferred employees and ordinary unsecured creditors)."

The fact remains that at the end of the day insolvency law has to make distributional choices and these very often lead to one party being favoured at the expense of the other. According to Goode[446], *"… the pari passu principle simply supplies a blanket to paper over these divergences and imposes an iron-clad idea of equity as equality. As an all-encompassing standard for bankruptcy, the pari passu rule is bankrupt of legitimacy."* He argues that from their very nature bankruptcy proceedings attract claims having competing and divergent rights emerging out of various branches of law (for example, the laws of contract, tort, employment and tax law). Thus he opines that it is inevitable that every asset distributional system will contain rules seeking to resolve conflicts between claimants and favouring one claimant over another. Goode[447] goes on to suggest in very strong terms, *"we must jettison, without the slightest tinge of regret, that hackneyed, and misleading phrase, 'the most fundamental of insolvency law is that of pari passu distribution."* Strong words indeed!

Ho[448] presents two approaches to the *pari passu* principle. The first is the "orthodox *pari passu* principle" which is embodied in section 107 of the Insolvency Act, 1986 and rule 4.181 of the Insolvency Rules, 1986. In terms of the observations made in **Re Smith, Knight & Co, ex p Ashbury[449],** *"The Act of Parliament unquestionably says, that everybody shall be paid pari passu, but that means that everybody after the winding-up has commenced… It takes them exactly as it finds them, and divides the assets amongst the creditors, paying their dividend on their debts as they then exist."* What this approach entails is that the principle is applied to claimants 'exactly as it finds them', that is the distribution of assets is done on the basis of pre-insolvency

[446] Roy Goode, *Principles of Corporate Insolvency* (4th edn, Sweet & Maxwell 2011).
[447] Ibid. (No 413).
[448] Look Chan Ho, 'The Principle against divestiture and the *pari passu* fallacy' (2010) Butterworths Journal of International Banking and Financial Law.
[449] (1968) LR 5 Eq 223, 226.

claims. In practice what this means is that all those having claims deemed to be unsecured under pre-insolvency law should be repaid the same proportion of their claims as all others similarly ranked. In line with this approach, the existence of set-off and preferential claims were deemed to be exceptions to this principle.

With regard to the second approach the *pari passu* principle would refer to the *pro rata* distribution within the different classes of creditors established by insolvency law itself. The principle is evident in section 175(2)(a) of the Insolvency Act, 1986 which states that preferential claims are to rank equally among themselves and shall abate in equal proportions if the company's assets are insufficient.

In his conclusions, Ho[450] remains extremely critical of the understanding of the true nature of the *pari passu* principle,

> *So, in sum, here we are nearly 150 years after **ex p. Mackay**. With the principle still imprisoned by the pari passu myth, misperceived rationale of the Principle continues to rage. So does the misconceived lumping together of the Principle with mandatory pari passu distribution, fuelled by a crabbed reading of the insolvency legislation. So does the conceptual muddle eclipsing the Principle's practical contours. So much, then, for Lord Neuberger MR's laudable aim to leave the law in a relatively clear state.*

In **Perpetual Trustee Company v BNY Corporate Services[451]**, Lord Neuberger MR explained that the principle *"was essentially based on the proposition that one cannot contract out of the provisions of the insolvency legislation"* and the relevant provisions that exemplified the principle are sections 107, 127, 143, 144, 238, 239 and 245 of the Insolvency Act 1986 and rule 4.181 of the Insolvency Rules 1986. Ho[452] is highly critical of the stance taken by the learned judge and observes that, *"the present case is another example of confusion of thought… While s 107 and rule 4.181 represent the orthodox pari passu principle, avoidance provisions such as ss 127, 238,*

[450] Ibid. (No 415).
[451] [2009] 2 BCLC 400.
[452] Look Chan Ho, "'The Principle against divestiture and the pari passu fallacy'", (2010) Butterworths Journal of International Banking and Financial Law.

239 and 245 have nothing whatsoever to do with the pari passu principle. They are to conserve the debtor's estate and sustain the order of insolvency priority – the realm of the principle of collectivity. Lumping the pari passu principle in a laundry list of statutory provisions shows the court's insufficient understanding of the pari passu principle."

Dalhuisen[453] too is not very keen on the supremacy of the principle of equality within collective insolvency proceedings. He observes that it is often said that equal distribution is the "essence" of modern bankruptcy law however it is not so. He points out that the distributional system is equitable but not equal. This is so since modern bankruptcy law provides numerous occasions for special laws creating for ranking privileges as well as for set-off or netting facilities. It is no longer all about the overriding interests of common creditors. The principle of equality he observes applies only to creditors within the same rank. He explains that since each class of secured creditors constitutes a rank of its own, in effect it is only at the lowest rank that equality will be triggered amongst the unsecured creditors - *"the added reason is that these creditors are likely to have only obligatory claims, which rank pari passu per se".* More importantly, he argues that it is only modern reorganisation proceedings that cater for a survival plan that suspend the priority and demand concessions even in respect of secured claims.

If the realization of the assets is done in an unprofessional manner there will be legal problems in the distribution of the debtor's assets[454]. Problems arise in the implementation of the principle of equality and the *pari passu pro rata* part in the management and settlement of assets. The principle of *creditorum* parity ensures that all creditors have the same rights to all assets of the debtor. On the other hand

[453] Jan H Dalhuisen, *Dalhuisen on Transnational and Comparative Commercial, Financial and Trade Law, Volume 3, Financial Products, Financial Services and Financial Regulation* (5th edn, Hart Publishing 2019).

[454] Winanto, Adi Sulistiyono and Y. Taruono Muryanto, 'Analysis of Equality on Creditor Standing Principle on The Process of Arrangement and Settlement of Bankruptcy Asset in Indonesia' (October 2019) - <https://www.atlantis-press.com/proceedings/icglow-19/125920819> accessed on 16 June 2020.

the *pari passu* principle emphasizes the distribution of debtor assets to pay off debts to creditors in a more just and proportionate manner.

3.6.4 Criticism of the *Par Condicio Creditorum* in Italian law

Returning to the Italian position the so-called principle of *par condicio creditorum* has also been subject to some criticism by some Italian practitioners. Fabiani[455] argues that the principle of a level playing field expresses the method by which, in bankruptcy, an asset distributional rule can be implemented between various competing creditors who aspire to enjoy the same capital guarantee. The criterion of equal treatment is an alternative to the criterion of temporal preference. Competitiveness is a logical implication of the principle (allocated in the above rule of article 2740 of the Civil Code) of the universality of patrimonial responsibility. In the liquidation procedures, the principle of equal treatment, net of the causes of preference is still a current rule, albeit no longer central, given the coexistence of the revocatory insolvency actions. In the agreed procedures, even if financial liability is carried out, the inclusion in the system of the new phenomenon of classes of creditors, as an instrument of flexibility in the composition proposals, enhances the rules of negotiation to the point of destroying the principle of equal treatment which although often practiced, is no longer indispensable. Not differently, the ability for the debtor to pay only some of the bank creditors (see article 100 *Codice di Crisi d'Impresa e dell'Insolvenza*) diminishes the equality of treatment in the name of business continuity. Before assessing whether and to what extent there has been, over time, the effective diminution of the principle of equal treatment, it is necessary to establish an early conclusion: the competition is nothing more than a natural effect of the plurality - current or potential - of the creditors who aspire to be satisfied on the same assets. Therefore, insolvency is an endemic and non-avoidable phenomenon whenever the debtor's resources are to be distributed according to a

[455] Masimo Fabiani, 'La *par condicio creditorum* al tempo del codice della crisi' (Questione Giustizia, Fascicolo 2/2019).

precise legal graduation order; on the contrary, the level playing field may or may not be there and, when it exists, it can be variously modular.

From a cursory look of the general part of the new Italian Insolvency Crisis Code, the expression "regulation of the crisis and insolvency" (*"regolazione della crisi e dell'insolvenza*") is used no less than fifteen (15) times. Is there a reason for this repeated use, one may ask? In the Code it is almost always preceded by the term "procedure(s)" (*"procedura/e"*). This can raise some doubts as to whether it should be understood as a substitute for "insolvency procedure" (*"procedura concorsuale"*). This lack of certainty on the precise meaning of the terms used in the Code may create difficulties in its interpretation and application. On the one hand, the term "insolvency procedures" is used, albeit sporadically, in the Code and in many other special laws; and on the other hand, the term "crisis and insolvency regulation procedures", is repeatedly is used many times but lacks definition. These two expressions coexist and one cannot help but think that their meaning is different and that the legal concepts related to them do not coincide at all. Now, the scenario has become complicated because, in addition to the insolvency procedures, which are in themselves not defined, the crisis regulation procedures are added, which are also not defined. It results that both insolvency and regulatory procedures of the crisis and insolvency include both compulsory and voluntary procedures, with the result that the perimeter of the insolvency procedures will be subject to interpretation. This lack of clarity has a detrimental effect on the application of the *par condicio creditorum.*

3.7 The Validity of the Exception to the *Pari Passu* Principle and the Charter of Fundamental Rights of the European Union

The Court of Justice of the European Union in **Private Equity Insurance Group**[456] insolvency case had occasion to examine the relationship between the deviations and exceptions to the *pari passu* principle and article 20 of the Charter of Fundamental Rights of the European Union[457], according to which everyone is equal before the law.

The case arose in connection with the insolvency proceedings of a Latvian company, Izdevniecība Stilus SIA (in respect of which Private Equity Insurance Group SIA is the legal successor). Pre-insolvency, the company opened a bank account with Swedbank AS. The opening of account contract included a clause pledging all the monies in the account to the bank as financial collateral to cover all debts owed to it by the company. Post-insolvency of the company, the bank relied on this contractual provision to debit monies from the account which were applied in payment of the company's debts to the bank.

Acting through its administrator the company brought proceedings to recover these monies relying on provisions of Latvian insolvency law relating to *pari passu* treatment of creditors. In its defence the bank argued that its actions were permitted and protected under the Financial Collateral Directive 2002/47/EC. With this in mind, the Latvian Supreme Court referred a number of questions on the scope and applicability of the Directive to the European Court of Justice.

The main legal issue raised concerned the right of the taker of financial collateral to enforce the collateral, notwithstanding the commencement of insolvency proceedings in respect of the collateral provider, under Directive 2002/47/EC on

[456] Case C-156/15 *Private Equity Insurance Group SIA v Swedbank AS* [2016] EUECJ.
[457] <https://fra.europa.eu/en/eu-charter/article/20-equality-law> accessed on 23 March 2020.

financial collateral arrangements[458]. This right confers a valuable advantage on the holder of financial collateral by comparison with other types of security which fall outside the scope of the directive.

The Court opined that, a difference in treatment is justified if it is based on an objective and reasonable criterion, that is, if the difference relates to a legally permitted aim pursued by the legislation in question, and it is proportionate to the aim pursued by the treatment. Therefore the special regime for financial collateral meets each of the criteria set out by the Court. This meant that the exception to the *pari passu* principle did not breach the principle of equal treatment. This demonstrates the fact that although on the one hand, the principle of *pari passu* is often-time recognised as a cornerstone of company law, on the other hand there are recognised exceptions to the principle that deviate from its primary application.

3.8 The "Misapplication" of the *Pari Passu* Principle in Cross-Border Insolvencies

3.8.1 Introduction on cross-border insolvency

The exponential growth of international business over the past twenty years has been truly astonishing[459]. It is a reality that whereas business has faced relatively few obstacles in overcoming national borders, the same cannot be said for the legal regimes that attempt to regulate such trade. In order to be effective, a cross-border system worthy of its name must include the need for cooperation and coordination when tackling the downfall of a multinational company. Put simply, a cross-border insolvency situation will arise where a debtor's operations fall within a number of jurisdictions.

[458][458] Arie Van Hoe, 'All creditors are equal, but some creditors are more equal than others' (12 November 2016) Corporate Financial Lab, Legal Aspects of Corporate Finance and Insolvency.
[459] Neil Thomas, 'The Need for an Effective Approach to Cross-Border Insolvency' (2010) University of Sussex, Vol 7 -Issue 6.

In a similar situation decisions have to be taken to address three crucial aspects:

1. The jurisdiction in which proceedings can be commenced;

2. the particular State's rules of law to be applied; and

3. the effect such rules would have on the proceedings.

In the absence of harmonised laws on the matter, these three determining factors have been integrated within private international law. By evaluating various cross-border insolvency laws, principles can be divided into three groups:

1. Jurisdictional principles: such the principles of unity, universality, equality, mutual trust, cooperation and communication, subsidiarity, and proportionality;
2. Procedural principles: such as efficiency, transparency, predictability, procedural justice, and priority; and
3. Substantive principles: such the principles of equal treatment of creditors, optimal realisation of the debtor's assets, debtor protection, protection of trust (for secured creditors or contractual partners), social protection (for employees or tenants)[460].

In other words, the liquidator and any other office holder need to be familiar with these basic principles of private international law in order to be able to determine how to handle a debtor's affairs in the case of insolvency. There has been an increase of multilateral or bilateral conventions with a view to coordinate State responses to common cross-border insolvency concerns. There are at least two main schools of thought as to the manner in which the subject of cross-border insolvency should be best approached. The first being the 'territoriality' approach which refers to

[460] Reinhard Bork, 'Principles of Cross-Border Insolvency Law – and their Value for Judges and Legislators' (2016) Commercial Law Centre, University of Oxford.

jurisdiction being limited to that of the State where proceedings were initiated. Through the application of this approach the office holder's reach is restricted to that of the respective State's borders. This means that any assets or liabilities of the debtor in another country will thereby fall outside the remit of the insolvency proceedings in question and remain intact. By contrast, the 'universalist' approach allows insolvency proceedings initiated in one State to take effect wherever the debtor's assets or liabilities may lie. These approaches seem to be at two polarised extremes and some kind of compromise would be in order.

3.8.2 Landmark Judgments on the Application of the *Pari Passu* Principle in Cross-Border Insolvency

There is no better way to bring to light the legal complexities that come into play whenever cross-border insolvency proceedings are afoot than to review some leading judgments that were delivered in this area. A very interesting international liquidation process with a strong local connection[461] is **Gardener v Walters N.O.**[462]. In brief, LeisureNet Limited owned around eighty five (85) health clubs in South Africa and which held 57.8% of the ordinary share capital in Healthland International Limited, a company registered in Malta. The Malta registered company was the holding company of LeisureNet's offshore business. In April 1999, Dalmare Limited sold its 50% shareholding in a Healthland subsidiary, Healthland Germany Limited to LeisureNet for 10 million Deutschmarks. The purchase price was paid in cash and four million Deutschmarks were transferred from Dalmore to two companies created for the benefit of two directors of LeisureNet Limited, Gardener and Mitchell. Subsequently, LeisureNet was placed in liquidation. *Inter alia* the liquidators alleged that:

(1) Gardener and Mitchell were the beneficial owners of some of the shares in Dalmore; and

[461] A related case is Ronald Attard and Mario Galea in their capacity of liquidators of Healthland International Limited vs Dr Beppe Fenech Adami *noe et,* First Hall Civil Court, 30 January 2004 and will be dealt with Chapter 4.
[462] 2002 (5) SA 796 (C).

(2) The same Gardener and Mitchell had appropriated in their favour in the guise of management fees, commissions that were properly due to Dalmore.

If the liquidators' action was successful and thereby they recovered such monies, the available assets for distribution among creditors would be larger. In other words, the outcome of these proceedings were very important to the unsecured creditors. In order for these proceedings to succeed there had to be coordination and cooperation between the Courts in Jersey and those in South Africa. The Court in this case, among other things, decided that a liquidator is entitled to an order authorising the institution of proceedings in a foreign jurisdiction which has the aim of obtaining documents and money alleged to be relevant to the company in liquidation and held by third parties.

The **MG Probud Gdynia sp. z o.o. case**[463] dealt with the effect of (EC) Regulation No. 1346/00 on the stay of individual executions as a consequence of the opening of the main insolvency proceedings. This case dealt with a Polish company which opened a branch in Germany. Polish insolvency proceedings were commenced on the 9 June 2005. The Customs Office in Germany applied for an attachment of the debtor's assets. An attachment order was delivered by a German Court on 11 June 2005. This decision was appealed. One of the main issues in contention was the fact that under Polish law it was not possible to attach assets subject to bankruptcy procedures. The judgment is very interesting because it clarifies some crucial concepts for the proper functioning of cross-border insolvency proceedings. The European Court of Justice held that after the main insolvency proceedings are opened in a Member State, the competent authorities of another Member State, where no secondary insolvency proceedings have been opened yet, are not entitled to order enforcement measures on the debtor's assets. In coming to its decision the Court relied heavily on the principle of the law applicable to the procedure in terms of articles 4-17 of the Regulation. Additionally, the stay on individual executions is considered to be an

[463] Case No. 444/07, [2010] EUECJ.

"own effect" of the judgment opening the main insolvency proceedings. This is to be inferred directly from the fact that there is a mechanism for the automatic recognition in terms of article 16 of the Regulation. This is the main tool found in EC Reg. No. 1346/00 to ensure a proper functioning of multiple concurrent jurisdictions. Furthermore, this is an expression of the principle that the insolvency proceedings have to have universal effect on all the debtor's assets wherever they are located within the European Union. Moreover, in terms of article 17 of the Regulation the judgment opening the main proceedings is to have the same effect in all Member States as it has under the law of the State where it is rendered. Finally, the stay of individual executions after the judgment opening the main insolvency proceedings is to be accepted in all the Member States because it reflects the principle of *par condicio creditorum* which is one of the fundamental rules of any collective insolvency proceeding in all Member States[464].

In **McGrath and Others v Riddell and Another[465]** (also referred hereinafter to as the HIH Insurance case) the House of Lords addressed important issues about the *pari passu* principle of distribution in cross-border insolvencies. It held that the fact that in the country of the principal winding up, there would be a class of preferential creditors who would not have priority under English insolvency law, was an insufficient reason for an English Court to refuse to exercise its discretion under section 426 of the Insolvency Act 1986, to order remission of assets located in England to the country of the principal winding up. In this regard, section 426 of the 1986 Act provides as follows:

> *(4) The courts having jurisdiction in relation to insolvency law in any part of the United Kingdom shall assist the courts having the corresponding jurisdiction in any other part of the United Kingdom or any relevant country or territory.*

And that for the purposes of sub-section (4) above,

[464] S Giovannini, 'The Stay of Individual Executions as a Consequence of the Opening of Main Insolvency Proceedings inside the Scope of (EC) Regulation No. 1346/00: the European Court of Justice's Point of View' (jul./set., 2010) Civil Procedure Reform, v.1, n.2: 143-163.,
[465] [2008] UKHL 21; [2008] WLR (D) 101.

> *a request made … by a court in … a relevant country … is authority for the court to which the request is made to apply, in relation to any matters specified in the request, the insolvency law which is applicable by either court in relation to comparable matters falling within its jurisdiction. In exercising its discretion under the subsection, a court shall have regard in particular to the rules of private international law.*

This appeal arose out of the insolvent liquidation of the HIH group of Australian insurance companies. The complicating factor was that four insurance companies were subject to a special Australian regime, which provided for the priority of Australian insurance creditors. Australian statutes modified priority so that assets in Australia were required to be applied first to the discharge of debts payable in Australia and proceeds of reinsurance policies to be applied in discharge of the liabilities which were reinsured. If the English funds were remitted to Australia, as the Australian Court had requested, Australian insurance creditors would receive more than ordinary creditors in both Australia and England[466].

Lord Scott said that Australian law had certain statutory provisions relating to insurance companies which departed from the insolvency principle of a *pari passu* distribution of assets among unsecured creditors. Most particularly, it gave preference to insurance creditors in priority to other creditors. During the course of proceedings, it was pointed out that English law itself adopted a regime for the winding up of insurance companies which gives preference to insurance creditors. This by means of Regulation 21(2) of the Insurers (Reorganisation and Winding Up) Regulations 2004[467], giving effect to the European Parliament and Council Directive 2001/17/EC on the reorganisation and winding up of insurance companies. So English courts are hardly in a position to say that an exception to the *pari passi* rule for insurance creditors offends against basic principles of justice.

Lord Hoffmann argued in this case that co-operation in cross-border insolvency had been accomplished to some extent by the initiative of English judges:

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[466] [2008] 1 WLR 852, 856 at [7], per Lord Hoffmann, citing Jay L Westbrook, 'A Global Solution of Multinational Default' (2000) (98) Michigan Law Review 2276.
[467] SI 2004/353.

> *Despite the absence of statutory provisions, some degree of international co-operation in corporate insolvency had been achieved by judicial practice. These were based upon what English judges have for many years regarded as a general principle of Private International Law, namely that bankruptcy (whether personal or corporate) should be unitary and universal. There should be a unitary bankruptcy principle in the court of the bankrupt's domicile which receives world-wide recognition and it should apply universally to all the bankrupt's assets*[468].

Townsend in his commentary on the case observes that the *pari passu* principle was the point of comparison in the decision of the Law Lords to remit assets to the Australia. He poignantly disagrees with Mokal's *"unconvincing suggestion that the pari passu principle is but a myth, it is quite plain that all the Law Lords in the HIH Insurance case regarded it as a material question whether the special Australian regime to which four insurance companies were subject was a justifiable departure from the pari passu principle*[469]*."*

The Court's justification of the departure from the *pari passu* principle was to achieve distributional justice among HIH general body of creditors. This in recognition of Finnis' assertion that distributional choices in insolvency can be mutually contradictory yet internally reasonable, *"the English law of bankruptcy applies principles of justice in ways which are reasonable but not necessarily or always the only reasonable, or even most reasonable, amongst possible ways*[470]*."* Jackson argues that distributional choices in insolvency is not merely a question of observing 'the respective value of entitlements fixed before the transition to bankruptcy[471]." The *pari passu* principle has been a fundamental principle of English insolvency law since 1542. Finnis argues that this demonstrates a compelling form of distributional justice[472]. Milman observes that "one suspects that the *pari passu* rule has been

[468] [2008] 1 WLR 852, 856 at [6].
[469] John Townsend, 'International Co-operation in Cross-Border Insolvency: HIH Insurance' (Sep 2008) The Modern Law Review, Vol 7, No 5 pp. 811-822.
[470] John Finnis, *Natural Law and Natural Rights* (Clarendon Press Oxford 1980) 190.
[471] Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Beard Books, 2001) 139.
[472] John Finnis, *Natural Law and Natural Rights* (Clarendon Press 1980) 190.

adopted by the courts as a convenient 'fall back' position that avoids the necessity of making difficult choices where the legislature has failed to take the initiative[473]."

Townsend concludes by saying that it is indeed striking that the Court in HIH Insurance made a difficult choice in the face of a clear statutory *lacuna.* Essentially what happened in this case is that Lord Hoffman opted against the territorial application of the *pari passu* principles in favour of the principle of universalism because it was "normatively desirable"[474] to remit assets to the domicile of the Australian companies. The assessment of the House of Lords was that the principle of *pari passu* distribution amongst unsecured creditors had been justifiably departed from by the foreign legislature. Therefore it was concluded that the Australian rules constituted a justifiable exception to the *pari passu* principle for the insurance creditors, and the assets were remitted accordingly[475]. The application of this ancillary liquidation doctrine in these circumstances so as to permit remission of assets seems to be gathering momentum[476].

3.9 The Application of the *Pari Passu* Principle and Insolvency Rules on Proof of Debt in Cross-Border Insolvencies – The "Hotchpot" Rule

The *pari passu* rule is said to be the underpinning principle for other insolvency rules relating to proof of debt. Goode[477] explains that the so-called "hotchpot" rule, by which a creditor who is trying to prove in the winding up of the company, must bring into account any dividend he has received in a foreign liquidation of the company. This "hotchpot" rule reflects the principle that the assets of the company in

[473] David Milman, 'Priority Rights on Corporate Insolvency' in A Clarke (ed), *Current Issues in Insolvency Law* (London, Stevens 1991).
[474] John Townsend, 'International Co-operation in Cross-Border Insolvency: HIH Insurance' (Sep 2008) The Modern Law Review, Vol 7, No 5 pp. 811-822.
[475] [2008] 1 WLR 852, 862 at [32].
[476] C H Tham, 'Ancillary Liquidations and *Pari Passu* Distribution in a Winding Up by the Court' (2009) Singapore Management University.
[477] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn., Sweet & Maxwell 2011).

liquidation after the provision for liquidation expenses and preferential debts are divided *pari passu* among the creditors.

The Privy Council decision in **Cleaver v. Delta American Reinsurance**[478] confirmed the view that the application of the hotchpot rule in cross-border insolvency is underpinned by the principle of *pari passu* distribution. In the course of trading the company had given security to carry on its insurance business. When the company became insolvent, the administrators required the creditor to bring into hotchpot credit (dividend) received in a foreign jurisdiction. It was said that having obtained an advantage over other unsecured creditors for the amount secured, the claiming creditor should make available to all creditors the payment already received.

The Privy Council held that the difference in the particular circumstances of the case was that the payment received had arisen from a letter of credit and had never been part of the insolvent company's estate. It was explained that the hotchpot rule applied only to assets regarded as part of the estate in liquidation and that Rule 4.88 of the Insolvency Rule did not operate as an exception to the hotchpot rules. For the above reasons the appeal was dismissed.

Similarly in **Banco de Portugal v Waddell**[479]**,** the appellants, who had received a dividend in Portugal, sought to prove in the English bankruptcy. The House of Lords held that appellants could only receive a dividend after all the other creditors had received an amount equal to the dividend they had received in the Portuguese proceedings[480].

[478] Appeal No 5 of 2000, [2001] UKPC 6.
[479] (1880) 5 App Cas 161.
[480] Fiona Tolmie, *Corporate and Personal Insolvency Law* (2nd edn, Cavendish Publishing 2003).

3.10 Conclusions

Throughout this Chapter substantially important aspects concerning the ranking of creditors and the application of the *pari passu* principle have been mentioned and elaborated upon from various angles. From this comprehensive analysis, a number of conclusions could be determined. The conclusions so reached can be synthesised as follows:

- There seems to be over-all consensus on the validity and relevance of the *pari passu* principle in the ranking of unsecured creditors.

- Although there is ample reference in academic literature to the legal notions of "fairness" and "equality", in practice creditor equality is disappearing rapidly.

- The more general question that remains to be answered concerns the balance between rule and exception. In order to reinforce the *pari passu* principle, the exceptions to it need to be reined in.

- The principle is expressly recognised by the Maltese Companies Act and it is buttressed by a number of legislative provisions intended to effectively apply it.

- Both English insolvency legislation as well as Italian insolvency law recognise this principle.

- It has been demonstrated that the most effective application of the principle takes the guise of avoidance of transactions ("claw back") and judicial shielding of the company in financial distress.

- The deviations to the rule take the guise of lawful causes of preferences and privileges.

- As a consequence of these lawful causes of preferences and privileges classes of creditors are created. These can be divided into two very broad categories namely, the secured creditors on the one hand, and the ordinary unsecured creditors on the other.

- The liquidator must carry out the exercise of compiling a list of creditors in accordance with their ranking at law in the instance when the company being liquidated is insolvent and the creditors are more than two.

- Although the basic rules on ranking of creditors are found in the Companies Act the majority of the lawful causes and preferences are scattered among numerous pieces of special laws.

- This piecemeal approach to the ranking of creditors makes the whole exercise increasingly and unnecessarily more complex for the liquidator.

- The plethora of tax privileges established in favour of the tax authorities in most cases take up all remaining assets of the company being wound up.

- A lot of criticism is levelled against the efficacy of the *pari passu* principle as an asset distribution mechanism in the winding up of a company. Most commentators observe that the principle is either misconstrued or misapplied.

- Proven breaches of the principle have been found not to be in violation of the Charter of the Fundamental Rights of the European Union.

- The principle has been misapplied in the context of cross-border insolvencies.

- The notion of *pari passu* is gaining ground in the sphere of company reconstructions.

From the above in-depth analysis and resultant set of conclusions, a number of lessons can be learnt. These can be conveniently grouped and summarised as follows:

- Despite its critics, the *pari passu* principle will persist even though reinterpreted to better cater for the current needs of companies in financial distress.

- The Maltese legislator needs to expressly state in the Companies Act the fact that the principle applies to all modes of winding up.

- A piecemeal approach to the ranking of creditors is completely incongruous and dated.

- Acceptance that deviations to the principle are to subsist.

- The fact alone that exceptions to the rule will always exist is of central importance to ensure that any unnecessary privileges are removed from the statute books.

- Keeping the above points in mind, the debate should shift towards the possibility of removing tax privileges altogether in favour of a more level playing field among creditors.
- The possibility of establishing a fund, a sort of reserved portion, for the benefit of unsecured creditors should be explored and if need be put in place.

- Since legal certainty is a fundamental general principle of law, it is of the utmost importance that this principle is extended to this area of law. As things stands today this is seldomly achieved. For this reason comprehensive insolvency legislation is to be drawn up.

- The law regulating cross-border legislation should be harmonised further in order to avoid disruption in the applicability of domestic rules on insolvency.

- The relevance of the *pari passu* principle must be promoted further through the vehicle of the Corporate Recovery procedure.

The stark reality that emerges from what has been written and analysed in this Chapter is that despite sporadic efforts to introduce reforms to Maltese insolvency law, a number of serious shortcomings and weaknesses persist. It has been noted for instance that most businesses in Malta finding themselves in financial straits sooner or later plunge into a deeper crisis and end up in liquidation. Inevitably, this state of affairs has a detrimental effect on businesses in general jeopardising efforts that could otherwise be utilised to rescue and restructure ailing companies but which are still viable. Similar rescue operations would be of benefit to the company, its creditors and the economy at large. All these findings beckon an investigation as to the reason why pressing reforms have not as yet materialised. Are there any barriers to these reforms? Can it be said that the local Courts are operating satisfactorily in light of these *lacunae* in our law? Are there any lessons to be learnt from the reforms undertaken in other jurisdictions which can serve as a model to Maltese law?

The truth of the matter is that Malta still lacks a transparent and predictable system of law that adequately addresses a company's failures and the adverse consequences that these entail. Having a sound and robust insolvency framework firmly in place would undoubtedly go a long way towards creating the right environment to attract all those interested in launching new business ventures taking well-calculated entrepreneurial risks, investing their capital soundly and enhancing credit facilities and thereby expanding the economy generally. Under a somewhat hazy company

law when it comes to insolvency matters, the much desired excellence in the Island's corporate infrastructure will never be completely achieved. Such a precarious state of affairs affecting insolvency proceedings needs to be addressed and rectified without further ado, bureaucratic procrastination or political dithering.

Chapter 4 Judicial Pronouncements on the Application and Interpretation to the *Pari Passu* Principle

4.1 Introduction

> *Any law – be it the best one – is of little use unless there are personnel who are willing and capable to transform the written rules into reality and daily practice.*[Christoph Paulus[481]]

In the field of insolvency, one would reasonably expect a number of stakeholders, interested parties, professional experts and office-holders to play a vital role in the proper functioning of the insolvency system. But the pivotal actors whose integrity, sense of fairness and expertise is crucial are the judges, liquidators and administrators[482].

The number of Maltese decided cases is not abnormally high and nothing to compare with other cases in foreign jurisdictions in terms of frequency and quantity. To be fair, one must also take into account the fact that Malta is a micro-State with a small jurisdiction and with an overall population of approximately half a million persons. Nevertheless, one can still observe a steady flow of insolvency proceedings accompanied by judicial pronouncements which, cumulatively, have contributed quite extensively and in a remarkable manner towards building a rich elaboration of Maltese insolvency law.

This said, one must also remark that there is no insolvency court as such in Malta. What happens is that each incoming case is assigned and seized by the Civil Court (Commercial Section) as provided by the Code of Organisation and Civil Procedure[483]. Moreover, it should be pointed out that the level of legal expertise and knowledge in this specialised area of law rests upon each presiding judge, albeit with the

[481] *Vide* Christoph Paulus, 'Germany: Lessons to Learn from the Implementation of a New Insolvency Code' (2001) 17 CONN. J. INT'L L., p.89 ff.
[482] *Vide* Jay L Westbrook *et*, *A Global View of Business Insolvency Systems* (Martinus Nijhoff Publishers 2010) 201.
[483] Chapter 12, Laws of Malta.

assistance of court appointed experts in the field. In the majority of instances, the presiding judge has probably, at least initially, little or a modest level of specialised knowledge in this area of law. On the positive side, insolvency cases are dealt with by the same judge and not distributed among different judges in the Civil Court. This arrangement at least ensures a measure of harmonisation in the judgments and the acquisition of experience on the part of the presiding judge in conducting these proceedings.

Furthermore it makes little sense and there is no real justification for creating an *ad hoc* insolvency court for Malta given its limited size and the sparse frequency of cases that are filed in the Court Registry. At the same time, however, the need is felt for each incumbent judge hearing such cases to be adequately prepared and equipped both academically and professionally in the area of insolvency law before he or she assumes the assignment. In practical terms, that means that before a judge deals with an insolvency case, ideally it should first be ensured that he or she is suitably prepared in that area. Attending a specialised academic course and visiting other foreign jurisdictions in order to be better acquainted with the proper conduct and management of insolvency cases and thereby obtaining first-hand experience thereof would seem appropriate. Unless this is done, there could remain the nagging doubt that the incumbent judge may be tempted to rely too much on the reports submitted by the administrators – a type of dependency that should be avoided at all cost. Moreover, a time should come when the wholesale reference and a very noticeable reliance upon a foreign jurisdiction on the part of Maltese judges be somehow whittled down and moderated. This aspect becomes more acute if one were to bear in mind that there might well be institutional and legislative differences between the local and the foreign jurisdiction which is being referred to by way of authority. A similar development can only happen if the Maltese judges become more confident to give a more autochthonous and unfettered interpretation of Maltese law, free from excessive outside influence.

The role played by the liquidator is a demanding and at times can even become a challenging endeavour. As is the case with the members of the judiciary who take

cognizance and decide insolvency proceedings, these court appointed officers do not receive any obligatory or specialised training to execute their mandate. In accordance with article 305 of the Companies Act the persons qualified to act as liquidator are the following:

(i) an advocate; or

(ii) an individual who is a certified public accountant or certified public accountant and auditor; or

(iii) a person registered with the Registrar as fit and proper to exercise the function of liquidator.

However, a person may not act as liquidator if he has held the office of director[484] or company secretary or has held any other appointment with or in connection with that company, at any time during the four years prior to the date of dissolution of the company.

Although the final arbiter is the presiding judge, the often daunting task of carefully wading through the various vicissitudes or complexities of the insolvent company to establish a fair and viable *modus operandi* in terms of law rests on the court appointed officers. Their task is normally fraught with hurdles and difficulties of all sorts which they have to surmount and determine. For example, when it comes to the point where the ranking of creditors has to be established and proposed on the basis of the evidence produced, the exercise can become quite onerous especially when tax or other privileges are invoked. There have been instances where the Courts rejected or reformed certain parts of a liquidator's report concerning creditor ranking due to a different opinion held by the presiding judge[485].

[484] In terms of article 305(3) of the Companies Act the term "director" includes a person in accordance with whose directions or instructions the directors of the company are or have been accustomed to act.

[485] *Vide* insolvency proceedings of Unibuild Company Limited, Civil Court (Commercial Section), 31 January 2019.

In **Fenech Estates Company Limited (C3634) vs HSBC Bank Malta plc *et***[486], the Court had occasion to examine and decide whether a request made by appellant company for the removal of the liquidator appointed by the Court on the ground of conflicting interest was justified or not. The appellant company had lodged an appeal on a preliminary judgment[487] which had rejected the Company's request for the removal and substitution of the liquidator and a declaration that should the liquidator remain in office this would be in breach of article 6 of the European Convention on Human Rights[488] concerning the right to a fair hearing. Appellant company submitted that one of the respondents was HSBC plc and that it had been sufficiently proven that the liquidator, a legal practitioner, had on previous occasions been consulted in his professional capacity by HSBC plc and that therefore there resulted a conflict of interest in his regard and in his capacity as a Court appointed liquidator. HSBC plc, the liquidator and the Attorney General, as the respondents, argued that the grounds for this part of its appeal were unfounded and that the first judgment merited confirmation. The respondent bank argued that although on previous occasions it was true that the administrator in question had been one of its legal consultants there was no *"institutional tie between the administrator and the bank."* The administrator and the Attorney General as co-respondents argued that the duty of the administrator was to proceed under the Court's direction and that the office of administrator was neither a Court nor a tribunal, and therefore article 6 of the Convention[489] was inapplicable and could not be invoked. The right to a fair hearing was a right to be guaranteed by an independent and impartial Court or tribunal and it did not extend to that of the administrator, who was neither an arbiter nor a judge.

The Appeal Court also held that although it was true that an administrator was not a judge, however in the liquidation proceedings he is deemed to be a court officer distinct from the lawyers of the parties who, although considered to be court officers

[486] Court of Appeal, 16 October 2017.
[487] First Hall Civil Court, 15 September 2015.
[488] European Convention for the Protection of Human Rights and Fundamental Freedoms, as amended by Protocols 11 and 14, 4 November 1950, ETS 5. Available at: <https://www.echr.coe.int/Documents/Convention_ENG.pdf> accessed on 10 June 2020.
[489] Ibid. (No 454).

as well, were certainly not expected to be impartial. At the same time as far as the administrator is concerned he must not appear to be dependant on or partial to one party or the other. The Court added that although it is not the administrator who ultimately decides the case, *"… his contribution to the final outcome of the proceedings is not indifferent. There was therefore the need for a liquidator to not only to be impartial and independent but also to have the appearance of impartiality and independence; the judicial process must be free from any element that casts a reasonable doubt guaranteeing independence and impartiality"* and made reference to **Lawrence Grech *et* vs Attorney General *et***[490] for support. The Court observed that the crucial question to be decided upon was whether there were enough reasons which objectively justify that there existed "the fear of partiality", and not simply whether a party to the case harboured a perception of fear on the lack of impartiality. The determining factor was whether this element of fear or perception of fear was based upon an objective consideration in such a way that a reasonable person and free from prejudice would come to a point where he or she would also have doubts on the impartiality of all those involved in the process leading to the decision. The perception of impartiality and independence was also important and required to ensure the parties' trust in the whole judicial process.

Although the Court of Appeal agreed with the First Court that up to that point there was no violation to a fair hearing, it did not agree with that part of the first judgment which held that if the liquidator's or special administrator's appointment were to continue, this would not be in violation to the right to a fair hearing. For this reason, that part of the appellant's company appeal was accepted by holding that "if the administrator were to continue with his appointment this would likely *("x'aktarx jista' jwassal"*) to a breach of the appellant's right as protected in article 6 of the Convention."

One other observation of a general nature that merits to be highlighted once more is that insolvency judgments emanating from Maltese Courts contain constant

[490] Constitutional Court, 6 March 2017.

references to English jurisprudence, case law, jurists and text-writers. This is to be expected when one considers that Maltese insolvency law is modelled to a large extent on its English counterpart. At the same time, one must recognise that domestic judgments are not devoid of local flavour echoing Maltese legislation and legal tradition. The ensuing overall result is that we can boast of a number of important judgments with domestic characteristics and containing an added value insofar as the law of insolvency is concerned. This noteworthy element stems from the fact that, whether individually or collegially, Maltese judges did not shy away from being proactive, unequivocal and decisive in their pronouncements.

4.2 The Maltese Experience in the Judicial Arena

To have a proper appraisal of the way insolvency proceedings have fared along the years and assess whether there is room for change and improvement, an in-depth review of a number of salient insolvency proceedings dealt with and decided by the Maltese Courts is a *sine qua non.* It is only after conducting a similar exercise that one can then venture in the area of suggested reforms. The proof of the pudding is in the eating and the insolvency regime is no exception.

The Maltese experience as seen and observed from a judicial standpoint may well be described as a mixed bag. Cases have ranged from business concerns that became insolvent at some point as a result of a commercial undertaking that simply went wrong due to the prevailing circumstances to other instances where a state of insolvency was the result of entrepreneurial mismanagement, financial over-exposure, risky gambits and worst of all fraudulent conduct by the directors at the expense of *bona fide* creditors and investors.

Some of the cases concerned only local businesses while others are a mixture of combined local and foreign commercial ventures. There were some businesses in financial distress that were salvaged to a certain extent while others were found to be in a state of complete financial ruin and as such it was next to impossible not only to attempt to rescue but also to establish the best way forward when it came to asset

distribution. From the point of view of time-frames with regard to the duration of the proceedings, here again the local experience has varied from what could be considered reasonable and moderate to excessively long delays at arriving to a final determination of the case by the domestic courts.

The cases that are reviewed have been specially selected because each of them contains some relevant aspect regarding insolvency. More specifically, they deal and cover a variety of aspects regarding issues like the cut-off date and interim distribution of assets, the revocation *contrario imperio* of a winding up order, due notification of a judicial act against a company being wound up, judicial shielding, the role and legal capacity of the administrator appointed by the Court, the ranking of creditors, final asset distribution, the further elaboration of Maltese law with regard to insolvency matters. Finally, it is again relevant to point out that some of these selected judgments clearly show the extent of the reliance by Maltese Courts upon English case law as a source.

4.3 A Selection of Insolvency Cases decided by the Maltese Courts

4.3.1 The application of the *pari passu* principle under Maltese insolvency law

In **Av. Andrew Borg Cardona in his capacity of liquidator of Price Club Operators Ltd (C-22704) vs CSMR (1994) Limited (C-16452)**[491] the Court dealt with a request made by plaintiff *nomine* to declare that the payment of the sum of twelve thousand four hundred and forty two Malta lira and ninety nine cents (Lm 12,442.99) made in favour of respondent company after a withdrawal of money deposited under the Court's authority some months before respondent company was wound up, amounted to a fraudulent preference in terms of article 303 of the Companies Act and for the Court to condemn the respondents to reimburse this sum of money.

[491] First Hall Civil Court, 5 October 2015.

Apart from other points of a legal nature, the Court held as follows,

1. An order to preserve property should have been available to the creditors but the property may have been already disposed prior to a compulsory winding up. All dispositions of the company's property after the commencement of the winding up are void, unless the Court orders otherwise;

2. The Courts have in general refused to validate payments which have the effect of preferring pre-insolvency creditors, unless the payment confers a benefit on creditors generally or the creditor did not know of the insolvency at the time of receiving payment;

3. Unless the Court orders otherwise the proceeds of an execution against the assets of the company or the attachment of a debt due to the company cannot be retained by the creditor against the liquidator unless completed before the commencement of winding up;

4. The Court has a discretion on whether to allow the enforcement to proceed, or if it has already proceeded but was not in time, whether to allow the creditor to keep the proceeds;

5. The underlying presumption in exercising these discretionary powers is that the Court must do what is fair and right in the circumstances and not allow the individual creditor the benefit of enforcing the judgment, if this will prejudice the equal treatment of creditors generally. Reference was made to Farrar[492] for authoritative support;

6. The overriding principle in winding up is that all creditors rank *pari passu* and weighty reasons are needed to put this rule aside;

[492] *Vide* John Farrar *et, Farrar's Company Law* (4th edn Butterworths 1998) 713-714.

7. Whether an act or sufferance by the company constitutes a preference is determined objectively. An act or sufferance which improves the creditor's or surety's position in an insolvent liquidation may be a preference.

The Court concluded that the respondent company did not manage to show that at the relevant moment it did not know or should have known that the financial situation of Price Club Operators Ltd was precarious. Moreover it held that the plaintiff *nomine* had succeeded to prove that the withdrawal of the money on the part of the respondent company amounted to a preferential act by means of fraud in terms of article 303 of Companies Act.

4.3.2 Tax Privilege: Value Added Tax Act

The ranking of creditors remains a crucial aspect of insolvency proceedings. A recurrent feature in Maltese decided cases has to do with competing claims to be ranked in priority to others, especially when the Commissioner of Inland Revenue and commercial banks are concerned. Each case however has its own particularities, legal or factual, to examine and decide upon. In **Bank of Valletta plc vs Crown Hotels Ltd**[493] it was held that Bank of Valletta had a right of preference to recover all judicial expenses including those relating to the judicial acknowledgement of its claim before all other creditors. In the course of its deliberations, and hence the relevance of this judgment from a legal standpoint, the Appeal Court had occasion to refer to various legal judgments on this issue. Some of these judgments go back quite a long way in time but the Court considered these to be still valid. The case dealt with the ranking of creditors involving competing claims, brought forward by the Bank of Valletta plc and the Director General of Inland Revenue and Value Added Tax with regard to immovable assets that belonged to the Crown Hotel. By a previous decision[494] the First Court decided that the sum of money deposited in Court should by right be

[493] Court of Appeal, 28 March 2014.
[494] First Hall Civil Court, 16 November 2012.

withdrawn by the Director General of Inland Revenue whose claim, according to the Court, ranked before the other claims by the VAT Department and the Bank of Valletta plc. It therefore authorised the Director General of Inland Revenue to withdraw this amount. Aggrieved by this decision, Bank of Valletta plc lodged an appeal to revoke this part of the decision and requested the Court to order the prior ranking of all judicial expenses and costs in connection with the ranking of creditors' proceedings. The Bank also asked for the revocation of that part of the judgment where the Civil Court First Hall held that the Director of General of VAT had a privilege on the proceeds deriving from the judicial sale by auction of the immovable property belonging to Crown Hotel and instead to give priority and precedence to the pre-existing secured claim enjoyed by the Bank over the said property. The Court of Appeal accepted the first grievance raised by the appellant in that the Bank had a right to be repaid before all other creditors. Reference was made to two earlier decisions namely **Aquilina vs Camilleri**[495] and **Bugeja vs Monreal *nomine***[496]. These two judgments had affirmed that all judicial costs were privileged and that this legal privilege extended to those costs incurred "in the common interest of creditors". For this reason the Appeal Court authorised the Bank to withdraw all the judicial costs and this before the claims of the other creditors. In this respect reference was also made to **Busuttil *utrinque***[497] in that *"it was more legally correct to accept that such expenses were included in the judicial expenses otherwise there would have been no court auction".*

The second grievance related to the rights of the Government to be paid fiscal credits before other creditors a right which the appellant was contesting. The Court referred to **Testing Limited**[498]**,** confirmed on appeal, that the claim by the Commissioner of Inland Revenue was a fiscal debt which in terms of article 23(8) of Act 18 of 1994 was privileged and had to be paid right after the wages of employees and the claim made by the Director for Social Services in preference to all other claims, regardless of

[495] Civil Court, 22 May 1950.
[496] Civil Court, 7 April 1886.
[497] Referred to in the ranking of creditors proceedings in the name of R. Farrugia dated 14 October 1937 (Vol. XXXIX.III.380).
[498] Court of Appeal, 3 March 2006.

whether these other claims were privileged or secured by a hypothec. Reference was also made to **Ranking of Creditors of Carmelo Gauci Ltd**[499] in so far as Maltese law assigned a special privilege to the Commissioner which privilege however had to be understood in terms of the provisions of the Civil Code. Whereas special privileges over movables need not be registered, article 2032(c) of the Civil Code provides that a special privilege over immovables had no effect unless registered in the Public Registry. Special privileges over immovables enjoyed *diritto di seguito* or *droit de suivre*. Registration was required in the interest of third parties for otherwise it would not have any effect. Maltese law did not specify that the special privilege pertinent to the Commissioner of Value Added Tax ranked with preference but that the tax had to be paid in preference. According to **Zammit vs Caruana *nomine***[500] the claim and the privilege were separate from each other. Although a privilege could not exist without a claim, a claim has an independent existence from a privilege. Failure on the part of the Commissioner for Value Added Tax (as he was then known) from registering his privilege did not extinguish his claim. But in terms of article 62 of Chapter 406, this claim had to be paid with preference to those of other privileged debts. So at the end of the day this means that if the special privilege has been registered the Commissioner for Value Added Tax, his claim could be enforced over the immovable property in question. If not, he could only claim over the other remaining assets of the debtor. Even if those assets were subject to a privilege, the Commissioner had to be paid first, save as provided by article 62 of Chapter 406. Payment had to be taken from the debtor's assets with preference of any other debt irrespective of what was provided in other laws. Once the funds consisted of proceeds from the sale of the Crown Hotel's assets, the claim for tax arrears had to be paid with preference and before other debts, including the other credit that had been claimed by Bank of Valletta plc.

[499] [Rik Nru. 53/06] Court of Appeal, 29 February 2009.
[500] Civil Court, 1958.

4.3.3 The role and responsibility of directors

The role and responsibility of directors in a commercial company was analysed in **Official Receiver in his capacity as liquidator of Smart Malta ICT Limited C41884 vs Steve Alamango and Geoffrey Farrugia**[501]. The case concerned a request by the plaintiff to declare respondents, or whoever among them responsible to pay him the sum of EUR 50,863 plus interest to cover the debt, expenses and interest incurred by the creditors. After considering all the evidence exhibited and the various pleas raised by respondents, which were rejected, the Court concluded that there resulted mismanagement on the part of the two respondents *qua* directors. The Court however was of the opinion that this was not enough to make a declaration in terms of article 316 of the Companies Act. What was crucial were the actions once a state of insolvency in the company became evident. Even if respondents seemed to be acting in a genuine manner, they ought nevertheless to have realised that their business venture, their first experience it so happened, had led the company to become insolvent. The Court had occasion to censure what it described as a manifest lack of co-operation by the directors to assist the Official Receiver as was expected of them. Furthermore the Court noted that there resulted lack of information between them and "other presumptions and assumptions of facts" that obstructed the flow of proper communication between the directors and the Official Receiver. This led to many misinterpretations and lack of cooperation that ultimately resulted in exposing the company's creditors to a greater risk. At the same time, and perhaps rather surprisingly, the Court considered the fact that this was the respondents' first business venture and that they acted with a good intention so much so that they even continued to collect money that was due to the company even when it had become insolvent. The respondents *qua* directors genuinely thought that there would be enough income for the company to break-even but a garnishee order issued at the instance of a third party, namely Guttenberg Press Limited, for the payment of advertising work, thwarted their plan. The Court rejected plaintiff's request.

[501] Civil Court (Commercial Section), 30 May 2019.

4.3.4 The close relationship between Maltese and English law on insolvency

The close relationship which exists between Maltese and English law on insolvency or better still the strong reliance upon the latter by Maltese Courts for purposes of interpretation and support is best highlighted in **The Accountant General and The Permanent Secretary, Ministry for Education and Employment vs Master Builders Ltd (C-38756) *et***[502]. Plaintiffs had been canonised as creditors of the respondent company in the sum of EUR 139,762.40 and interests by an earlier decision dated 17 October 2012. A portion of this amount was partly offset by a sum of money deposited before the start of proceedings by the respondent company while the balance remained unpaid. Notwithstanding the lapse of more than twenty four weeks from the issue of an executionary warrant the balance was still due. The plaintiff requested the execution of the judgment in terms of article 214(2)(ii) and (5) of the Companies Act. The Court was asked to declare the respondent company unable to pay its debts and therefore order the dissolution and consequential winding up. In the course of its elaborate deliberation the Court held that the source of Maltese Company law is English law, upon which our law was modelled. When in 1995 the new law on companies came into force in Malta it replaced the Commercial Partnership Ordinance[503]. Specifically those provisions that regulated dissolution and the consequential winding up were integrated in Act XXV of 1995. Under English law, the Court held, the dissolution and consequential winding up of companies was dealt with by an *ad hoc* legislation namely the Insolvency Act of 1986. From an examination of section 123 of the Insolvency Act, the Court added, it clearly resulted that insolvency according to English law is dealt with in a wider way in comparison with what is provided under Maltese law. In our case, the law contemplates only two instances when a company can be held unable to pay its debts and these are provided for under article 214(5)(a) and (b) of the Companies Act. Article 123 of the Insolvency Act 1986 contemplates four methods on how to examine if a company were in state of insolvency, three of which fall under a cash flow test, whereas the fourth method

[502] Civil Court (Commercial Section), 27 September 2018 [Rikors Nru 123/2018/JZM].
[503] Chapter 168, Laws of Malta.

of evaluation is known as the balance sheet test. Maltese law, on the other hand, refers to something different from "inability to pay debts as they fall due" as found in English law. The Court found a resemblance with what is provided under article 214(5)(a) and "cash flow" insolvency under English Law. The major point of interest here is that the presiding judge instead of simply resorting to copious references to English law in support of his considerations went on to make some pertinent comments concerning certain nuances that exist between Maltese and English law. The fact that the Maltese Courts normally mention the cash flow test and the balance sheet test as important indicators of a possible state of insolvency does not mean that they constitute the only tests available. To be fair, Maltese law refers only to these two types of tests but nevertheless these are not exhaustive. For example, Andrew Muscat mentions other instances when a company and its directors would be deemed to fall under the legal insolvency regime on account of failing the cash flow or balance sheet tests. Other possible scenarios that Muscat[504] mentions are the following:

1. When the company is imminently likely to become insolvent;

2. Where there is no reasonable prospect that the Company could avoid going into insolvent liquidation;

3. Where the company is doubtfully solvent; and

4. If a contemplated payment or other course of action could jeopardise the company's solvency.

This trend of thought was again reflected by the same judge in **Tamamu Company Limited [C36981] vs Pizza Factory Company Limited [C51901]**[505] with reference to article 214(2)(a)(ii) of the Companies Act. This article, the Court held, gives it

[504] Andrew Muscat, 'Directors' liabilities during company insolvency' *Times of Malta* (20 April 2020).
[505] Civil Court (Commercial Section), 31 October 2019 per Mr Justice Zammit McKeon.

discretion to order the dissolution and consequential winding up of a company if it is unable to pay its debts, which provision of law must be read in conjunction with article 214(5). When Maltese law is referring to a company which is unable to pay its debts, it has a precise and definite meaning. In a more restricted way, what is provided in article 214(5)(a) of the Maltese Companies Act is similar to what is known as "cash flow insolvency" under English law, while that which is required in article 214(5)(b) is similar to "balance sheet insolvency". The Court concluded that although it was evident that there was a resemblance between article 214(5)(a) and (b) of the Companies Act and article 123(2) of the Insolvency Act, 1986, these two provisions of law were not identical.

The divergence stems from the fact that while under Maltese law the text states simply "the company is unable to pay its debts" account being taken also of contingent and prospective liabilities of the company; in English law the criterion is a different one because the Court must take into consideration that the value of the company's assets is less than the amount of its liabilities by taking into account contingent and prospective liabilities.

The Court affirmed that the differences between the two laws is not one of drafting but one of substance. With this distinction between the two systems of law in mind, the Court then goes on to refer to the English doctrine on the way it deals with the concept of contingent and prospective liabilities with respect to balance sheet insolvency in the context of article 123(2) of the Insolvency Act, 1986.

4.3.5 The Liability of Directors

According to Andrew Muscat[506] a very critical moment for company directors is when the company becomes insolvent because at this point the directors *"become bound to have regard to the interests of creditors, who would at such stage, have a primary interest in the proper application of the company's assets. A breach of these duties*

[506] Andrew Muscat, 'Directors' liabilities during company insolvency' *Times of Malta* (20 April 2020).

can lead to personal liability and even disqualification from acting as a director of any other company."

At this point some pertinent questions arise:

- Can there be rehabilitation of a company in distress?
- Where there any instances of directors continuing to trade regardless of the precarious situation of the company?

And finally,

- Can a company's name be reinstated once it has it been struck off from the Registry of Companies?

The Court in fact does have the power to reinstate the name of a company even after it has been struck off the Company Register as held in **Mark Bugeja vs the Registrar of Companies**[507]. Following the voluntary winding up of Malta Wine Containers Limited ("the company") on 15 May 1998 at the instance of its creditors, plaintiff Bugeja was appointed liquidator on 28 May 1998. Subsequently, on 21 September 2016, the company was struck off as defunct from the Registry of Companies without the liquidation process being finalised. On 11 May 2019 the liquidator filed an application in the Civil Court to revoke the striking off action taken by the Registrar of Companies and reinstate the name of the company on the Register in the interest of the creditors. The liquidator submitted that it was never the intention for the company's name to be cancelled before the liquidation was concluded. He added that the company owned various liquidated assets which could not be assigned to the creditors once the company had been struck off. This request was possible at law, he further argued, on the basis of article 325(4) of the Companies Act, and the fact that the five year period mentioned in this article had not yet elapsed since the date when the company's name had been struck off. Unless the strike off was

[507] Civil Court (Commercial Section), 14 May 2019.

reversed, the company's creditors would have been denied from receiving any of the liquidated assets of the company in settlement of their credit. The Registrar replied that the last statement presented by the liquidator was in 2011 and the liquidator stopped providing further statements as required by law. For this reason there was sufficient ground to apply article 325(3) of the Companies Act and strike off the said company from the Register. It was also clarified that the liquidator had subsequently regularised his position in terms of law and the Registrar had no objection to the relisting of the company on the Registry of Companies as requested by plaintiff. The Court declared that the liquidator had proven to its satisfaction that, following his actions to regularise his position the required criteria showing sufficient interest to have the company's name reinstated had been met. Through this reinstatement, the Court added, the liquidator would be in a position to finalise the liquidation and this would serve to protect the company's creditors who otherwise would be prejudiced if the removal of the company's name from the Company Registry were to continue. For this reason the Court acceded to plaintiff's request. This judgment highlights the Court's view that protecting creditors' rights is crucial to liquidation proceedings and the distribution of assets of the company in terms of law.

Andrew Muscat[508] is quite categorical on the link of responsibility that exists between the director of a company and the application of the *pari passu* principle. Until a company goes in liquidation and a liquidator is appointed it is up to the director to *"… ensure that the principle of pari passu and preferential payments is strictly adhered to."* Failure on his part to do so, Muscat affirms, *"… may render the transaction 'vulnerable' to the point of constituting a breach of duty potentially leading to personal liability."*

[508] Andrew Muscat, 'Directors' liabilities during company insolvency' *Times of Malta* (20 April 2020).

4.3.6 The Appointment of a Provisional Administrator

It stands to reason that if an ailing company is left to rot financially while all or most of its assets are getting dissipated, any possibility of ever applying the *pari passu* principle would be thwarted. A timely intervention to safeguard the interests of creditors by preventing such a situation from happening can take the form of the appointment of a provisional administrator as contemplated in the Companies Act. The chief function of the provisional administrator is to preserve the assets of a company in difficulty and thereby prevent the dissipation of its assets or the possible diminution of their value. This issue came under review in **Panta Contracting Limited vs DA Holdings Limited**[509] following an application by plaintiff requesting the Court to appoint a Provisional Administrator to which the respondent company initially objected. The Court explained that the point at issue was not whether the respondent company was *de facto* or *de iure* in a position to pay its debts because that point would be reviewed by the Court at a later stage when deciding on whether to dissolve and to liquidate the said company but whether a provisional administrator should be appointed or not. The appointment of a provisional administrator is regulated by Article 228 of Chapter 386. This provision refers to the possibility of such an appointment at any time after the presentation of a winding up application and before the making of a winding up order and either the official receiver or special controller or any other competent person may carry out this function. One interesting point emerging from the judgment is that Maltese law does not elaborate on the role of the provisional administrator but instead it leaves the matter to the discretion of the Court. In other words, the Court has the discretion to decide whether to appoint or not a provisional administrator and also what powers to give him or her having regard to the facts and circumstances of the case. In reality this makes a lot of sense considering that each case has its own specificity. In the case under review for instance the respondent company had opposed the request but later on during the proceedings ended up by agreeing with the creditor company that the Court should indeed appoint a provisional administrator. The Court

[509] Civil Court, 23 October 2014.

observed that the financial situation of the respondent company was poor and that such an appointment would not have a negative effect on the company's operations. The Court added that it did not wish that the provisional administrator's task would be limited to day-to-day administration. Instead, he would be assuming all the duties and powers of the directors even if the directors remained in office but with their powers, whether individually or collectively, vested in the provisional administrator including judicial and legal representation. This was done in the best interest of the company's shareholders and creditors. The directors of DA Holdings Ltd had to provide the provisional administrator with full and complete access to all information and documents in their possession. Finally the Court held that the provisional administrator had to take under his control the assets and debts of the company and manage and administer its financial position from worsening.

4.3.7 "Cut Off Date" and Interim Distribution of Assets

The liquidators of Healthland International Limited[510] filed an application in Court requesting direction on the *modus operandi* of the liquidation. The Court was informed that the company in liquidation, Healthland International Limited, was being wound up by means of a shareholders' resolution dated 28 May 2001. The liquidators proceeded with the creditors voluntary winding up. One of the claims submitted was by Eastlink Projects PTY Ltd for the payment of A$5,702,784. By means of a Mareva injunction, the amount of A$2,629,135.90 was withheld by Healthand Australia PTY Ltd by way of dividend. An agreement was reached between the parties – Eastlink and Healthland International Limited – whereby Eastlink would agree to enter into a compromise with Healthland International Limited on condition that *"they be admitted as a creditor in the sum of A$4 million, that within 6 months of the commencement of the liquidation an application be made in terms of section 292 of the Companies Act to fix the time within which the creditors are to prove their debts or claims to the date of the application and to sanction the payment of an interim dividend."* It was noted that in terms of article 292 of Act XXV of 1995, the

[510] Ronald Attard and Mario Galea in their capacity of liquidators of Healthland International Limited vs Dr Beppe Fenech Adami *noe et,* First Hall Civil Court, 30 January 2004.

liquidator may file an application in court to decide on any matter during the winding up of a company. Reference was also made to article 255 of Act XXV of 1995 in terms of which the court may establish a time frame within which creditors are to prove their debts. To this end the liquidators requested the Court to declare the date of the application as the final date in which debts are to be proven or claims made and furthermore authorise an interim distribution.

With respect to the liquidators' request to set the deadline as the date of their application, the Court observed that the Maltese legal system never looked favourably at retroactive orders or measures. Applying this general principle to the facts of the case, the Court was not of the opinion that a deviation from the set rule was warranted. However, although the Court rejected the request to have a retroactive cut-off date, it acceded partially to the request in that it set a short time-frame and deadline for creditor claims to be presented. In addition, in considering the second claim whereby the liquidators sought authorisation to make interim distribution, the Court opined that once again problems could arise since there was the real danger that some creditors had not yet made their claim or had not proven their claim. It also resulted that such interim payments could prejudice *bona fide* creditors. The Court made reference to an English Court of Appeal judgment which held that *"in deciding whether or not to sanction a proposed compromise the Court must consider whether the interests of those, whether creditors or contributories who have a real interest in the assets of the company in liquidation are likely to be best served*[511]*."* The Chancery Division in **Re Barings Ltd (No 5)**[512] referenced favourably **Re: Alabama, New Orleans, Texas and Pacific Junction Railway Company**[513] which held that, *"everybody will agree that a compromise or agreement which has to be sanctioned by the Court must be reasonable."* For the above reasons, the Court decided the application by acceding to the first request. The Court however imposed a restriction by stipulating the final date for the admission of claims to be the 28

[511] *Re Greenhaven Motors Limited* (1999) 1 BCLC 635.
[512] [2000] 1 BCLC 523.
[513] [1891] 1 Ch 213 at 243.

February 2004 and turned down the second request and thereby rejected the liquidator's proposal to carry out interim distributions.

4.3.8 Revocation *"Contrario Imperio"* of a Winding Up Order

In **D.A. Holdings Limited (C18064)**[514] applicant company[515] requested the revocation *contrario imperio* of the winding up order issued against D.A. Holdings Limited, as part of an attempt to execute a company rescue plan. One important procedural point raised by the Court was that since the declaration for the dissolution and winding up of this company was made by an "order[516]", the Court opined that it was not equivalent to a "judgment" or a "decision" in terms of the *lex generalis*, namely Chapter 12[517]. The declaration for the dissolution and winding up of D.A. Holdings Limited was done in terms of the *lex specialis,* in this case the Companies Act. The fundamental and novel issue that needed to be determined was whether the order dated 17 March 2016, precisely because it is not a "decision" or a "judgment", could indeed be revoked in terms of Chapter 386. Since the Court focused its analysis on creditor protection it is of relevance to the application of the *pari passu* principle.

At the outset the Court highlighted the fact that article 214(5)(b) of Chapter 386 is modelled upon article 123(2) of the Insolvency Act 1986 in England. The Court had to evaluate whether, once a Court has exercised its discretion to dissolve and wind up a company owing to its inability to pay its debts, it was possible to revoke that discretion in the event that in due course a number of new circumstance would arise that were not present at the time when the winding up order was delivered. The Court held that although winding up proceedings may be initiated by the individual

[514] Court decree was delivered on the 8 February 2018, in the acts of the Court winding up order delivered on the 17 March 2016 in the proceedings, Panta Contracting Limited vs D.A. Holdings Limited *et* (First Hall Civil Court, 494/14JZM).
[515] Alison Investments Limited, that was subrogated into the rights of Panta Contracting Limited *qua* creditor of D.A. Holdings Limited.
[516] The Maltese legal term being *"provvediment".*
[517] Also referred to the Code of Organisation and Civil Procedure.

trader, the action in its essence remains *"a collective procedure for the benefit of creditors generally*[518]*."*

As to the application of this provision, Keay and Walton[519] comment that while the status and powers of the company are not affected by the liquidation, once the winding up process commences, its continued existence is limited only to the beneficial winding up of the affairs of the company. The directors' powers are transferred to the liquidator and there are restrictions on what can be done with company property. The above happens due to a lack of statutory enactments that prevent the company, of its own motion, from reverting back to its former state. It can only be achieved by obtaining an order of the court staying proceedings in the winding up[520]. Such orders are most commonly applied in cases where the company has paid off all its debts and wishes to recommence business or where it is desired to give effect to a plan of reconstruction or a scheme of arrangement[521] or a proposal for the entering into a company voluntary agreement.

For a better understanding of the comparative exercise undertaken by the Court it would be better to reproduce both articles of law *verbatim.* Reference was made to section 147 of the Insolvency Act, 1986 which states that:

> *(1) The court may at any time after an order for winding up, on the application either of the liquidator or the official receiver or contributory, and on proof to the satisfaction of the court that all proceedings in the winding up ought to be stayed or sisted, make an order staying or sisting the proceedings, either altogether or for a limited time, on such terms and conditions as the court thinks fit.*
>
> *(2) The court may, before making an order, require the official receiver to furnish it with a report with respect to any facts or matters which are in his opinion relevant to the application.*

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[518] A J Boyle and John Birds, *Boyle & Birds' Company Law* (8th edn, Jordans 2011) 913-914; Brenda Hannigan, *Company Law* (4th edn, OUP) 694; Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 36.

[519] Andrew Keay & Paul Walton, *Insolvency Law – Corporate and Personal* (Longman, Pearson Education Limited 2003).

[520] Section 147(1) of the Insolvency Act, 1986.

[521] *Re Stephen Walters & Sons* [1926] WN 236.

(3) A copy of every order made under this section shall forthwith be forwarded by the company or otherwise as may be prescribed to the registrar of companies who shall enter it in his records relating to the company.

Article 248 of the Maltese Companies Act, cited as being its counterpart, runs as follows,

(1) The court may at any time after a winding up order, on the application either of the liquidator or the official receiver or any creditor or contributory, and on proof to the satisfaction of the court that all proceedings relating to the winding up ought to be stayed, make an order staying the proceedings, for such duration and on such terms and conditions as the court thinks fit. Any such stay of proceedings shall not affect the continuing validity and operation of the winding up orders.

(2) On an application under this article the court may, before making an order, require the official receiver or liquidator to furnish to the court a report with respect to any facts or matters which are in its opinion relevant to the application.

(3) A copy of every order made under this article shall forthwith be forwarded by the Registrar of Courts to the Registrar for registration.

In Maltese company law this provision is found in Part V, Title II, Chapter V of the Companies Act dealing with the general powers of the Court in a compulsory winding up. Although it is clear that article 248 of Chapter 386 was modelled on section 147 of the Insolvency Act 1986, the two provisions are not identical. The Court also explained that although in both pieces of legislation there is an element of discretion, there exists in effect a substantial difference between the two. Whereas in terms of section 147(1) of the Insolvency Act 1986, the Court *"may make an order staying or sisting the proceedings, either altogether or for a limited time, on such terms and conditions as the court thinks fit",* article 248(1) of Chapter 386 restricts the power of the Court to issue *"an order staying proceedings, for such duration and on such terms and condition as the court thinks fit"*. However, it cannot terminate the winding up process and reinstate the *status quo ante* before the winding up order. The Court buttressed its arguments by pointing out that the Maltese legislator opted

to insert an additional sentence wherein it is made amply clear that *"any such stay of proceedings shall not affect the continuing validity and operation of the winding up orders."*

This case underpins the difficulties faced by the Court in such extraordinary proceedings. It is evident that whereas the Court may have preferred a different solution, its hands were tied by the letter of the law. The Court was in a difficult predicament when all the creditors participating in the winding up proceedings took a completely opposite position to that prior to the commencement of the winding up. It was noted that this stance was not taken in a capricious manner but in consequence to the manner in which the particular circumstances of the case unfolded. The Court was unhappy with the situation since it was unable to intervene when events occur in the course of the winding up proceedings that were unforeseen prior to the dissolution of the company.

The Court concluded that the Maltese legislator chose to preclude its power to order a *status quo ante* as in its opinion this discretionary power was not extended to it, in contrast to what is found under English law. In the present case the best interests of the creditors necessitated a different solution to that envisaged by the provisions of the Companies Act. The Court however was bound to apply the law as found in the Companies Act in application of the maxim *dura lex sed lex*.

4.3.9 Due Notification of a Judicial Act against a Company being Wound Up

One of the major procedural hurdles in any judicial process is that of giving proper notice of a judicial act in accordance to law. Extensive provisions in the Code of Organisation and Civil Procedure set out the necessary conditions for a valid notification. In the realm of insolvency one can cite **Rees Furniture Company Limited *et* vs Direttur Generali tat-Taxxa Fuq il-Valur Mizjud**[522]. In brief, the Department for Value Added Tax issued a judicial letter requesting payment amounting to EUR

[522] First Hall Civil Court, 2 October, 2012 [Rikors Nru 221/2011].

58,797.51 against Rees Furniture Company Limited and others. Said company rebutted the claims made by the Department for Value Added Tax as being unfound in fact and in law. The company argued that it had been inoperative and was undergoing a winding up process on the request of the Department of Value Added Tax in terms of article 218 of Act XXV of 1995 and an Official Receiver had been appointed and later the liquidator. One issue related to what constituted valid notification according to law in the context of the judicial shielding. The company argued that notification ought to have been effected against the liquidator. The Court had to decide *inter alia* about the correct procedure of notification to be followed against a company being wound up. After examining the combined effect of the application of both articles 222 and 224(2) the Court observed that *"… this means that from the moment the winding up application was filed or a winding order was delivered on the 25 October 2002, the department could not issue a notice for payment directly against the company which was undergoing a winding up process, and an official receiver was appointed… This is prohibited by virtue of articles 222(1) u 224(2) of Chapter 386."*

The defendant contended that notwithstanding the winding up proceedings, plaintiff company was notified by the judicial letter in terms of article 181A(1) of Chapter 12 and at that particular moment the company was not represented by the official receiver. At the same time the Court did not agree with the position taken by the defendant. Reference was made to **Il-Kummissarju Taxxa Fuq il-Valur Mizjud vs Rees Furniture Company Limited**[523] in connection with a winding up order in terms of article 214(2) of Chapter 386. A number of liquidators were nominated but since they could not obtain access to the company books, they were unable to carry out their function and so the Official Receiver had to be appointed. In terms of article 229 of Chapter 386, the Official Receiver becomes the liquidator of the company and continues in office until another person becomes liquidator and shall, upon notification by the Court, be the liquidator during any vacancy. The Court also referred to three legal provisions, namely articles 222, 223 and 224(2) of Chapter

[523] First Hall Civil Court, 25 October 2002.

386. In light of these provisions and the fact that the winding up order was delivered on 25 October 2002, the defendant was not able to issue the notice for payment directly against the company. This was due to the fact that since 2002 and until the date of these current proceeding, the company was in the process of being wound up and the official receiver appointed. The Court pointed out that the approach taken by defendant was prohibited in terms of articles 222(1) u 224(2). The defendant did not follow the specific procedure laid down by law in the case of a company being wound up. It was no defence for defendant to state that the director of the company had corresponded with the defendant in 2010. Such correspondence could not alter the legal position of the company which was still being wound up. Defendant could not rely on a notification effected at the last known address and by a subsequent notification by means of affixation and publication in terms of Chapter 12, since this was not a legally valid mode of notification in a winding up scenario. In addition article 72 of the Value Added Tax Act[524] states that *"any notice, warrant or other proceeding purporting to be made in accordance with the provisions of this Act shall not be deemed to be void or voidable for want of form or be affected by the reason of a mistake, defect or omission therein, if the same is in substance and effect in conformity with or according to the intent and meaning of this Act"* – which the Court deemed inapplicable in this specific case. It was not a mistake made by the defendant but rather a case where he voluntarily opted to go against the specific provisions of the law.

The Court concluded that the notice sent by defendant to plaintiff company was null and without effect. In this instance, although the Department for Value Added Tax had a proven claim against the plaintiff company, it had failed to observe the proper procedure prescribed in the special law. The provisions in the Companies Act that deal with companies being wound up are drafted in a manner that the collective interests of the general body of creditors, as opposed to the individual creditor, in this case the Department for Value Added Tax, are supreme.

[524] Chapter 406, Laws of Malta.

4.3.10 Judicial Shielding

The intention of the legislator in enacting articles 222 and 224(2) of the Companies Act encapsulates the ethos of our corporate insolvency regime. Maltese corporate insolvency legislation is focused on preserving the best interests of the general body of creditors. The Court of Appeal's judgments reviewed below recognise and confirm this overriding principle. Since in practice court proceedings in a winding up context constitute an exception to the principle of *pari passu,* it follows that the relevant legal provisions are to be observed *ad unguem*. It is only through a strict application of the judicial shielding provisions that the underlying objectives of the winding up legal provisions are best implemented in practice.

In **Matthew Vella vs One Blue Lemon Co Limited**[525] the Court highlighted a discrepancy between the Maltese and English text of the same provision dealing with judicial shielding and precisely article 222 of the Companies Act. On the one hand the Maltese version of Article 222 of Chapter 386 reads as follows:

> *Meta kumpannija tkun qed tigi stralcjata mill-Qorti, kull att jew mandat, sew kawzjonarju jew ezekuttiv, barra minn mandat ta' inibizzjoni, mahrug jew migjub kontra l-kumpannija wara d-data li fiha jkun meqjus li sar ix-xoljiment ikun null.*

On the other hand the English text of the same provision reads as follows:

> *When a company is being wound up by the court, any act or warrant, whether precautionary or executive, other than a warrant of prohibitory injunction, issued or carried into effect against the company after the date of its deemed dissolution, shall be void.*

It is evident that the English and Maltese texts of the same provision are not identical. Whereas the Maltese text stipulates that when a company is being wound up by the Court, every warrant, whether precautionary or executive, issued or requested to be

[525] Court of Magistrates (Malta), 3 December 2014.

issued against a company after the date of the deemed dissolution is null, the English text states that every warrant whether precautionary or executive issued against or pending (that is, although it us issued it is still pending being *'carried into effect')* is null once there is a winding up order.

Due to these textual divergences between the Maltese and English law, two opposing arguments were brought forward:

1. Once a warrant was in force when a company is declared wound up then the said warrant is null;

2. The provision applies only to those warrants issued against the company which is already undergoing winding up process and not to all warrants issued against the company pre-liquidation.

The first interpretation is incorrect since article 222 of the Maltese Companies Act is intended to ensure that in insolvency proceedings the interests of all creditors are protected with no preference or discrimination in order to ensure the *"par condicio creditorum".* The intention of the legislator is for the liquidator to be in a better position to pay the creditors out of the assets of the company being wound up.

4.3.10.1 Judicial Shielding and the Application of the Principle of Ius Superveniens

From the ensuing selection of judgments delivered by the Maltese Courts, a new judicial trend seems to emerge concerning the application of the principle of *ius superveniens.* This point was examined in **FourX Limited vs Mediterranean Flower Products Limited (C-2197) u Flower Power (Sales) Limited (C-13901)**[526]**.** The defendant companies argued that the action as instituted by plaintiff company was

[526] First Hall Civil Court, 29 April 2015.

in breach of proper procedure as set out in the Companies Act. The plaintiff company had failed to notify the Provisional Administrator and did not obtain leave of Court prior to instituting Court action in breach of the specific procedural requirements laid out in article 224 of the Companies Act. It was only after that Court proceedings had started that the required authorisation was obtained. The Court applied the doctrine of *ius superveniens* and thus the action that was originally in breach of proper procedure was subsequently ratified. The justification for this course of action, the Court said, was to minimise costs and to ensure the proper administration of justice[527]. For this reason the argument raised by defendant companies was rejected.

In my opinion, however, the application of this principle could have the effect of annihilating the immediate purpose of these legal provisions which are largely intended to preserve and promote the application of the *pari passu* principle. Thus by application of the rule *lex specialis derogat generalis* the provisions contained in the Companies Act ought to override other generally applicable principles of law**.**

In **Mediterranean Flower Products Limited vs Flower Power (Sales) Limited *et***[528]**,** the Court of Appeal had to decide whether the action brought by plaintiff company was validly instituted according to the relevant legal provisions under review. Defendants raised a preliminary plea on the nullity of the action in that it alleged that plaintiff company had failed to observe the requirements of article 224 of the Companies Act. Defendants argued that a provisional administrator had been appointed for plaintiff company but failed to request prior court authorization. It resulted that such authorisation had been requested and granted *ex post facto*. The Court of Appeal drew a distinction between an instance where a provisional administrator is appointed for plaintiff company as opposed to a case where a provisional administrator was appointed for defendant company. The appellate Court observed that article 224(2) referred to cases or judicial actions taken against

[527] See Vella vs Dr Galea – Vol XXXIII-i-254; Paul Azzopardi vs Maria Lourdes Sciberras, Court of Appeal (Inferior Jurisdiction), 12 February 1996; David Clarke *noe* vs Dr Mario Griscti *nomine,* Commercial Court.
[528] Court of Appeal, 30 July 2010.

a company in a winding up process and not to instances where an action is brought by a company which is a party to the proceedings.

Of note are the Court's observations on the purpose of this legal provision namely,

> *… to preserve the status quo of the creditors of the company being wound up and to avoid a situation in which one creditor tries to take a special advantage by taking unilaterally proceedings against the company being wound up and obtain an executive title (and subsequent registration of judicial hypothec against the company) to the prejudice of the other creditors.*

The Court concluded that the provisions of article 224 were inapplicable in the case where plaintiff company was in a winding up process and a provisional administrator had been appointed. In no unclear terms, however, the Court specified that no judicial acts could be instituted against a company in a winding up process except with the prior consent of the Court,

> *in that once a company is undergoing a winding up process and a provisional administrator is appointed to take over the administration of the company, it is logical that no judicial acts are to be lodged against the company, unless the consent of the Court which presided over the winding up proceedings is obtained.*

The Court of First Instance[529] had also occasion to decide whether the fact that plaintiff company failed to request prior authorization from the Court in terms of article 224 of the Companies to institute judicial proceedings would give rise to the nullity of the action. The Court confirmed the fact that prior to instituting proceedings, no prior authorization of the court had been sought - even though plaintiff company was fully aware that defendant company was in a process of winding up and that a provisional administrator had been appointed. Court authorization was only requested and subsequently granted after the opening of

[529] Mediterranean Flower Products Limited vs Flower Power (Sales) Limited *et,* First Hall Civil Court, 9 December 2009.

court proceedings. The Court opted to apply the doctrine of *ius superveniens* in this instance by stating that,

> *… since plaintiff company had no right to commence a judicial action on the day it was instituted there is no doubt - even on the basis of doctrinal teachings - that the right was [subsequently] obtained during the court proceedings and therefore the principle of ius superveniens is to apply.*

A similar approach was adopted in **Nicholas Sammut et vs Flower Power (Sales) Limited *et***[530] wherein the Court observed that,

> *… the exceptions dealt with by article 224 of Chapter 386 are no longer valid in terms of the court decree and this through the application of the principle of ius superveniens. In any case it is to be noted that during the course of the court proceedings the company was no longer under the control of the provisional administrator.*

Therefore, even though there was a recognition of the applicability of the principle of *ius superveniens*, adherence to the requirements of article 224(2) of Chapter 386 was no longer of real relevance because the company was no longer under the control of a provisional administrator.

In **Dr Adrian Delia *noe* vs European Insurance Group Limited**[531] the Civil Court was seized with a request made by claimant against respondent company to declare the nullity and hence revoke the issue of a precautionary garnishee order previously obtained by the respondent. The action was based on article 222 of Chapter 386 and article 836 (1)(f) of Chapter 12. Reference was made to an earlier decision in **Dr Mark Refalo *noe* vs. European Insurance Group Ltd**[532] on a similar merit decided in favour of claimant. The respondent company objected to such a request also pointing out that the other case referred to an executive warrant and not to a precautionary one. The claimant argued that in winding-up proceedings of an insolvent company all the

[530] First Hall Civil Court, 8 January 2014.
[531] First Hall Civil Court, 4 February 2013.
[532] First Hall Civil Court, 6 March 2012.

company's creditors are to be treated *pari passu*. Should the warrant be not revoked, the sequestering party would be receiving a preferential treatment to the detriment of the other creditors. In the wake of prior judgments cited by claimant and after referring to **Dr Michael Zammit Maempel *noe* vs European Insurance Group Ltd**[533], the Civil Court acceded to plaintiff's request by annulling and revoking the said precautionary warrant in terms of law.

The Court also explained that article 222 of Chapter 386 had the aim of ensuring that in certain instances, such as cases of insolvency, the interests due to all the creditors are safeguarded without any right of preference and/or discrimination and to secure the *par condicio creditorum*. For this reason a precautionary garnishee warrant that *prima facie* appears to be null at law in terms of article 222 of Chapter 386, article 28(1) of Chapter 403 and article 10(2) of Legal Notice 208.2004 could never be held as being "reasonable" by the Court.

Reference was also made to **Dr. Mark Refalo *noe* vs European Insurance Group Limited**[534] where the Court of Appeal stressed that in a winding up order issued by the Malta Financial Services Agency (MFSA),

> *This Court deems that it should be bound ad litteram with the words used in article 222 of Cap. 386 which is found in the provisions dealing with winding up ordered by the Court but it should principally look at the regulating principle of all forms of winding up both voluntary and imposed (koatt) as is the present case which aims at gathering all the assets, the payment of all the debts and if there remain something left this is distributed among the shareholders.*

According to the Court the main objective of the whole exercise was that,

> *The principal aim for the gathering of all the assets is that the liquidator, at the beginning of the winding-up procedure, would have the control of the assets and would be obliged to dispose of those assets to whosever is entitled to them namely the creditors and*

[533] Court of Appeal, 25 January 2013.
[534] First Hall Civil Court, 16 March 2012.

according to the ranking that is allowed by law. All this is done to protect all the creditors without distinction in the context of the par condicio creditorum.

4.3.11 Company Recovery Procedure not to be prejudicial to creditors

Article 329B of the Companies Act is meant to help ailing companies with the possibility of recovery and rescue instead of putting them into liquidation. Muscat describes it as a far reaching procedure meant to be an alternative to the liquidation of a troubled business. At the same time, he goes on to add that *"it is not, however, intended to make effective insolvency or to merely postpone the inevitable crash*[535]*".* Whether it is opportune to appoint or not a special controller, following an application to this end, is for the Court to decide. The Court must first be satisfied that the company is unable to pay its debts or is likely to become so and that the order will favour the survival of the company in whole or in part, or one that would achieve a compromise or an arrangement between the company and its creditors or members. Past experience has shown that not much use has been made of such a rescue and recovery mechanism.

In **More Supermarkets (Hamrun) Limited vs X** [536] the Civil Court held that the rescue procedure for company restructuring was intended as an alternative to liquidation and not to make effective insolvency or to postpone an inevitable crash – a clear reference to an opinion expressed by Andrew Muscat. This was the main reason why the Court rejected the application[537] to put More Supermarkets into administration. The presiding judge decreed that the company's position had become irreversible since there existed no viable plan for recovery. The Court therefore denied the application requesting the company to be put into administration. It also held that the application had been filed by the company and not by its directors or creditors and did not contain the required extraordinary resolution by the company's general meeting. The judge noted that the Court had been informed about the existence of

[535] Andrew Muscat, *Principles of Maltese Company Law* (Malta University Press 2007).
[536] First Hall Civil Court, 27 October 2014.
[537] filed on 17 October 2014.

a restructuring plan but that at a later it was discovered that there was nothing in writing. The Court held that it was not satisfied that there were real prospects for the company's recovery. It transpired that the franchise had been left in the lurch and with a mounting number of unpaid bills. To make matters worse the company director, Ryan Schembri, had absconded from Malta in the intervening period when he found out that he was not in a position to pay his many creditors. It is believed that, in total, director Schembri left the company with a staggering debt to the tune of 40 million euro.

In **Publishers Enterprises Group (P.E.G.) vs X**[538] the Civil Court ordered the liquidation of P.E.G Limited, a once popular Maltese publishing house following an application filed by the company itself. The case is important for two reasons: it is an example of an aborted rescue operation which unfortunately typifies other Maltese cases facing financial distress and secondly, because the Court thought it fit to recommend that the termination of the workers' employment should be a last resort. The company had been operating since 1983 with a thriving business for a number of years. At a certain point in time, although it was still recording profits and employing a sizeable workforce, the company started to experience financial distress and this downward trend persisted. In April 2009 one of its creditor companies, SADO Limited, issued a warrant, against which P.E.G. Limited unsuccessfully tried to revoke. On examining the evidence produced the Court came to the conclusion that P.E.G. Limited had incurred debts in the region EUR 500,000 and had no feasible means of making good for this amount which was due to its creditors. The Court had, in virtue of an earlier decree, put the company under a company recovery procedure by appointing a special controller to administer its business. The special controller submitted to the Court that, P.E.G. Limited owed substantially more money in excess of its assets and had no realistic hope of earning a reasonable income to offset its debts. It also resulted during a special meeting that the company's creditors had unanimously voted for P.E.G. Limited to be put in liquidation.

[538] Civil Court, 9 August 2009.

By contrast, a successful application of the corporate recovery process was decided upon in **DQR Limited *et* vs X**[539]. DQR Limited was a blockchain company originally set up in Germany and in 2017 migrated some of its operations to Malta together with Genesis Mining, the largest partner in the Group. In 2018, it was decided to set up a second holding company to address all the needs for any blockchain participant in Malta. In early October the partner company informed the local company that it was experiencing financial difficulties. The market conditions of cryptocurrency had meantime fallen by approximately 18% and later on that same month DQR Limited were asked by Genesis Mining to file for insolvency.

Subsequently, Genesis Mining exited the Company by transferring its shareholding to the Chief Executive of DQR, Mr. Haehndel. The latter took over the liability himself and became the sole shareholder of the holding company and its sole director. Mr. Haehndel testified that they hid nothing from their creditors stating that, *"we notified the major creditors and asked them to submit the proposal for payment structure over a period of twelve to twenty months. The creditors submitted a proposal on what they anticipated as payment schedule…The major creditors were informed of the special recovery procedure".* The witness added that as a result of forming up DQR-OTC, *"we are able to pay off everything within four months, but definitely we can structure a payment plan during those four months".*

The Court recognized that applicant's financial position was untenable because it was on the brink of insolvency, as foreseen in Chapter 386. The crux of the matter was whether the situation was irreversible. The Court was in no doubt that nothing could prevent the ultimate beneficial owner from going into liquidation on the part of the applicants, as had been after all proposed by the other shareholders, notably Genesis Mining. Instead, applicant opted to go for the company recovery procedure.

The Court held that the recovery proposals supported by other documents were *prima facie* doable and not prejudicial to the creditors. The Court stressed that the

[539] Civil Court (Commercial Section), 9 May 2019.

proposed recovery plan was not "a fairy tale" (*sic*). By working assiduously with everyone on board the plan could be executed in the interest of everyone but above all in the creditors' interest. The Court stressed once more that the applicant, instead of resorting to a dissolution and consequential winding up procedure, opted for the procedure under review so that with due caution, as well as the Court's supervision, all the necessary changes be effected so that no one remained without a remedy especially the creditors.

For these reasons, the Court decided as follows:

1. To accept the first request and to place each one of the applicant companies under a company recovery procedure in terms of article 329B of Chapter 386 of the Laws of Malta.

2. To appoint a special controller in terms of article 329B of Chapter 386 from the date of the judgment.

4.3.12 The Insolvency Tests

In **Brava Limited vs Sakaras Holding Limited**[540] the Civil Court had occasion to elaborate on article 214(5) of the Companies Act of 1995 in relation to its equivalent in English law. It observed that under English law the liquidation and winding up of a company was regulated by a special law namely the Insolvency Act 1986. When the new Companies Act of 1995[541] was introduced it replaced the Commercial Partnerships Ordinance 1962 and the dispositions concerning liquidation and winding up proceedings were incorporated in it. Under Maltese law, the fact that a company is unable to honour its debts has a specific meaning defined by law in terms of article 214(5). Under English law the position is broader in concept. By comparison insolvency under Maltese law is more restricted, even though some overlaps exist.

[540] First Hall Civil Court, 4 July 2014.
[541] Chapter 386, Laws of Malta.

Citing Boyle & Birds' Company Law[542], the Court held that: *"There are two principal, although not exclusive or exhaustive, tests of insolvency: a company is insolvent if it is unable to pay its debts as they fall due ("cash flow insolvency"); it is also insolvent it its liabilities exceed its assets ("balance sheet insolvency")..."*

In the Companies Act of 1995, "cash flow insolvency" is linked with article 214(5)(a) whereas "balance sheet insolvency" with article 214(5)(b) and the case in judgment fell under the latter category.

Keay and Walton[543] comment as follows on cash flow insolvency in the context of the Insolvency Act 1986:

> *The court…..will consider whether the company is actually paying its debtors. Courts must take into account what current revenue the company has as well as what the company can procure by realizing assets within a relatively short time… A company can rely upon money which might be obtained on the strength of its assets…it is possible that sometimes a debtor might be able to establish solvency by demonstrating that funds can be obtained through an unsecured loan. In considering whether a person or a company is insolvent, the debtor's whole financial position must be studied….and a temporary lack of liquidity does not necessarily mean that the company is insolvent…*

According to these text-writers[544] judicial opinion on the matter in the UK did not remain unchanged in that, *"At one time courts were rather strict on what they required to be established before they were willing to deem a person or a company insolvent, but in more recent times they have become more liberal as far as creditors are concerned…"*

The new trend of thought held that a debtor is considered insolvent if a creditor is able to prove that he or she has not paid an undisputed debt after a demand has

[542] AJ Boyle and John Birds, Boyle & Birds' Company Law (9th edn, Jordan Publications, 2016).
[543] Andrew Keay and Paul Walton, *Insolvency Law – Corporate and Personal* (Pearson Longman 2001) 17.
[544] Ibid (No 510).

been made. This would also be the case even if there is no other evidence which suggests that the value of the assets outweighs liabilities.

On the same lines in **Axel John International AB vs. Aluminium Extrusions Limited**[545] it was further elaborated that,

> *This condition can be verified by means of the balance sheets after a consideration as to whether the assets are less than its liabilities. But…it is not sufficient for the company to be able to meet its current obligations if its total liabilities can be ultimately met only by the realization of its assets over a lengthy period (**Re: European Life Assurance Society 1869 LR 9 Eq 122**). Therefore there is no reason for the creditors to wait until the company sells its assets so that maybe they can be paid at some time.*

Adopting a similar approach the Maltese Court was satisfied that the company was insolvent in terms of article 214(5)(b) on the basis that the other requisites fell under articles 214(2)(a)(ii) and under article 214(5)(b) and ordered the dissolution and winding up of the respondent company.

4.3.13 Difficulties in the Ranking of Creditors

In **Ranking of creditors of Victor Zammit *et***[546] the Court addressed the question of the ranking of creditors and deemed it appropriate to list a number of Maltese cases which in its opinion contributed appreciably to better clarify this issue. In **Ranking of creditors of Da Vinci Limited**[547] the Court went a step further and established the ranking of creditors in the following order:

1. In the first place judicial expenses incurred for the sale of the immovable property and realisation of the distribution of the proceeds;

[545] First Hall Civil Court, 28 May 2003.
[546] Court of Appeal, 28 April 2017.
[547] First Hall Civil Court, 13 November 2000.

2. Secondly, the Commissioner for Inland Revenue for Value Added Tax which was privileged in terms of article 62 of the Value Added Tax Act;

3. Employees' wages up to a maximum of two hundred Maltese *liri* (Lm 200) and claims by the Director for Social Services for First Class Contributions which were privileged in terms of article 116(3) of Chapter 318;

4. Fourthly, the Commissioner for Inland Revenue for PAYE tax which was privileged in terms of article 23(8) of Chapter 372;

5. From the fifth to the tenth grade of ranking those other hypothecary creditors with HSBC plc being placed in the seventh grade;

6. In the eleventh place, ranked ordinary creditors that did not enjoy any privilege.

It should be observed that by being ranked in the last place ordinary unsecured creditors could hardly be expected to receive a part of the distributable assets and the possibility to apply the *pari passu* principle becomes too remote to be applied.
The second case referred to was **Ranking of creditors of Testing Limited**[548] with respect to a credit claimed by the Commissioner for Inland Revenue for the payment of sums of money withheld from the employees by way of PAYE which privileged credit was covered by a special law but which was neither hypothecated nor registered as a privileged debt in the Public Registry. The Appeal Court held that this debt was of a fiscal nature in terms of article 23(8) of Act XVIII of 1994 and it was privileged but had to be paid after other payments due to the employees and the Director of Social Services and in preference to all the other claims both "if they are privileged or hypothecary debts." For this reason this credit ranked over the other competing claimants.

[548] Court of Appeal, 3 March 2006.

In **L&D Attard Company Limited and BOV plc vs Anthony and Bernardette spouses Gauci**[549] the Court held that the Commissioner for Inland Revenue for PAYE ranked before BOV plc, even if the Commissioner's claim was not registered or inscribed in the Public Registry, contrary to what BOV was claiming in terms of Title XXIII of Chapter 16. In this instance the Court ranked the creditors in this order:

1) the Director of Courts in relation to Court Registry fees in terms of article 2003 of Chapter 16 of the Laws of Malta;
2) Social Security contributions;
3) Pay As You Earn (PAYE); and
4) BOV plc credit[550].

The Appeal Court described **Ranking of creditors of Carmelo Gauci**[551] as an interpretative judgment with respect to the nature of privilege enjoyed by the Commissioner of Inland Revenue under article 45(3)(f) of the Income Tax Act, 1948. This article gives a "special privilege" to the Commissioner "and not a right to a privilege" as found in other legislations and in our juridical system there exists only one type of special privilege namely the one found in article 2001(2) of the Civil Code. The legislator does not define "special privilege" for the purpose of fiscal law. The meaning should be as provided in the Civil Code which, and unless not excluded, applies only in a general manner. It also noted that the special privilege was not extended to all the assets of the debtor, in which case there would be a need for it to be described as a "general privilege" in terms of article 2000(1) of the Civil Code namely, *"in the active part forming the economic activity of the person – thereby showing the legislator's intention of linking the privilege with what is found in the Civil Code."* The Court however held that the law does not go as far as to state that the special privilege ranks in preference but that "the tax mentioned must be paid in

[549] In the proceedings relating to schedule of deposit number 173/98 decided on 3 October 2007.
[550] On similar lines refer to the schedule of deposit 59/84 in the names Paul Xuereb on behalf and on representation of Malta Development Corporation vs Francis Flynn *nomine* (Mid-Med Bank) vs Dr Albert Manche' *nomine* (Grand Hotel Verdala Limited).
[551] Court of Appeal, 29 February 2009.

preference…." [Court emphasis]. As held in **Zammit vs Caruana *nomine***[552], the credit and the privilege are separate from one another. The credit is one thing, while the privilege is something else. Although a privilege does not subsist without the credit, the credit can subsist independently from the privilege. In practice this means that the failure of the Commissioner for Value Added Tax to register the privilege does not extinguish the credit, and in terms of article 62 of the Value Added Tax Act, this credit should be paid "in preference to a debt that enjoys some other privilege[553]".

4.4 A Selection of English Court judgments on insolvency referred to by Maltese Courts with particular reference to the application of the *pari passu* principle in the ranking of creditors

The constant and lengthy references on the part of the Maltese Courts to English jurisprudence and case law has been so extensive and pervasive in content that it would not only make it worthwhile to review some of the more relevant judgments delivered by English Courts on insolvency issues but more of an imperative. This said there still remains a number of leading and more recent judgments delivered by the English Courts which deserve to be mentioned in their own right on account of their contribution towards a better understanding of insolvency proceedings with special reference to the ranking of creditors.

The review of these judgments will be split in two sections. The first part comprises decisions which Maltese judges themselves selected to lend greater authoritative support and provide a more enhanced elaboration for interpretative purposes to their judgments. The second part consists of leading English Courts decisions which deal more specifically with crucial aspects of the ranking of creditors and the application of the *pari passu* principle.

[552] 8 January 1958.
[553] See also pages 10 and 11 of the judgment.

4.4.1 English cases cited by Maltese Courts

Directors play a vital and determinate role in all the operations of the company. In a general way the directors take charge of the management of the company's business. They devise the strategy and take the operational decisions of the company and are responsible for ensuring that the company meets its statutory obligations. Failure on their part to meet these obligations come at a price for they have to bear the consequences. On the role and responsibility of the directors, the Court[554] cited **Howard v Herrigel**[555] in that in common law,

> *once a person accepts appointment as a director he becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company in his dealings on its behalf. That is the general rule and its application to any particular incumbent of the office of director must necessarily depend on the facts and circumstances of each.*

In **Grant & Anor v Ralls & Ors**[556] the Court held that whilst the question of whether a director knew that there was no reasonable prospect of the company avoiding an insolvent liquidation is a question of 'subjective' test the question of whether the director ought to have concluded that this was so is an objective question. The judgment refers to section 214(4) of the Insolvency Act, 1986 which specifies that,

> *the facts which the director ought to know, the conclusions he ought to take, are those which would be known, reached or taken by a reasonably diligent person, having the general knowledge and experience that may be reasonably be expected of a person carrying out the same functions as those of the director and the general knowledge, skill and experience that director in fact has.*

Similarly on the level of knowledge required of directors in carrying out their functions, the Court cited **Produce Marketing Consortium Limited**[557] where it was

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[554] *Vide* Official Receiver in his capacity as liquidator of Smart Malta ICT Limited C41884 vs Steve Alamango and Geoffrey Farrugia on 30 May 2019.
[555] (1991)(2) SA660A.
[556] *Re Ralls Builders Ltd* [2016] EWHC 234 (Snowdon J).
[557] [1989] 5 BCC 1 (Knox J).

held that, *"… the general knowledge, skill and experience postulated will be much less extensive in a small company in a modest way of business … than it will be in a large company with sophisticated procedures."*

Nevertheless the Court observed that *"certain minimum standards are to be assumed to be attained."* The Court went on to add that notably there is an obligation to be kept such as to disclose with reasonable accuracy at any time the financial position of the company at that time[558]. In addition, directors are required to prepare a profit and loss account for each financial year and a balance sheet at the end of it[559]. Directors are also obliged to lay before the company in general meeting copies of the accounts for that year and to deliver to the registrar of companies a copy of those accounts.

In **Rubin v Gunner**[560] the Court accepted the respondents' analysis of the company's financial position in that it found that although the company was insolvent the respondents had a genuine and reasonable belief that an investor would provide sufficient funding for the company to avoid going into insolvent liquidation. On the test of "knowledge" on the part of the directors the Maltese Court[561] cited Lewison J in **Re Hawkes Hill Publishing Co Ltd**[562] in affirming that it is impossible at the outset to be clear about the relevant question namely, whether the directors knew or ought to have known that the company was insolvent and that there was no reasonable prospect of avoiding insolvent liquidation.

On the subject of companies' legislation vis-à-vis the director's duties Chadwick J in **CS Holidays Ltd**[563]**,** observed that the law did not impose on them a statutory duty to ensure that their company does not trade while insolvent; nor did that legislation impose any obligation to ensure that the company does not trade at a loss.

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[558] Companies Act, 1985 section 221(1) and (2)(a).
[559] Companies Act, 1985 section 227(1) and (3).
[560] [2004] EWHC 316 (CR) BCC 2004 BCC684 (Etherton J).
[561] Official Receiver in his capacity as liquidator of Smart Malta ICT Limited C41884 vs Steve Alamango and Geoffrey Farrugia on 30 May 2019.
[562] (2000) BCC 937.
[563] [1997] 1, WLR.

In **Re Continental Assurance Company of London plc**[564], Parker J accepted the evidence given by the directors where they showed that they had reduced the commercial activity of the company to a cautious minimum, and had stopped all business when it resulted that the company was insolvent. The Maltese Court[565] agreed with Parker J's opinion that it would be an extraordinarily harsh result if the directors in this case were liable for wrongful trading.

On the question of a company finding itself in financial difficulties due to capital investment, reference was made by the Court[566] to **Purpoint Ltd**[567], where Vinelott J held that he had felt some doubt whether a reasonably prudent director would have allowed the company to commence trading at all. To begin with, the company had no capital base at its disposal. Also its only assets were purchased by bank borrowing or acquired by hire-purchase and its working capital was contributed by a loan. The business it inherited had been proved unprofitable and with the winding up of that company the creditors, other than the Royal Bank of Scotland, were left with an empty shell. Vinelott J opined that, *"I cannot say that there was a belief that could not have been entertained by a reasonable and prudent director conscious of his duty to persons to whom the company would incur liabilities in the ordinary course of carrying on its business."*

According to the Maltese Civil Court[568] although Andrew Muscat[569] did not share the conclusion reached by Vinelott J on this point, Muscat still comments that liability for wrongful trading is not attracted by mismanagement or by undercapitalised incorporation but by the failure to take appropriate steps to minimise the potential loss to creditors after insolvency became inevitable.

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[564] [2001] BPIR 7330.
[565] Official Receiver in his capacity as liquidator of Smart Malta ICT Limited C41884 vs Steve Alamango and Geoffrey Farrugia on 30 May 2019.
[566] Ibid (No 531).
[567] [1991] BCLC 441.
[568] Tamamu Company Limited (C36981) vs Pizza Factory Company Limited (C51901), Civil Court (Commercial Section), 31 October 2019.
[569] Andrew Muscat, *Principles of Company Law* (Malta University Press2007) 279-280.

Regarding the cash flow test, the Maltese Civil Court in **Tamamu vs Pizza Factory** referred to **Re Byblos Bank SAL v. Al-Khudhairy**[570] which held that if a debt presently payable is not paid because of lack of means, that will normally be sufficient to prove that the company is an unable to pay its debts. According to this judgment, "*That will be so even if, on an assessment of all the assets over the liabilities, there is a surplus of assets over liabilities. That is trite law."* The same trend of thought was echoed in **Re A Company**[571] where Hoffmann J held that,

> *a company's non-compliance with a statutory demand on non-satisfaction of execution of judgment debt is a matter that can be proved quite simply, usually by single silent witness statement. If proved, it establishes the Court's jurisdiction to make up a winding-up order…*

Cheyne Finance plc (no 2)[572] and **BNY Corporate Trustee Services Ltd vs Eurosail UK**[573] were described by the Maltese Court[574] as important and authoritative pronouncements. These were subsequently synthesised in **Re Bucci vs Carman (Liquidator of Casa Estates) (UK) Ltd**[575]. The Supreme Court *inter alia* held that the so-called "point of no return" test was no longer the right test to apply to determine whether a company was insolvent, as subsequently confirmed again in **BNY Corporal Trustee Services Limited v Eurosail-UK**[576]**.**

After making reference to Walker J in **Eurosail**[577]**,** the Court[578] held that:

1. The tests set out in section 123 of the Insolvency Act, 1986 (the "Act") were not meant to significantly change the law as it existed before the implementation of the Act;

[570] [1987] BCLC 232.
[571] [12209] (1982) BCLC, 856-868.
[572] ChD 17 Oct 2007.
[573] 2007-3BL Plc (2011) EWCA Civ 227.
[574] Tamamu Company Limited (C36981) vs Pizza Factory Company Limited (C51901), Civil Court (Commercial Section), 31 October 2019.
[575] Court of Appeal, 3 April 2014, EWCA, CIV, 383.
[576] 2007-3BL Plc (2011) EWCA Civ 227.
[577] Ibid (No 542).
[578] Ibid (No 540).

2. The cash flow test is a flexible and fact sensitive test which looks to the reasonably near future as well as to the present;

3. The cash flow test and the balance sheet test stand side by side and the balance sheet test is not a mechanical test, especially when it is applied to contingent and prospective liabilities – once the court has to move beyond the 'reasonably near future' any attempt to apply the cash flow test will become purely speculate and the only sensible test is to then compare a company's present assets with present and future liabilities, and

4. Finally, whether the balance sheet test is satisfied depends on the evidence available in relation to the particular circumstances of the case. The Court must make a judgment as to whether a company can reasonably be expected to meet its liabilities when looking at that company's assets and making a proper allowance for prospective and contingent liabilities. If it is not in a position to do so, it will be deemed to be insolvent even though it is currently able to pay its debts as they fall due.

In light of the **Eurosail**[579] decision, Lewison LJ observed that the balance sheet test should not be excluded merely because when applying the cash flow test a company was for the time being paying its debts as they fall due. The two tests stand side by side as a realistic examination could reveal that a company was in reality insolvent. The balance sheet test is an alternative test and the two tests are part of a single exercise in determining whether a company was unable to pay its debts. In **Re Casa Estates**[580], the Court of Appeal noted that in essence the company was only able to continue to pay its debts as they fell due by relying on new deposits and using them to pay off old debts. Whether one applies the cash flow test or the balance sheet test the company was insolvent from a commercial point of view.

[579] 2007-3BL Plc (2011) EWCA Civ 227.
[580] Court of Appeal, 3 April 2014, EWCA, CIV, 383.

Two important points highlighted by Briggs J in **Re Cheyne Finance plc (no 2)**[581] regarding the cash flow test were the following:

1. Cash flow solvency or insolvency is not to be ascertained by a blinkered focus on debts due at the relevant date.

2. Even if a company is not cash flow insolvent, the alternative balance sheet test will afford a petitioner for winding up of a convenient alternative means of proof of a deemed insolvency.

One other relevant English case that the Maltese Courts[582] considered worth mentioning was **Re BNY Corporate Trustee Services Ltd and ORS**[583] containing a detailed analysis of section 123 of the Insolvency Act with particular reference to the cash flow test and those debts falling due from time to time "in the reasonably near future". The Supreme Court explained that what is reasonably near future, for this purpose, will depend on the circumstances but especially on the nature of the company's business but it is still very far from an exact test, the burden of proof must be on the party which asserts balance-sheet test insolvency.

On the compensation due by the director by way of liability, the Maltese Courts[584] referred to **Re Product Marketing Consortium Limited**[585], in that the jurisdiction under article 214 is primarily compensatory rather than penal. *Prima facie* the appropriate amount that a director is declared to be liable to contribute is the amount by which the company's assets can be discerned to have been depleted by the director's conduct which caused the discretion under subsection (1) to arise. But

[581] ChD 17 Oct 2007.
[582] Official Receiver in his capacity as liquidator of Smart Malta ICT Limited C41884 vs Steve Alamango and Geoffrey Farrugia on 30 May 2019.
[583] Supreme Court, 9 May 2013.
[584] Ibid (No 548).
[585] [1989] 5 BCC.

according to Knox J[586], *"Parliament had indeed chosen very wide words of discretion and it would be undesirable to seek to spell out limits on that discretion."*

4.4.2 References by Maltese Courts on Insolvency by English Text Writers

Maltese judgments also included various contributions by eminent English text-writers on insolvency for authoritative support. In **Emanuel Azzopardi *et* vs Sea Malta Company Limited *et***[587] the Court considered a collective action with summary proceedings for a group of employees against respondent company for the payment of a fixed sum of money for wages, benefits and other payments due to them. The respondent company raised a plea that it was in the course of liquidation and any claims had first to be verified and determined by the liquidator and for that reason plaintiff's action was premature. After citing Bailey, Groves and Smith[588], the Court rejected this preliminary plea and held that there is no inhibition on a creditor from commencing or carrying on with proceedings against a company in voluntary liquidation whether before or after the resolution to wind up. An application may, however, the Court observed "*be made to restrain or stay the proceedings under the Court's jurisdiction in voluntary liquidation to exercise any of the powers available to the Court if the company were being wound up by the Court."*

By way of general comment this case is important as it seizes the individual enforcement action in favour of a collective action in the interest of the general body of creditors. It manifests that the principles of collectivity and *pari passu* are interdependent. Failure to observe a simple and straightforward rule of procedural law in the acts of the proceedings will most likely lead to unpleasant or unforeseen results. In other words, those rules emanating from the Code of Organisation and Civil Procedure cannot be taken for granted, ignored or derogated from. On the contrary, they are to be observed and applied *ad unguem*. The following two cases amply demonstrate this point. In **Ranking of creditors of Testing Limited**[589] the Court

[586] [1989] 5 BCC.
[587] First Hall Civil Court, 6 June 2006.
[588] *Corporate Insolvency* (2nd edn, Longman & Pearson 2001) 647.
[589] Court of Appeal, 3 May 2006.

accepted one of the grievances raised by the appellant, HSBC Bank Malta plc in that once it resulted that the Court Registrar failed to participate in the ranking of creditors process to claim the judicial fees incurred and, in the absence of other evidence that the Registrar made such a claim, the Registrar should not qualify to pre-rank in the list of creditors. Incidentally this judgment once again reaffirmed that in terms of article 23(2)(ii) of Chapter 372, it is expressly provided at law that,

> *… the demand notice to the Commissioner of Inland Revenue … showing the amount due to be paid under this article shall constitute a privileged claim [Court emphasis] over the assets of the employer … and shall be paid after such wages [of the employee] and in preference to all other claims whether privileged or hypothecary.*

The law does not impose any particular method as to how the demand notice should be formulated. In this instance it was clear that Testing Limited had failed to settle the PAYE to the Commissioner *qua* employer and that moreover it had reached an agreement with the Commissioner in order to determine the amount of tax that was due, and which debt had been acknowledged by the company. The company had in fact been notified by the Commissioner with a request for payment of this amount.

Court proceedings for the ranking of creditors can only commence if there are more than two persons claiming competing claims in terms of ranking for payment purposes. In this respect article 416(1) of Chapter 12 is quite clear on this requisite. Despite this, there have been a number of court cases on this straightforward provision of law. The matter was discussed *in extenso* in **Ranking of Alexander Aloisio and Dagmar Pallmar Fiorini**[590]. Following the deposit of a sum of money under the court's authority in consequence to separate proceedings and in an earlier judgment, two creditors namely Lombard Bank plc and John Bugeja came forward with a claim for payment alleging to be the rightful creditors eligible to withdraw the money so deposited. As held in **Michael Attard Limited (C32362) vs Lee Nathan Mayne**[591], the Court reaffirmed that the procedure can only take place provided that

[590] First Hall Civil Court, 29 September 2016.
[591] First Hall Civil Court, 14 May 2015.

more than two claimants. If not, the procedure cannot move forward. Once there are more than two creditors the possibility for other claimants *qua* creditors to join in still remains. Reference was made to **Ranking of creditors of Joseph Ellul**[592], where the applicant had premised that he was unable to withdraw the deposit because there were other competing creditors. He had notified the Court appointed curator, Dr Louis Cassar Pullicino, *qua* respondent. The latter, in turn, entered a note claiming that it did not result that there were more than two creditors. Upon verification, it resulted that this was indeed the case. The applicant's action was turned down and declared *per inutile.* In a similar vein the Court referred to **Charles Grech and Co Limited (C2473) vs Dr Clarence Busuttil and Bay Catering Limited (C39787) *et***[593]. What usually happens in similar instances is that there would indeed appear *prima facie* that there are more than two creditors, but at a later stage for one reason or another no more than two creditors show up to present their claim. As a result, proceedings are stillborn and turned down by the Court.

The same judgment also dealt with the nature of the office of a liquidator on the question of personal liability this time quoting Farrar and Hannigan[594] for support. The Court explained that when carrying out their functions, liquidators act as agents of the company and any contracts any liquidator makes will be between the company and the outsider and the liquidator will incur no personal liability. Liquidators are in a fiduciary relationship with the company and must not place themselves in a position of conflict of interest.

Sometimes the issue boils down to a question of reality over appearance. In **Bank of Valletta plc vs Mexico Garage Rent-A-Car Limited**[595] it was held that although it resulted that there was a number of creditors of the respondent company in the liquidation proceedings in reality there was only one participant namely, the Commissioner of Inland Revenue. The Commissioner was moreover acting in his

[592] First Hall Civil Court, 27 January 2003.
[593] First Hall Civil Court, 14 May 2015.
[594] *Farrar's Company Law* (4th edn,Butterworths 1998) 718.
[595] First Hall Civil Court, 15 January 2020.

capacity as Commissioner of Inland Revenue, the Commissioner of Value Added Tax and as Comptroller of Customs in terms of the relative Acts relating to taxes, whereupon the Commissioner was claiming three credits. The Court referred to article 3 of Chapter 517. It appeared *ictu oculi* that there were three separate creditors with regard to the payment of income tax, value added tax and excise tax, however it was sufficiently clear that while the credits were distinct from each other, the creditor was one and the same namely the Commissioner. Although Bank of Valletta plc had declared that it was not going to take part in the liquidation proceedings, nonetheless the credits claimed by the Commissioner for Inland Revenue had to be considered as well in order to establish whether the Commissioner was indeed entitled to oppose to the withdrawal of monies by plaintiff. Upon examining the evidence produced and citing also articles 62 of Chapter 406, article 116(3) of Chapter 318 and article 23(11) of Chapter 372 the Court held that these dispositions were relevant in respect to the various claims made by the Commissioner. Moreover it held that these credits of a fiscal nature pre-ranked the credit claimed by plaintiff. For this reason it decided that the opposition raised by the Commissioner to plaintiff's application for a declaration of compensation in its favour was justified and that therefore plaintiff's request was unfounded and consequently there was no basis for a ranking of creditors.

In **Gallaria Management Limited vs Angele Calleja *et***[596] we find again references to English text-writers to add more weight to another important area of insolvency law concerning fraudulent behaviour. For an elaborate interpretation on the notion of intent to defraud and what amounts to fraudulent behaviour in light of section 213 of the Insolvency Act, the Court referred extensively to Keay and Walton[597]. These authors in turn make copious references to other English judgments on the meaning of fraud in relation to insolvency and these decisions, so quoted, are reproduced in the Maltese judgment. We find another reference to authors Arlidge and Parry[598] on

[596] First Hall Civil Court, 31 October 2017.
[597] Andrew Keay and Paul Walton, *Insolvency Law – Corporate and Personal* (Pearson Longman 2001).
[598] Anthony Arlidge & Alexander Milne, *Arlidge and Parry on Fraud* (5th edn, Sweet & Maxwell 2016).

what amounts to the carrying on of business with intent to defraud creditors. Three distinct situations may arise namely,

- Putting the trader's existing creditors at the risk of not being paid;

- Causing people who are not his existing creditors to become his creditors at a time when he is, or is likely to become, insolvent;

- Doing things which give rise to causes of action sounding in damages against him in favour of people who are not his existing creditors.

It is worth noting that for a better understanding of English law on insolvency the Court cites extensively from contributions by Maltese legal scholar, Andrew Muscat, namely *Principles of Maltese Company Law*[599] and *The Liability of the Holding Company for the debts of its insolvent subsidiaries*[600].

4.5 Leading Cases decided by the English Courts on the *Pari Passu* Principle and the Ranking of Creditors

4.5.1 Introduction

The extent of supportive case-law cited by Maltese Courts touching upon various aspects of insolvency law and procedure is quite wide and far-ranging but not exhaustive. There remains some other leading cases and legal contributions by text-writers that also merit a closer look on account of the fact that they throw more light on the utility of the *pari passu* principle and the exercise of ranking of creditors. The review that follows will serve to further complement and enhance the analysis of the complexities of insolvency proceedings with special reference to the ranking of creditors.

[599] (Malta University Press 2019).
[600] Dartmouth Publishing Company 1996).

4.5.2 Tracing the Origins of the *Pari Passu* Principle in English law

The origins of the *pari passu* principle in English law was laid down in detail in **Lehman Brothers International (Europe) (In Administration)**[601]**.** The first relevant Act is the Bankrupts Act 1542[602] which required creditors to seek satisfaction through a process of collective enforcement. There was no provision for discharge of the bankrupt. If the process did not discharge the bankrupt's liabilities in full, creditors were entitled to claim any shortfall from the bankrupt. The bankruptcy process thus merely affected the way in which creditors' rights could be enforced, but otherwise left them untouched. It provided that the bankrupt's assets were to be sold and distributed *"to every of the said creditors, a portion rate and rate like, according to the quality of their debts".* This was the origin of the *pari passu* rule.

The position remained essentially the same following the enactment of the Bankrupts Act 1571[603]. That Act also provided for the appointment of Commissioners who could be required to make a declaration as to how the bankrupt's assets had been applied and *"… to make payment of the overplus (that is, the surplus) of the same, if any such shall be, to the said bankrupts".* This declaration was the first reference to the concept of the surplus.

Thus, as early as 1571, the bankruptcy regime already included the fundamental concepts of the collective process of enforcement, namely:

- the *pari passu* distribution of the bankruptcy estate in respect of debts;
- a cut-off date for such debts of the commencement of the bankruptcy;
- a surplus;
- the rights of creditors to payment of any debts (including post-bankruptcy interest) not satisfied by such distributions out of the surplus; and
- the entitlement of the bankrupt to any residue.

[601] High Court of Justice No. 7942 of 2008 Chancery Division.
[602] 34 & 35 Henry VIII Cap. 4.
[603] 13 Elizabeth Cap. 7.

The Bankruptcy Act 1883 was to the same effect as the Bankruptcy Consolidation Act 1849, although the form of the relevant provisions were rearranged. Section 40(4) of the 1883 Act provided for all debts proved to be paid *pari passu*.

The citation from the above-mentioned landmark judgment goes to show that for centuries the bankruptcy regime already included the basic concepts of the collective process of enforcement as well as the *pari passu* distribution of the bankruptcy assets in respect of debts. It is particularly interesting since it traces the origins of the principle just up to the enactment of the Insolvency Act, 1986 wherein *pari passu* is clearly enshrined.

4.5.3 Equality vs Equity

The strongest underlying principle with regard to distribution in a winding up is the *pari passu* rule but more specifically that the unsecured creditors within a class shall be treated equally, with their debts abating on a *pro rata* basis where there is a shortfall of assets. The maxim that equality is equity expresses in a general way the objective both of law and equity, namely to effect a distribution of property and losses proportionate to the several claims or to the several liabilities of the persons concerned. Equality in this connection does not necessarily mean literal equality, but may mean proportionate equality. Arden LJ[604] explains that the application of the *pari passu* principle means that the creditors of the same rank should be treated on the same footing. It follows that lenders and private investors are treated in the same way and without distinction, unless the law provides otherwise. The principle is not universal because it is subject to major exceptions such as in the case of set-off. It differs from a principle of equal distribution because not all creditors of the same class, for example private investors, are treated in the same way. On the face of it, investors who have been repaid are entitled to retain their repayments unless the transaction can be impeached under one of the claw-back provisions such as

[604] *In the matter of Stanford International Bank Ltd (In Liquidation)* [2019] UKPC 45 Privy Council Appeal No 0075.

fraudulent preference whereas the rest can only prove in the liquidation and may recover only a small dividend on their investment.

4.5.4 Pre-Eminence of the Pari *Passu* Principle

British Eagle International Airways v Cie National Air France[605] has been described as the *'leading modern authority on the pre-eminence of the pari passu principle*[606]*'*. It centred on the liquidation of British Eagle International Airways in November 1968. Both parties to the case were members of the International Air Transport Association (IATA). The IATA administered a 'clearing house' scheme under which debts and credits owed by and to its various members were paid into a central pooling account with the balance at the end of each month paid to or by the respective member airlines. At the time of its liquidation, British Eagle was a net debtor to the IATA clearing house scheme. However, its specific position vis-à-vis Air France was that of a net creditor. So while British Eagle had an overall liability to the IATA clearing house scheme, in the absence of such a scheme, it was owed money by Air France.

The Court held that the clearing house scheme was contrary to public policy[607] as its effect was to contract out of the *pro rata* repayment of unsecured debts. Lord Cross of Chelsea noted that what the respondents were saying here is that the parties to the clearing house arrangements, by agreeing that simple contract debts are to be satisfied in a particular way, had succeeded in contracting out of the provisions contained in section 302 for the payment of unsecured debts *pari passu*.

The presiding judge went on to elaborate as follows:

> *It is to my mind irrelevant that the parties to the "clearing house" arrangements had good business reasons for entering into them and*

[605] [1975] 1 WLR 758.
[606] Fidelis Oditah, 'Assets and the Treatment of Claims in Insolvency' (1992) 108 LQR Law Quarterly 459.
[607] L S Sealy and R J A Hooley, *Commercial Law Texts, Cases, and Materials* (4th edn Oxford University Press 2009).

> *did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of the parties. Such a "contracting out" must, to my mind, be contrary to public policy. The question is, in essence, whether what was called in argument the "mini liquidation" flowing from the clearing house arrangements is to yield to or to prevail over the general liquidation.*

He could not doubt that on principle the rules of the general liquidation should prevail.

For these reasons he held that notwithstanding the clearing house arrangements, British Eagle on its liquidation became entitled to recover payment of the sums payable to it by other airlines for services rendered by it during that period and that airlines which had rendered services to it during that period became on the liquidation entitled to prove for the sums payable to them. He therefore dismissed the appeal so far as it concerned the September clearance but allowed it for the period from October 1 to November 6.

4.5.5 Statutory Collective Insolvency Regime

Creditors of companies in financial difficulty frequently face a choice between engaging actively in settlement or debt restructuring negotiations with other competing creditors or going it alone and pursuing their claims through the Courts. For those creditors who choose to pursue litigation, the incentive is to put themselves in a position of advantage over the debtor's other creditors by enforcing against the debtor's limited assets first. It is this prospect which justifies the potential expense and inconvenience of the Court process[608].

It has generally been the position of the English Court that, in the absence of a statutory insolvency regime, the principle which governs the enforcement of judgments by competing creditors is *'first past the post'*. As to the practical meaning that should be given to this rule, Lord Denning in **Pritchard v Westminster Bank**[609]

[608] Natasha Johnson, *Obtaining and Enforcing English Judgment Debts: First Past the Post?* (Chase Cambria Company (Publishing) Ltd 2013).
[609] [1969] 1 WLR 547 at 549.

stated, in a most succinct way, that the general principle when there is no insolvency is that *"the person who gets in first gets the fruits of his diligence"*. However, as held in **Re Gray's Inn Construction Ltd**[610] once a company enters insolvency this creditor environment is replaced by one where creditors hold general rights standing alongside all others within the general body of creditors entitled to a rateable portion of the distribution of the net proceeds *pari passu*.

Winding up is *"a process of collective enforcement of debts*[611]*".* In other words the winding up leaves the debts of the creditors untouched affecting the way in which they can be enforced. When the order is made, ordinary proceedings against the company are stayed. The creditors are confined to a collective enforcement procedure that results in *pari passu* distribution of the company's assets. The winding up neither creates new substantive rights in the creditors nor destroys the old ones. Debts are discharged by the winding up only to the extent that they are paid out of dividends. Once the process of distribution is complete, there are no further assets against which they can be enforced. There is no equivalent of the discharge of a personal bankrupt which extinguishes his debts. When the company is dissolved, there is no longer an entity which the creditor can sue. But again discovery of an asset may result in the company being restored and the process resumed.

In **Parmalat Capital Finance Ltd v Food Holdings Ltd**[612], Hoffmann LJ observes that a winding-up order does not affect the legal rights of the creditors or the company. It only puts into effect a process of collective execution against the assets of the company, for the benefit of all creditors.

The above-quoted judgments do not only spell out the fact that winding up involves a process of collective enforcement of debts but also that the said debts due to the creditors remain untouched and in such a way that winding up order does not affect the legal rights of either the creditors or the company.

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[610] [1980] 1 WLR 711.
[611] *Re Lines Bros Ltd* [1983] Ch 1, 20.
[612] [2008] UKPC 23.

4.5.6 Payment of interest accruing after the date of the winding up order

We now come to the question of interest accruing after the date of the winding up order. As to interest not being provable in so far as it is payable in respect of any period after the commencement of the liquidation, this point is well-illustrated in the following two judgments. In **Re Humber Ironworks and Shipbuilding Company**[613] Giffard LJ observed that the rule was judge-made law *"…but it was made after great considerations, and no doubt because it works with equality and fairness between the parties; and if we are to consider convenience, it is quite clear that, where an estate is insolvent, convenience is in favour of stopping all the computations at the date of winding up".*

In **Wight v Eckhardt Marine GmbH**[614] the Privy Council made reference to the aforementioned **Re Humber Ironworks and Shipbuilding Company**[615] in order to reaffirm the principle that the claims of creditors are valued as at the date of the winding up order. Acting upon this principle, no allowance was to be made for made for interest accruing after the date of the winding up order.

4.5.7 Claw-Back Claim and Cut-Off Date

Under English law a claw-back claim cuts across another cardinal principle of liquidation, namely that the line is drawn at the date of the liquidation. The principle is well brought out and elaborated upon in a number of leading cases:

(a) In **Re British American Continental Bank Ltd**[616] it was held that a date has necessarily to be fixed on which all debts and other liabilities are to be treated as definitely ascertained, both for the purpose of placing all creditors on an equality and for the purpose of properly conducting the winding up of the affairs of the company.

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[613] [1869] LR 4 Ch App 643 at 647-648.
[614] [2004] 1 AC 147 at [24].
[615][1869] LR 4 Ch App 643.
[616] [1922] 2 Ch. 575 at 582.

(b) In **Re Dynamics Corporation of America**[617] the Court held that it is only in this way that a rateable, or *pari passu*, distribution of the available property can be achieved. Thus it is *"axiomatic that the claims of the creditors amongst whom the division is to be effected must all be crystallised at the same date, even though the actual ascertainment may not be possible at that date, for otherwise one is not comparing like with like".*

(c) **Re Lines Bros**[618] underlined the point that the winding up date is the date of valuation of liabilities. As an account can only be struck in a single currency, it must follow that the scheme of company liquidation requires that a foreign debt shall be converted into sterling as at the date of liquidation and at no other date.

(d) **Wight v Eckhardt Marine GmbH**[619] affirmed that the image of collecting and at the same time distributing the assets of the company on the day of the winding up order is a vivid one. The Courts apply it to give effect to the underlying purpose of fair distribution between creditors *pari passu.*

(e) In **Revenue and Customs Commissioners v Football League Ltd**[620] the Court observed that as an essential element of the *pari passu* system, there is a single date at which provable debts are ascertained and quantified. It is the date on which the company goes into liquidation.

In **Commerce International SA (in liquidation)**[621] Hoffmann LJ referred to the retroactivity principle. The effect of this principle is that insolvency set-off is treated as having taken place on the date of commencement of the insolvency even though it is not taken, and in practice cannot be taken, until a later date. There are some exceptions to the retroactivity principle and these apply principally where the law allows the liquidator to make a claim for fraudulent preference, but in such case,

[617] [1976] 1 WLR 757 at 764.
[618] [1983] Ch 1, 19.
[619] [2004] 1 AC 147 at [29].
[620] [2012] EWHC 1372 (Ch) at [77].
[621] [1993] Ch 425, 432-3.

there is a special law for this purpose. Unless an exception to the principle applies, only the assets as at the date of the liquidation, including intangible assets such as claims, form part of the estate in liquidation.

As Lord Neuberger explained in **Nortel**[622], in order to give effect to *pari passu* distribution it is necessary to have a cut-off date by reference to which claims are admitted to proof thus entitling the claimants to participate in the *pari passu* distribution. It is necessary to enable a company to be wound up within a reasonable time. But there may be liabilities which arise after the cut-off date which are not provable and which do not count as expenses of the insolvency. For example in **Re RR Realisations Ltd**[623] claims made by the air crash victims occurred after the company's entry into liquidation which had allegedly manufactured the faulty engines. These claims were nevertheless liabilities of the company.

4.5.8 Voidable Transactions

One reliable way which serves to preserve the efficacy of the *pari passu* principle lies in the Court's power to void certain types of transactions that are meant to circumvent the application of *pari passu.* **Taylor (Liquidator of The Caprice Clothing Company Limited) v Ziya**[624] dealt with the law prohibiting preferences which is a small but important area of corporate insolvency law. The prohibition is designed to counter attempts to undermine or circumvent the proper application of the *pari passu* principle in an insolvency. Those managing an ailing company during its downfall may become tempted to favour certain particular non-preferential unsecured creditors over the general body of creditors of this class, by improving their positioning in the likely forthcoming insolvency. The availability of the Court's power to set aside and void such preferences is an effective weapon in the office-holder's fight to counter any circumventing or undermining of the fundamental *pari*

[622] [2013] UKSC 52.
[623] [1980] 1 WLR 805.
[624] [2012] BPIR 1283 and Finch Plc [2016] BCLC 394.

passu principle and its ethos of sharing losses equally among the non-preferential unsecured creditors[625].

4.5.9 The *Pari Passu* Principle and the Anti-Deprivation Rule

The English Courts have in no uncertain terms made it clear over and over again and in a number of landmark judgments that contracts which are in conflict with the *pari passu* were to be considered void without any necessity to prove that their purpose was to avoid a *pari passu* distribution. In ***ex parte* Mackay; *Ex parte* Brown; In Re Jeavons**[626] Mellish LJ stated that according to the anti-deprivation rule a person cannot make it a part of his contract that, in the event of bankruptcy, he is then to get some additional advantage which prevents the property being distributed under the bankruptcy law.

In **Revenue and Customs v Football League Ltd**[627], the role of the defendant company was that of regulating football competitions run by it and the conduct of clubs. It was also a commercial organization which negotiated and held other commercial rights for the benefit of its member clubs. Its Articles of Association contained a rule that in the event of a member club becoming insolvent, particular classes of creditors such as other clubs in the Football League, players, managers other employees and the Football League itself, were paid in full in priority to any other creditors. The Revenue Commissioners contended that this rule caused a loss to the Revenue and Customs as well as to other creditors.

Two central issues were given particular attention namely:

[625] Stephen Hill, *Understanding s239 Preference under Insolvency Act 1986* (2014). Available at: < https://www.33bedfordrow.co.uk/insights/articles/understanding-s239-preference-under-insolvency-act-1986> accessed on 18 June 2019.
[626] [1973] LR 8 Ch App 643.
[627] [2012] EWHC 1372.

(i) whether the *pari passu* principle and the anti-deprivation rule applied to a company in administration; and

(ii) whether the rule which applied on insolvency of a football club was void and of no effect on the ground that they were contrary to the *pari passu* principle and anti-deprivation rule.

The Court ruled that the *pari passu* principle applied to any distribution whether or not it was expressly triggered by the relevant insolvency procedure. It was enough that the effect of the relevant contractual or other provision was to apply an asset belonging to the debtor at, or following the commencement of, the insolvency procedure in a non-*pari-passu* way. Contracts conflicting with the *pari passu* principle were void without any need to show that their purpose was to avoid a *pari passu* distribution. The *pari passu* principle served a purpose and should come into play only if the purpose of the insolvency procedure was to effect a distribution. In the case of liquidation or bankruptcy, that was the moment when the company entered liquidation or the debtor was declared bankrupt. In the case of administration, that was the moment when the administrator gave notice of the proposed distribution. It was settled law that the anti-deprivation rule was meant to stop attempts to withdraw an asset of bankruptcy, liquidation or administration, thereby reducing the value of the insolvent estate to the detriment of creditors. While there was some overlap with the *pari passu* principle, it was distinct from it and aimed at a different mischief.

The anti-deprivation rule applied only if the deprivation was triggered by the insolvency proceedings and the deprivation had to be of an asset of the debtor which would otherwise be available to creditors. It therefore followed that the anti-deprivation rule would apply to a company going into administration as it did to a company going into liquidation. Accordingly, if a transaction had the effect of depriving a company of an asset in order to distribute it among only some of the creditors, otherwise eligible to participate in the distribution, it would go against both principles namely the *pari passu* principle and anti-deprivation rule. On the

other hand, if the deprivation occurred in the company going into administration only the anti-deprivation principle would be breached.

In **Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd and Ors**[628]**,** the Court of Appeal set out a thorough review of the case-law on the anti-deprivation rule stretching back to the nineteenth century, and concluded that deprivation had not occurred. The Court noted that in the first place the Insolvency Act 1986 now provided a complete statutory regime governing matters of insolvency, which had to be given primacy such that, in the words of Patten LJ, the modern anti-deprivation rule was *"little more than the direct application of the provisions of the Insolvency Act".* The purpose of the common law rule was simply to reinforce the Insolvency Act 1986 and in particular the *pari passu* principle by preventing parties from contracting out of its terms. In other words, a provision that does not offend the Act will not offend the principle. Secondly, for the deprivation to occur, there would have to be the property of the company in liquidation to which the contract relates.

Some commentators criticized the English Court of Appeal for seemingly basing its judgment on protecting the *pari passu* principle that is the ranking with respect to unsecured creditors once insolvency has begun rather than applying the principle of collectivity by which a debtor's estate must be conserved for the benefit of creditors generally. One critic went so far as to remark that the Court's understanding of the anti-deprivation rule was *"breath-taking and indefensible"*[629]*.*

4.5.10 Is tax a post-liquidation liability?

Lord Hoffmann chose to adopt the simple approach of Brightman J in **Re Mesco Ltd**[630] in that namely, *"the Statute expressly enacts that a company is chargeable to corporation tax on profits or gains arising in winding up… it follows that the tax is a*

[628] [2009] 2 BCLC 400.
[629] Look Chan Ho, 'The Principle Against Divestiture and the *Pari Passu* Fallacy' (2010) 1 JIBFL 3.
[630] [1979] 1 WLR 558, 561.

post-liquidation liability which the liquidator is bound to discharge and it is therefore 'a necessary disbursement' within the meaning of the Insolvency Rules."

In conducting a review of insolvency legislation and related cases such as **Re Toshoku Finance plc (in liquidation)**[631] Briggs J concluded that,

> *the Toshoku principle does indeed establish a general rule where by Statute Parliament imposes a financial liability which is not a provable debt on a company in an insolvency process then, unless it constitutes an expense under any other sub-paragraph in the twin expenses regimes for liquidation and administration, it will constitute a necessary disbursement of the Liquidator or Administrator.*[632]

It was concluded that tax was in fact a post-liquidation liability.

4.5.11 Effect of the new compensation order regime on the application of the *pari passu* principle

The main purpose of the new compensation order regime provided for in the English Company Directors Disqualification Act 1986 was to enhance the protective aspect of the disqualification regime by giving monetary redress to creditors who had lost out as a result of a director's misconduct. A compensation order requires the disqualified person to pay a specified amount to the Secretary of State for the benefit of a creditor or creditors specified in the order or a class or classes of creditor so specified as a contribution to the assets of a company[633]. This new procedure was first tested in **Secretary of State for the Business, Energy and Industrial Strategy v Eagling**[634]**.** The Secretary of State applied for an order against the director under the 2016 compensation order regime on behalf of certain creditors which, through their

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[631] [2202] 1 WLR 671.

[632] The case in Bloom & Ors v. The Pensions Regulator (Nortel, Re**)**[632] was an application for directions by the Administration of twenty companies in two groups, all of which raise the same common questions as to whether financial support directions (FSDs) and contribution notices (CNs) issued by the Pensions Regulator to companies in administration or liquidation would rank as "expenses" having super priority in the insolvency proceedings or merely as provable debts ranking *pari passu* with other unsecured creditors of each company.

[633] 'Disqualifications of Company Directors: A Comparative Analysis of the Law' in JJ du Plessis and J Nel de Koker (eds), *Routeledge Research in Corporate Law* (2019).

[634] [2019] EWHC 2806 (Ch).

trading with the company, had led to the company having £559,484 in cash before the director paid it away. To qualify for a compensation order, creditors of an insolvent company must have suffered a loss caused by the misconduct of a disqualified director. In its decision the High Court disqualified a director, in terms sections 15A and 15B of the Company Directors Disqualification Act 1986, for paying £559,484 to another company he controlled without any concern for the interests of creditors. As a result, the judge ruled that these creditors should receive compensation in specific sums amounting to £559,484 in total. In coming to his decision the judge noted that the regime was *"a new, free-standing, regime, and must be interpreted as such"* and one main difference between the compensation regime and the recovery routes under the Insolvency Act was that with the former, liability is not based on the loss to the relevant company, but rather loss to individual creditors.

Some commentators emphasised the fact that in practice this new regime poses a threat to *pari passu* distribution since it allows for creditors that meet the test of the regime to bypass recovering their debts through insolvency procedures and make recoveries through an application to court brought by the Secretary of State. As a result, the new regime potentially brings into conflict the interests of creditors who might benefit from an application for compensation at the request of the Secretary of State with creditors relying on liquidators and administrators to recover their debts. This conflict of interest could result in the Secretary of State and the liquidator or administrator seeking to enforce against the same assets of a disqualified director concerning broadly the same group of creditors. The development of this rival regime is indeed a matter of concern to the proper application of the *pari passu* principle. However, the main intention underpinning this new disqualification regime was to provide a more forceful mechanism and to offer a remedy to creditors where these were unavailable under the Insolvency Act 1986.

At this point one could ask: what is the corresponding position in this regard in Malta? A simple answer would be that although some provisions are in place under Maltese company law their overall effectiveness has been somewhat doubtful. In

this context reference can be made to the **Supermaster Limited case**[635]. During the winding up process the liquidating committee[636] appointed to wind up Supermaster Limited requested the Registrar of Companies to disqualify the company's former directors from acting as directors for any Maltese company and thereby to be considered unfit to manage a company. As a concluding commented it should be pointed out that although some provisions are in place in the Companies Act these provisions are not often used. However, some change seems to be on the way by virtue of the Companies Act (Amendment) Act. This matter and related issues will be discussed in more detail in Chapter 5.

4.5.12 Civil Liability of Auditors to Third Party Creditors

The judgment that follows is of unique importance because it affirms that in case of professional negligence of a serious nature on the part of the auditors engaged by a company could be held responsible and civilly liable for damages to third party creditors. In similar cases, Maltese Courts followed Maltese law and the principle of good faith when it came to civil liability and responsibility concerning third parties which could be different from the position held under English Common Law which is more restrictive.

In **Valle del Miele Limited vs Raphael Alosio *et***[637], the Civil Court held that the group of auditors engaged by the Price Club Supermarkets Limited had acted negligently when it resulted that a year before the publication of the auditors' report in September 2000, the company had already stopped paying its creditors and, this notwithstanding, the report went on to give "an optimistic view of an enterprise having a large business activity" but with no hint as to any "possible series financial problems" looming ahead. This picture could have served as a good reference point

[635] Electronic Products Limited vs Emanuel Micallef *et,* Court of Appeal, 25 October 2013.
[636] Supermaster went bankrupt in 2001 and left debts of Lm1.6 million at the time and the liquidating committee was made up of Deloitte and Touche and representatives of General Soft Drinks Co Ltd and F Busuttil & Sons, as the larger unsecured creditors, the *Union Haddiema Maghqudin*, and MIMS Supplies.
[637] First Hall Civil Court, 16 December 2013.

for suppliers like Valle Del Miele to extend its credit even further as in fact happened. But while declaring that the auditors had acted negligently, the Court concluded that they were not to be held responsible for damages to Valle del Miele. The latter, the Court remarked, should not have relied on the Price Club's own audited report but should have instead engaged its own experts to examine the Price Club's real financial situation.

An appeal was lodged by both Valle Del Miele as the plaintiff and the auditors as the respondents.

The Court of Appeal[638] confirmed the declaration of the First Court regarding the auditors' negligence but went on to add that there also resulted a causal link between their shortcomings and the losses suffered by the company's creditors including the plaintiff. The Court ruled out any fraudulent intent on their part but held that in this instance the auditors had exercised insufficient care and failed to make good use of their "vast" professional experience in the execution of their task. While rejecting the auditors' argument that their professional responsibility towards third parties was very restricted and applicable only in certain limited instances, based on English Common law and jurisprudence, the Court affirmed that the case had to be decided in line with Maltese law on civil liability and the principle of good faith.

The Court observed that the Maltese Companies Act binds auditors to hand over their report not only to shareholders and those attending the company's general meeting but are also obliged to deposit the audited accounts with the Registrar of Companies. The respondents knew that their audited accounts report was accessible to the public, including therefore the plaintiff Valle Del Miele which was already owed a significant sum of money by Price Club.

[638] Valle del Miele Limited vs Raphael Alosio *et,* Court of Appeal, 9 July 2020.

Although a creditor ought to seek personal advice before conducting business, that advice would likely rest upon the published audited accounts of his debtor, based upon the premise that the conclusions were "objectively true". Indeed, any creditor had little else to go by, unlike the auditors who had full access to the company books, the Court observed. The Supermarket in question was exposed to shortage of capital since its inception and the company was structured in a way as to shift the risk of possible losses onto its creditors rather than its investors. In liquidating damages, the Court considered that the amount due was to be calculated on the difference between the credit before Valle Del Miele decided to continue business with Price Club Supermarket and the final amount owed at the time when the latter stopped payments.

4.6 Conclusions

As a general reflection one could conclude that while the Maltese Courts give a lot of weight and nourish a high view of the element of fairness of the *pari passu* principle, very often they are unable to apply the principle in practice because of prior rights enjoyed by secured creditors. So long as tax privileges remain enforced the way they are now the situation can hardly change. Local Courts have not shied away from underpinning shortcomings in the Maltese insolvency framework as evinced from numerous judgments and decrees that have been referred to *in extenso* in this Chapter.

Finally, there was a strong and in my opinion a most valid reason in researching, compiling and citing the cases and material that have been reviewed in this Chapter. Putting it in a nutshell, there is no known publications so far on cases and material specifically dealing with Maltese insolvency law. This Chapter is therefore intended to fill this serious gap, even if the contents - local judgments and references to local and foreign authors found in these judgments – might appear somewhat limited in content and extent. One should also bear in mind that citations and references from locally decided cases do not always necessarily quote or rely upon the more recent foreign judgments or legal contributions. Indeed, quite often the contrary is true in

that one finds repeated references to earlier editions by way of publications that seem oblivious to or simply ignore the fact that there existed later editions of the publications concerned. On the positive side one notes that the research material reviewed shows that the basic elements of insolvency and related issues and problems that featured in English Courts and other jurisdictions have had to be faced and dealt with also by the Maltese Courts.

Chapter 5 Proposals for Reform and Reformulation of the *Pari Passu* Principle in the wider context of the Ranking of Creditors and Asset Distribution.

5.1 General Introduction

Law reform is ideally an on-going process by which existing legislation is shaped and modified over time with the aim of better reflecting present day needs and realities. It is also a reflection of the fact that law itself is dynamic and fluent in nature and not meant to remain still at all times or oblivious to changing circumstances. In other words law reform is essential if the law is to remain relevant within the context of an ever-changing society where the economy in general and commercial activity in particular, play a key role in people's lives and their living standards. This is where the law reforming process comes into play. In more practical terms law reforms are embarked upon for different reasons. In this respect one or more of the following reasons come readily to mind namely, if the existing legal framework needs strengthening to render it more robust and effective and more fit for purpose; to eliminate *lacunae*, possible contradictions or lack of clarity; overlapping or inadequate institutions.

The approach or working method for undertaking these reforms can take different forms such as by creating new laws or regulations or through the simplification, modification, consolidation, or abrogation of existing legislation. As much as possible it would be desirable that the law reforming process is conducted in a holistic rather than piecemeal manner, but this is not an obligatory requirement. There are instances where sudden or unforeseen circumstances or a set of circumstances will necessitate the taking of special measures with urgency through a packet of reforms, which may even be of a temporary or transient nature, to counter the evolving situation. The recent novel coronavirus pandemic is one obvious example of how an unforeseen and serious health crisis triggers an imperative need for the

promulgation of legislative enactments as a quick response. Like many other States, Malta did not remain passive in the face of a full blown pandemic. On the contrary it took various measures some of which consisted of legal rules and regulations that were directly connected with insolvency law. This is a classic example where a crisis of pandemic proportions spurred on the necessity to take immediate action in the form of a number of legal notices and legislative amendments which will be highlighted and reviewed in this Chapter.

Any legal reform process presupposes a thorough examination of existing laws with the purpose of advocating and implementing changes in the system and thereby providing clarity or greater efficiency as the case may be. Any piece of legislation does not exist *in vacuo* but usually reflects the surrounding and concomitant aspects be they political, legal, economic or social. The legal framework regulating corporate insolvency is also meant to lessen any negative impact on businesses facing financial difficulties as well as to enable the restructuring of viable businesses and help them to return to normality as quickly and smoothly as possible.

Strong insolvency rules promote safer and more efficient commercial enterprise and good financial investments. A sound understanding *ex ante* of applicable procedures and time frames can best be achieved through legal certainty. Such a regime would in turn lead to an efficient way to settle claims, minimise costs, avoid unnecessary delay and provide a satisfactory way of asset distribution, benefitting all the stakeholders. Conversely, in a system where insolvency mechanisms function at a slow pace, such a state would serve to discourage the timely restructuring of viable companies facing financial difficulties and thereby ending in liquidation rather than restructuring as a going concern. Legal uncertainty or *lacunae* will generate doubt among entrepreneurs, investors and other interested parties with respect to credit recovery.

The observations made by the Cork Committee in its Report[639] are most apt and enlightening in this regard: *"The world in which we live and the creation of wealth depend upon a system founded on credit and that such a system requires, as a corelative an insolvency procedure to cope with its casualties…"*

Accordingly, the main aims of any insolvency system should ideally incorporate the following objectives:

- to relieve and protect where necessary the insolvent company or an insolvent debtor from any harassment and undue demands by his creditors;

- to have regard to the rights of creditors whose own position may be at risk because of the insolvency;

- to realise the assets of the insolvent which should properly be taken to satisfy his debts with the minimum of the delay and expense;

- to distribute the proceeds of the realisation among the creditors in a fair and equitable manner;

- to return any surplus to the debtor;

- to ensure that the processes of realisation and distribution are administered in an honest and competent manner.

Although the Maltese insolvency regime does include some of the above features there is still a considerable amount of work which needs to be accomplished to update and improve the efficacy of the insolvency framework especially with respect to *pari passu* distribution. Identifying specific areas in Maltese insolvency law that

[639] Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558 1982).

are in dire need of reform to ensure the proper application of the *pari passu* principle as a viable mechanism should be the starting point of a similar endeavour.

5.2 Why propose a reformulation?

The overriding purpose of this final Chapter is to focus upon and analyse the main legal aspects concerning the application of the *pari passu* principle and to recommend amendments and suggestions in the form of specific proposals for reforms and a possible holistic reformulation of the existing legal framework. The entire exercise will be done while bearing in mind and in the knowledge that the Maltese corporate insolvent regime needs to keep abreast and never lose sight of other developments taking place in the majority of European Union jurisdictions and beyond. One current trend prevalent today for example is designed to offer support and assistance to a company in financial distress with a view to maximizing the return due to creditors. Although provisions for a compromise or arrangement in the Maltese Companies Act do exist, in practice experience has shown that their actual application has been rather limited in extent. Moreover, amendments to the Companies Act provisions on dissolution and consequential winding up may also serve to improve the efficacy of the winding up process which means that the provisions need to be studied as well.

All the proposed reforms are ultimately aimed at maximising the principal objectives of restoring the debtor company to profitable trading wherever possible and conversely to securing the best return possible to creditors as a whole where companies cannot be saved. For this to happen an improved system for the ranking of creditors is called for. In this context the proposed reforms and reformulation of the Maltese insolvency system will be presented through a number of effective measures:

a) Put forward proposals dealing with financial rehabilitation of companies in distress;

b) Delineate more clearly the comprehensive exceptions and bypassing devices permitted by the *pari passu* principle;

c) Suggest ways for a holistic treatment of the rules governing the distribution of assets in a winding up process;

d) Make proposals concerning provisions for a stay of insolvency proceedings;

e) Formulate provisions to better regulate the office holders in a winding up;

f) Suggest provisions to improve the reorganization of viable businesses with short-term cash flow problems;

The practical effect of all these measures and legal amendments would go a long way to strengthening the application of the true rationale of the *pari passu* principle. To begin with creditors would certainly be better placed to know exactly where they stand. These changes would have the added benefit of positively improving the present system by enabling creditors to take an informed decision as to the most appropriate mode of protecting and preserving their best interests.

5.3 Three Types of Reforms: Circumstantial, Remedial or Rehabilitative

As a general observation one can state that reforms can either be short term or long term depending upon their nature and objective. Motive-induced prompters and reasons triggering reforms can be classified under three distinct types or categories as follows:

1. Circumstantial or Situational;
2. Remedial;
3. Rehabilitative.

Circumstantial reforms, normally short term in character, are primarily intended to provide measures to counter, better contain and manage unforeseen or sudden events which, if left unattended, may produce serious negative effects on one or more vital public sectors impacting the economy, trade, commercial enterprise and level of employment.

Remedial reforms, as the name suggests, are meant to provide new laws, rules and regulations amending existing legislation with a view to address inadequacies and fill in *lacunae* in the existing legislation. This type of reform can be either legislative or institutional in nature. Legislative reforms moreover can be substantive or procedural in kind. If the obtaining legal framework is felt to be inadequate and needs strengthening, institutional changes might provide a remedy through structural amendments and new mechanisms.

Finally, the rehabilitative reforms are intended to promote and offer a viable alternative solution in the form of company rescue to safeguard companies in distress and stop them from ending in liquidation. These reforms are of particular importance to this study since the provisions dealing with the corporate recovery procedure[640] in Maltese law contains within it the protections offered by judicial shielding that are inherent part of the *pari passu* principle.

Each of the above-mentioned reform categories will now be examined from an insolvency law perspective vis-à-vis actual case scenarios or pieces of enacted legislative reforms, either in Malta or in foreign jurisdictions, but all bearing some connection with one or more aspects of insolvency law.

[640] *Vide* in particular article 329B(4), Companies Act.

5.3.1 Circumstantial Type of Reform

5.3.1.1 Measures as a Response to the Covid-19 Pandemic

There is no better way to exemplify legal reforms of the circumstantial type other than by referring to some of the specific legal measures with regard to insolvency law that were adopted as a direct consequence of the Covid19 pandemic. With the rapid spread of the novel coronavirus pandemic across the globe, it soon became apparent that business companies, large and small, had all of a sudden found themselves having to face a challenge of gargantuan proportions, both immediate with regard to time as well as strategic with regard to its nature. In a matter of days major business concerns almost grounded to a halt. Predictably, governments in many jurisdictions around the world announced measures to try and minimise the harm caused to their economies and its negative effect on trade, employment, investments and entrepreneurship. From an economic perspective the impact fell mostly upon cash flow and the employment sector.

Under normal circumstances, insolvency proceedings occur when a commercial concern or a group of companies find themselves in serious financial difficulties. Recent experience has however shown that a major economic set-back may not only cause ripple effects impacting upon particular business concerns but it could even have a direct effect upon current insolvency proceedings. In other words, there exists a co-relation between insolvency proceedings and major economic shocks as a result of which insolvency proceedings may become susceptible to restrictions, filing extensions and other changes imposed in order to contain and minimise the economic harm as much as possible.

In the wake of the Covid19 outbreak a number of measures saw the light of day in various jurisdictions around the world with a view to easing the evident harsh effect on global economy. Some of these measures were directly related to insolvency. The measures vary from one country to another reflecting the particular economic situation of each jurisdiction in a given point in time.

5.3.1.2 Measures taken in the United Kingdom

In the United Kingdom speculation was rife as to whether a temporary moratorium against creditor action would be enacted by the government at some point. For example, the need was felt to protect commercial tenants against eviction due to non-payment of rent. Ways had to be devised to help businesses adversely affected by the pandemic to continue trading and also explore viable options for them to rescue or restructure.

Along these lines three main measures were adopted namely:

1. Granting a temporary moratorium of ninety days to companies facing liquidity problems, thus allowing them some breathing space to seek a rescue or to restructure, thereby holding creditors from enforcing debts during the relevant period;

2. Protecting the access of companies to supplies and the ability to accept new borrowings thereby facilitating continued trading;

3. Enhancing government plans for new restructuring procedures announced in May 2018[641].

Another important amendment to the Insolvency Act, 1986 was the temporary suspension of wrongful trading provisions for company directors. These measures were designed to allow directors to run their business during the pandemic without the threat of incurring personal liability by doing so. Another measure was an interim moratorium protecting companies in difficulty and the creation of a new restructuring plan procedure.

[641] Liam Preston and Paul Keddie, 'Covid-19 Proposed Changes to UK Insolvency Laws' (*McFarlanes*, 2020): <https://www.macfarlanes.com/what-we-think/in-depth/2020/covid-19-proposed-changes-to-uk-insolvency-laws/ > accessed 8 May 2020.

The proposed amendment introducing a temporary suspension of wrongful trading for company directors in terms of section 214 of the Insolvency Act, 1986 raised eyebrows and some concern among legal practitioners. Was the suspension of the wrongful trading provision really required? Would a Court ever exercise its discretion to make an order against a director of a company facing tough challenges due to Covid19, even if the provisions had not been suspended, except in cases of clear cut wrongdoing?[642]

Since the suspension order applies to all companies, the risk of some companies abusing the measure by continuing to trade on, despite poor performance irrespective of Covid19 and thereby inflicting more losses to creditors by doing so cannot be completed erased. Of course, creditors would always be protected against fraudulent trading by directors since the relevant provisions under the Act remain in force together with the fiduciary duties of directors. The United Kingdom Government's stated intention was therefore to strike a balance between measures aimed at protecting companies from short-term liquidity challenges and other measures ensuring that the creditors get the best return possible in the circumstances. It has already been observed however that *"perhaps inevitably that balance is likely to favour debtor companies more than creditors whose businesses may also be threatened with Covid19 related liquidity and operational pressures, particularly as a consequence of their debtors seeking relief under these new moratoria provisions*[643]*."*

The United Kingdom Government was among the first to announce that its intention to make changes to insolvency law to allow United Kingdom companies undergoing a rescue or restructuring process to continue trading by means of a provision that would provide a breathing space to these companies. The measures taken also

[642] Shearman, 'Covid19 Changes announced to UK Insurance Law and for AGMs' (*Perspectives*, 31 March 2020): <https://www.shearman.com/perspectives/2020/03/covid-19-changes-announced-to-uk-insolvency-law-and-on-agms> accessed 2 April 2020.
[643] Ibid. (No 609).

included a temporary suspension of wrongful trading rules for a period of three months, retrospectively, from the 1 March 2020 and which was aimed at assisting directors to keep their businesses going without the threat of personal liability.

5.3.1.3 Special Measures introduced in Malta

To counter any adverse impact that could be caused by the Covid19 pandemic, Malta lost little time in taking a series of initiatives and measures some of which dealt with the country's economic and commercial activities. In a recent contribution on the duties and liabilities of directors of companies facing potential financial difficulties due to the pandemic, Andrew Muscat stated that the impact on businesses has made it difficult for directors to determine whether there is a realistic prospect for their company to ride out the turmoil or whether insolvency proceedings have become unavoidable. Should the directors make the wrong call, they can expose themselves to personal liability and warns that, *"this is leading to concerns that directors may feel constrains to file for insolvency proceedings without perhaps giving due consideration to other possible rehabilitative alternatives that might still be viable businesses down the path of liquidation*[644]*."*

Meantime, the Superintendent of Public Health put into force a number of measures relating to the suspension of time frames and deadlines of both public and private deeds and transactions[645]. A Legal Order[646] brought into force the suspension of legal times of promise of sale agreements, notarial and other related matters. Specifically this order suspended the running of all the legal terms imposed on a Notary Public by law to register any deed, will, acts or private writing for any period within which the Notary Public, in terms of the applicable law, has to pay taxes collected by him in relation to his professional activity. This moratorium was to last for a period of forty five (45) days following the lifting of the repeal of any such order

[644] Andrew Muscat, 'Duties and liabilities of directors of companies in financial difficulties' *Times of Malta* (18 April 2020).
[645] *Vide* article 27(c) Public Health Act, Chapter 465, Laws of Malta.
[646] Legal Order 43.2020 entitled "Epidemics and Infectious Diseases Order".

by the Superintendent of Public Health. By means of another Legal Notice[647] made under article 6 of the Public Health Act a number of regulations were put into force imposing a moratorium on credit facilities in exceptional circumstances aimed to regulate those provisions taken to support economically vulnerable persons materially affected by the pandemic outbreak. This moratorium provided for a deferral of payments of capital and interests from credit facilities granted by credit and financial institutions.

Credit facilities covered the lending of a sum of money by way of an advance, overdraft or loan, or any other line of credit including discounting of bill of exchanges and promissory notes, guarantees, indemnities, acceptances and bills of exchange endorsed *par aval.* This moratorium was for a period of six (6) months, which period could be extended.

This Legal Notice[648] specifies that these regulations apply to credit institutions licensed by the competent authority in Malta under the Banking Act[649] and to financial institutions under the Financial Institutions Act[650]. It further explains that for the purposes of these regulations the Covid19 outbreak is formally recognised as a serious disturbance to the Maltese economy within the meaning of article 107 of the Treaty on the Functioning of the European Union[651] which as a consequence also seriously threatens stability in Malta[652].

An earlier Legal Notice[653] put into force some important provisions of a general nature with regard to the Suspension of Legal and Judicial Times Regulations, 2020. Following the publication of the Closure of the Courts of Justice Order, the Justice Minister suspended the running of any time period under any substantive or

[647] The Moratorium on Credit Facilities in Exceptional Circumstances Regulations, 2020.
[648] LN 142.2020.
[649] Chapter 371, Laws of Malta.
[650] Chapter 376, Laws of Malta.
[651] Consolidated version of the Treaty on the European Union and the Treaty on the Functioning of the European Union [2008] OJ C 115/01.
[652] Regulation 4(1) LN 142.2020.
[653] LN 141.2020, "Legal and Other Time Periods (Suspension and Interruption) Act", 2 April 2020.

procedural law, including any periods of prescription and any peremptory period. These suspensions orders covered also decrees and orders given by any court, government departments or public authority and established in any agreement, whether by a private writing or a public deed, including any time period for the performance of any obligation set out in such agreement. These suspensions were to remain in force until the lapse of seven (7) days following the lifting of the said Order of the Superintendent of Public Health and they will thereafter continue to run. With regard to agreements, private or public, any time period was to remain suspended until the twentieth (20) day following the lifting of the said Order.

The overall impact of these exceptional measure has yet to be gauged but they will inevitably affect payment and other obligations due by debtors. This same concern applies also with regard to the suspension of legal and judicial time frames. It is still too early to assess the ensuing effect on the economy generally.

5.3.1.4 Powers to the Minister to make Regulations in connection with dissolution and winding up applications and the action for wrongful trading

A Bill entitled the "Companies Act (Amendment) Bill"[654] was tabled in the House of Representatives on 13 May 2020 by the Minister for the Economy, Investment and Small Businesses put forward a number of amendments to the Companies Act[655]. It became a law by virtue of Act XXXI of 2020[656]. In what could be described as a preventive measure against abusive behaviour as an offshoot of the Covid19 pandemic and the anticipated effects it might have on companies, article 5 of the Act states that the Minister may make Regulations suspending the right of any person to file a winding up application against a company and to suspend, even retrospectively,

[654] Bill No. 128 of the Thirteenth Legislature. Available at: https://parlament.mt/en/13th-leg/bills/bill-no-128-companies/

[655] Chapter 386, Laws of Malta.

[656] Dated 23 June 2020 and available at: https://parlament.mt/media/107044/act-xxxi-companies-amendment-act.pdf

the provisions on wrongful trading. In anticipation of an increase in logistical difficulties faced by companies, article 5 of the Act introduces a new provision to article 429 of the Companies Act. It allows the Minister to prescribe Regulations for electronic file and/or electronic signing of notices required by the Act and for the issuing of electronic certificates, letters, and any other documents issued by the Registrar. Additional Regulations that could be made by the Minister are the following:

I. To extend the term for the holding of the Annual General Meeting and the laying of accounts;
II. To provide for the suspension of any periods for the holding of the General Meetings; and
III. To provide for the holding of virtual Annual General Meetings and other meetings.

5.3.1.5 A sample of actual instances linking the pandemic and companies in financial distress

The novel coronavirus outbreak has been causing distress to many businesses and in particular the retail sector which was already struggling before the outbreak. What follow are some instances illustrating this negative impact on businesses. Incidentally this shows the importance of having a solid insolvency framework in place sufficiently resilient to cater for an increased influx of adversely affected cases.

5.3.1.5.1 Laura Ashley case

In the United Kingdom for example fashion and home retailer Laura Ashley was among the first retail casualties of the pandemic. Following increased pressure to make ends meet, the company felt that the best option available was to file an intention to appoint administrators in the interest of the company and all stakeholders. In mid-April 2020, it was confirmed that Laura Ashley had collapsed

into administration following further pressure put on retailers. As a result a number of administrators were appointed[657]. However in a significant turnaround global advisory, restructuring and investment firm, Gordon Brothers struck a deal with the ailing retailer company and acquired its global brand, archives and related intellectual property[658]. The relevance of the case is that it truly shines a light and exemplifies the advantages and strengths of rescue procedures when properly carried out, even against the backdrop of a global pandemic.

5.3.1.5.2 A Company In Distress: Azure Services Limited

In Malta the situation was not that much different. Predictably the tourism industry was among those most likely to be badly affected by the Covid19 pandemic. In April 2020, a timeshare company operating at the Radisson Blu Golden Sands Resort was placed in voluntary liquidation. A resolution was taken by the shareholders of the Azure Services Limited appointing a liquidator. A restructuring process was announced on 5 May 2020 by International Hotel Investments Limited which incorporates the Corinthia Group. Azure Services Limited originally belonged to Island Hotels Group. In 2015 the Corinthia Group took over 50% of the company's shareholding as part of their takeover of the Islands Hotel Group. In December 2019 Azure Services Limited announced that it would no longer sell timeshare but focus on its existing members. Operations were scaled down progressively leading to the company's liquidation. Most clients had entered into contracts of up to twenty five (25) years. Corinthia Group expressed its readiness to conduct the liquidation process in an orderly manner and timeshare owners would continue to enjoy the same benefits as before. The shareholders also reaffirmed that the Golden Sands Resort

[657] Company Rescue, 'Laura Ashley set to become first casualty of pandemic' (17 April 2020) - <https://www.companyrescue.co.uk/guides-knowledge/news/laura-ashley-saved-from-administration-4468/#:~:text=23.04.2020,archives%20and%20related%20intellectual%20property.> accessed 8 May 2020.

[658] Company Rescue, 'Laura Ashley saved from Administration' (14 May 2020) - <https://www.companyrescue.co.uk/guides-knowledge/news/laura-ashley-saved-from-administration-4468/#:~:text=23.04.2020,archives%20and%20related%20intellectual%20property.> accessed 28 May 2020.

would fully honour its timeshare commitments arising from obligations with existing members.

5.3.1.5.3 St Philips Hospital Case

The Covid19 pandemic moved a sole director of a company facing insolvency proceedings to offer the Malta health authorities the temporary use of the company's St Philip Hospital. One of its chief creditors objected. In **HSBC Malta plc vs The Golden Shepherd Group Limited *et*[659],** the Civil Court appointed a provisional administrator in terms of article 228 of Chapter 386 even though no evidence had as yet been gathered at that stage, raising an objection from the respondent company. Plaintiff premised that the very grave situation in the company's finances had even led the bank to pay the ground rent to protect the property from the rescission of the emphyteusis. The Bank did not oppose the proposal *per se* but argued that it was unacceptable that pending insolvency proceedings, the company's sole director could propose a similar offer affecting the company's assets in relation to third parties. The respondent argued that no deal had as yet been concluded, there would not be any prejudice to plaintiff's claim and the appointment of a provisional administrator lacking experience in the health sector would be of no benefit. The respondent also contended that the Bank's credit was adequately guaranteed by hypothecs and privileges over the hospital. In light of its wide discretionary powers the Court acceded to plaintiff's request and appointed two provisional administrators while retaining the sole director to assist. One final observation would perhaps be in order: does it make legal sense to have administrators and directors jointly managing the company's operations? Although as the term itself implies the office of the provisional administrator is of a temporary nature and there is a possibility that the company resumes business as usual thus favouring the current legal position whereby directors are not automatically displaced on such an appointment there are real dangers that in the absence of proper safeguards there could be a further dissipation of assets. For this reason, the Court in the order

[659] Civil Court (Commercial Section), 6 May 2020.

appointing the provisional administrator must clearly state his range of powers and how these are to be exercised vis-à-vis the incumbent Board of Directors.

5.3.2 Remedial Type of Reform

5.3.2.1 Sporadic Legislative Reforms in Malta

There can be little scope for analysis of the application of the *pari passu* principle without first making sure that a sound and efficient law on insolvency is in place, especially when it comes to the pivotal issue of the ranking of creditors. From time to time sporadic efforts were made by the Maltese legislator to take stock of the existing framework on insolvency law and introduce a spate of reforms. This said, developments in this area have either been registered through what could be described as half measures or characterised by the lack of a proper and informed use of the reforms so introduced.

5.3.2.1.1 Bill entitled "Act to amend the Code of Organisation and Civil Procedure and Various Laws relating to the Lease of Immovable Property"

A Bill containing a number of partial amendments concerning a motley of existing legislation was tabled in the House of Representatives in 2009 entitled an "Act to amend the Code of Organisation and Civil Procedure and Various Laws relating to the Lease of Immovable Property[660]" by the then Minister of Justice and Home Affairs[661]. At this point some preliminary observations on the proposed Bill would be in order. The Bill is hybrid in nature, non-homogeneous in the areas of law it touches upon and fragmentary in content. It is made up of random amendments across the board touching various aspects of Maltese law and it is not limited solely to the law on bankruptcy. Limited in scope and extent, the Bill is a far cry from a real attempt

[660] Its shorter title is "The Various Laws (Civil Matters) (Amendment No. 2) Act, 2009".
[661] Hon. Carm Mifsud Bonnici, MP.

towards reforming the existing legal framework on bankruptcy. In the course of the debate in the House of Representatives the Justice Minister stated that the various legal amendments he was proposing were aimed at strengthening the country's commercial sector.

With regard to insolvency law the Justice Minister said that according to the proposed amendment employees of an insolvent company topped the ranking list of competing creditors. Next in line to the employees came debts due to the Director of Social Services (National Insurance), the Inland Revenue and VAT departments. Other creditors would rank after them. The spokesman for the Opposition[662] agreed that the overall objective was to render insolvency proceedings more expeditious and less confusing. With regard to the existing law on insolvency Dr Herrera[663] remarked that, *"what was meant to be a simple mathematical problem was becoming a major legal issue, which at times turned into a never-ending dispute".*

The Justice Minister highlighted the manner in which the ranking of creditors should be improved for the sake of better certainty. He said that they had been working on the Bill over a three year period and it was an important step in the right direction assuring speedier settlement of payments and a stronger framework for the settlement of disputes in the commercial sector.

The Opposition spokesman replied that the legal framework of a country affects its economic activity and without it there will be a lack of investment. Other countries have legal systems which stipulate that once an individual becomes bankrupt his/her assets could be sold and once it is assured that no other assets are being concealed that person could then start afresh. Unlike other EU countries, Malta lacked a framework to deal with personal bankruptcy. This failure deterred Maltese citizens with substantial funds from investing locally. When it came to an insolvent company its assets could be distributed, but when an individual went bankrupt the

[662] Hon. Jose' Herrera, MP.
[663] Spokesman for the Opposition.

repercussions continued to be felt by their next of kin. Even if all assets are sold and existing funds are seized they still remain in a state of debt.

In Malta, the bankruptcy of an individual or the insolvency of a company has always been considered as a stigma and returning *in bonis* remained somewhat difficult to achieve. Our legal system was primarily oriented towards the liquidation of the debtor's assets rather than the recovery of the debtor. With a Bill like the one under review the focus of the legislator should have gravitated more towards the recovery of the debtor, not unlike what is found in foreign jurisdictions notably in the United States. The same applied to companies where bankruptcy law is also equipped with what is generally known as a "second chance" mechanism.

When it came to ranking, the spokesperson added that the Government claimed its rights *qua* creditor prior to others. In protecting Government interest however there had to be a safeguard protecting those who invested funds in the knowledge that they could do so with their mind at ease. He further suggested that a third of the assets should remain unaffected by this amendment.

An examination of the Bill immediately shows – both from its long and shorter titles and its declared objects and reason – that its concern with insolvency law was secondary. Rather, the Bill was meant for *"the clarification and further reform of the laws relating to the lease of immovable property"*. Divided into four parts, only Part One is of real interest from our point of view[664]. This said, the relevant part on bankruptcy law does succeed in rendering the issue of ranking of creditors more clear.

Besides the obvious reference to the Code of Organisation and Civil Procedure where the amendments were to be included, no mention is made of the law on bankruptcy. Instead in the part dealing with the ranking of creditors the Bill makes reference only

[664] *Vide* article 4, Various Laws (Civil Matters) (Amendment No. 2) Act, 2009.

to the Employment and Industrial Relations Act[665], the Social Security Act[666], the Income Tax Management Act[667] and the VAT Act[668].

The Bill sets to amend the Code of Organization of Civil Procedure by adding a new sub-article on the ranking of competing creditors. It proposed that competing creditors be ranked as follows:

a. Judicial costs incurred in the sale of any immovable and judicial costs incurred in the distribution of the proceeds;

b. Any claims by any employees in respect of the maximum as established by law of the current wage payable by the employer to such employees in terms of article 20 of the Employment and Industrial Relations Act;

c. Any claims of the Director General (Social Security) of any amount due by way of Class One or Class Two contributions under article 116(3) of the Social Security Act;

d. Any claims of the Commissioner of Inland Revenue of any amount by way of tax deducted from income (P.A.Y.E.) in terms of article 23(11) of the Income Tax Management Act;

e. Any claims of the Commissioner of Value Added Tax in terms of article 59(2) of the VAT Act[669];

f. Any other fiscal claim where the law provides that such claims shall rank in preference to all other claims notwithstanding the provision of any other law;

[665] *Vide* Chapter 452, Laws of Malta.
[666] *Vide* Chapter 318, Laws of Malta.
[667] *Vide* Chapter 372, Laws of Malta
[668] *Vide* Chapter 406, Laws of Malta.
[669] *Vide* Chapter 406, Laws of Malta.

g. Any privileges and hypothecs registered in the Public Registry as the case may be;

h. Any other claim.

Provided that where the assets of the bankrupt include assets over which taxes on importation have not been paid, the Comptroller of Customs shall be notified and any claim made by him for such taxes on importation shall rank prior to the other creditors. Aside from whether one agrees or not with the proposed order of ranking the Bill spells out clearly the hierarchy of ranking as set out above.

5.3.2.1.2 Companies Act (Amendment) Act

New amendments[670] have also been proposed by the Maltese Governments introducing other grounds for ineligibility and disqualification from holding certain offices under the Companies Act. Additional powers are given to the Minister to make regulations on winding up applications, on wrongful trading and regulations on the suspension of time periods for holding general meetings, and the laying and approval of accounts. More powers are given to the Official Receiver and other rules affecting the special controller are introduced.

In addition to the existing disqualifications in the Companies Act[671], the Act[672] provides that where, *"a person shall also not be qualified to act as director or company secretary of any company if, during the time he has been a director or a secretary of a company, he breaches the provisions of the Act for three consecutive times in a period of three years to be reckoned from the first breach".* The Official Receiver will now have a right to apply for the issuance of such a disqualification order.

[670] Companies Act (Amendment) Act, Act XXXI of 2020 and available at: https://parlament.mt/media/107044/act-xxxi-companies-amendment-act.pdf
[671] *Vide* Articles 142 and 320, Companies Act, Chapter 386, Laws of Malta.
[672] *Vide* Article 2(4), Companies Act (Amendment) Act, Act XXXI of 2020.

With regard to this amendment the Act does not distinguish between minor or serious breaches. This lacuna has already attracted some criticism in that the effects of this proposal could be quite far reaching due to the fact that minor breaches seem to be included as well as a ground for a disqualification673. Breaches could lead to a disqualification from holding the post of director or secretary of any company and subject a person to a disqualification order. Also the absence of any reference to timeframes or time bars in article 142 implies that any breach affecting the eligibility to act as a director or company secretary will not be limited in time674.

5.3.3 Substantive Reform: Abolition of Tax Preferences

5.3.3.1 Abolition of the Crown Preference in England

It is interesting to point out that in England the Crown preference was abolished in 2003 by the Enterprise Act 2002. It was part of an overhaul of the UK insolvency regime. It was devised after due consideration of the lessons learned from the previous experience of company insolvencies. The abolition of Crown preference was described by the government at the time as an "integral part" of that package of reforms[675]. This package of reforms was intended to achieve some return to unsecured creditors, whereas previously an insolvent company's assets often went to repay secured and preferential creditors including the Crown for tax debts with very little or nothing left for floating charge holders and unsecured creditors[676].

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673 Michael Psaila and Joshua Chircop, 'Bill Proposing Amendments to the Companies Act' *Times of Malta* (21 May 2020).

674 *Vide* Article 2, Companies Act (Amendment) Act, Act XXXI of 2020.

675 Department of Trade and Industry, *Insolvency – A Second Chance* (White Paper, Cm 5234, July 2001).

676 Watson, Farley & Williams, 'UK Insolvency Priorities to Change Through the Partial Return of HMRC's Preferred Status' 8 November 2018 - <https://www.wfw.com/articles/uk-insolvency-priorities-to-change-through-the-partial-return-of-hmrcs-preferred-status/> accessed on 10 June 2020.

However, the Government announced in the Autumn 2018 Budget[677] its intention to restore the Government as a preferred creditor from 2020 in respect of certain taxes. This is significant since the UK Government is one of the largest creditors in many insolvencies but currently sits behind floating charge holders as an unsecured creditor. Its claim does not therefore dilute the funds available to pay secured lenders.

The changes are to be introduced in the Finance Bill 2019-2021[678]. Through the proposed amendments, the UK Government will become a secondary preferential creditor in insolvency[679] for pre-insolvency tax liabilities including P.A.Y.E., employee national insurance, Value Added Tax and Construction Industry Scheme deductions. Basically this will cover all pre-collected taxes[680] for which the Government will rank ahead of floating charge holders and unsecured creditors.

The rationale behind this back-track in policy is to ensure that taxes paid in good faith by employees and customers, which the company holds in trust before paying the government authorities, go towards funding public services as intended rather than to settling other creditors' debts. This adjustment to the insolvency waterfall is expected to yield £185m *per annum* for the Treasury. The UK Government stated that this change in policy is not expected to have a material impact on lending. However, the Association of Business Recovery Professionals have described the move as a "retrograde and damaging step[681]". There are concerns that the Revenue will pursue an insolvency solution more aggressively due to their enhanced recovery prospects.

Through these amendments the realisations from these assets will go to the preferential creditors, including the UK Government, before the floating charge

[677]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752136/Insolvency_web.pdf

[678] https://services.parliament.uk/bills/2019-21/finance.html

[679] Principally behind employees and the redundancy payments office.

[680] This means that corporation tax or employer national insurance are not included.

[681] Available at https://www.r3.org.uk/index.cfm?page=1114&element=32639.

holder. Lenders who would traditionally take only a floating charge may want to consider enhancing the security package with fixed charges[682] or personal guarantees from directors. Thus the overall effect on the economy could be that borrowing is both harder to come by and also more costly as lenders may consider increasing rates or reducing the loan amount to mitigate the potential additional risk. There are concerns that the changes will make business rescue much more challenging and also Treasury losses will be transferred to the private sector[683].

The UK Government published a summary of responses to the tax abuse and insolvency consultation on 7 November 2018[684]. It raised questions around the control of insolvency processes. At present unsecured creditors generally control the approval of proposals and remuneration in administration and liquidation, unless in administration there will only be a return to secured and preferential creditors. Secured creditors also have limited approval powers in liquidation. The balance of interests in insolvency is always difficult and the fact that a decision was made to abolish Crown Preference seventeen years ago does not mean that it is the right decision long term. However, it may be seen as a regressive step in light of the current Government's aim to become a world-leading restructuring jurisdiction[685].

[682] Which will rank in priority to the preferential creditors.

[683] CMS, 'Fortune favours the … Crown' (16 November 2018) - <https://www.cms-lawnow.com/ealerts/2018/11/fortune-favours-the-crown> accessed on 8 June 2020.

[684] HM Revenue and Customs, *Tax Abuse and Insolvency* (Consultation Paper, 11 April 2018) - <https://www.gov.uk/government/consultations/tax-abuse-and-insolvency> accessed on 2 May 2020.

[685] CMS, 'Days of Future Past: the Reintroduction of Crown Preference' (4 March 2019) - <https://www.cms-lawnow.com/ealerts/2019/03/days-of-future-past-the-reintroduction-of-crown-preference> accessed on 30 March 2019.

Whilst the rest of Europe looks forward to making changes to its insolvency processes in order to implement the EU Restructuring Directive[686] bringing other countries in line with the UK, the UK appears to be taking a step back in time with proposals that are more damaging to business rescue than the position pre-Enterprise Act.

5.3.3.2 The International Insolvency Institute Committee on Tax Priorities in Bankruptcy

The International Insolvency Institute Committee on Tax Priorities in Bankruptcy within the International Insolvency Institute carried out a comparative study on the governmental tax priorities in bankruptcy proceedings[687]. Its considerations were made in light of the adoption by the United Nations General Assembly of the "UNCITRAL Legislative Guide on Insolvency Law[688]". The Institute's report compares the priority of tax claims in the insolvency laws in thirty five countries. This Report is a development on a previous study entitled "Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy[689]." It examined the origins and justifications of the tax priority rules as well as the criticism of the priority rules and reform efforts in Australia, Canada and France.

It is worth noting that the Report[690] outlines the fact that the priority afforded to government tax claims has been justified on a number of grounds. Five major justifying factors have been identified:

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[686] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) (OJ L 172, 26.6.2019, pp. 18-55).

[687] International Insolvency Institute - International Insolvency Institute Committee on Tax Priorities in Bankruptcy, 'Governmental Tax Priorities in Tax Proceedings' (Washington DC, March 2006) - <https://www.iiiglobal.org/sites/default/files/media/1_Day_Governmental_Tax.PDF> accessed on 5 April 2020.

[688] UNCITRAL Legislative Guide on Insolvency Law (2004)- <http://www.uncitral.org/english/texts/insolven/insolvencyindex.html> accessed on 17 February 2020.

[689] 74 Am. Bankr. L.J. 461 (2000).

[690] International Insolvency Institute - International Insolvency Institute Committee on Tax Priorities in Bankruptcy, 'Governmental Tax Priorities in Tax Proceedings' (Washington DC, March 2006)

1. Common Good Element: in the sense that tax claims, unlike the claims of private commercial creditors, are for the benefit of the whole community. This is so since the priority provides an amplification of the revenue base for the benefit of the common good. In so doing the possible shifting of the burden of the debtor's unpaid taxes to other taxpayers is avoided.

2. Involuntary Creditors: Tax authorities and tort creditors are regarded as being "involuntary creditors". What this means in practice is that tax authorities are unable to choose their debtor or obtain security for debt before extending credit. Thus the fundamental justification for the creation of these priorities is to compensate tax authorities for this apparent disadvantage. Essentially this gives the tax authorities ability to assess and review the amounts due and mobilize their collection remedies. Similarly, tort creditors are involuntary non-consenting creditors as they have a credit relationship with the corporate debtor that they have entered into unwillingly.[691]

3. Due Protection to Unsecured Creditors: this scenario comes to the fore with respect to those taxes for which the debtor acts as the government's tax collector. These would include for example sales tax, value added tax or employee withholding tax. The priority in favour of tax authorities operates in such a manner to prevent a windfall to general unsecured creditors. It is to be pointed however that very often tax authorities make the argument that the funds collected by way of taxes are merely held by them on trust and as such unsecured creditors would not be prejudiced as they were never entitled to such assets.

<https://www.iiiglobal.org/sites/default/files/media/1_Day_Governmental_Tax.PDF > accessed on 5 April 2020.

[691] Luca Enriques and Martin Gelter, 'How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law', (February 2006) European Corporate Governance Institute (ECGI) Working Paper, Working Paper N°. 63/2006.

4. Promotion of Reorganization: some argue that if the tax authorities are not reasonably secure they will be discouraged from negotiating payment terms with debtors, thus forcing premature and possibly unnecessary business failures. Affording priority is beneficial to reorganization because it encourages the tax authorities to delay current collection efforts.

5. Non-dischargeable tax liabilities: it has been argued that the priority is needed to effectuate an individual debtor's discharge where tax liabilities are made non-dischargeable in order to discourage tax evasion through bankruptcy. Granting priority to those non-dischargeable tax debts supports the individual debtor's rehabilitation, making it more likely that the tax claims will be paid in a personal bankruptcy and that the debtor will be left with fewer non-dischargeable debts at the conclusion of the proceeding.

On the other hand, the International Insolvency Institute shines a light on the work being done by law reform commissions and commentators that have raised a number of policy criticisms of unsecured creditor priorities in general and the tax priority in particular. The major heads of criticism have been identified as being the following:

1. Inconsistency with the fundamental principle of *pari passu*: All priority claims are inconsistent with the concept of equal treatment of creditors in a collective insolvency proceeding to the extent that the creditors have not made a separate commercial bargain with the debtor prior to the proceeding. All unsecured creditor priorities should be minimized because:

    a. it can foster unproductive debate over which creditors should be afforded priority and why;
    b. it can impact the cost and availability of credit which will increase as funds available for distribution to other creditors decreases;

c. the concern that is the basis for the priority may be more readily addressed by non-bankruptcy law such as social welfare legislation; and
d. it can complicate the basic goals of insolvency and make it more difficult to achieve efficient and effective insolvency proceedings.

2. Excessive burden to Private Creditors: a tax priority is not required to safeguard the public interest because the debt owed to the government is unlikely to be substantial in terms of total government taxes, whereas the loss to private creditors who often receive nothing in a winding-up process when there are numerous priority claims - may cause significant hardship and trigger other insolvencies. Moreover, to the extent private creditors receive a higher return on their claims, part of the loss to the tax authorities can be recovered through additional taxes paid by the same creditors. Additionally, a loss of priority does not stop the tax authorities from sharing in an insolvent estate *pro rata* with general unsecured creditors. While the government is not able to "choose its tax debtor" and must instead deal with all taxpayers, the fact that taxpayers cannot "choose their tax collector" certainly works to the advantage of the government which is in a position to establish tax policy by setting tax rates in ways that diversify its risks and protect the revenue base. Finally, the government is not disadvantaged by being an "involuntary creditor" because there are mechanisms in place enhancing its ability to collect debts, offsetting its involuntary position, that are not shared by private creditors, including the imposition of fines with relatively high interest rates

3. Unjustified preference of Involuntary Creditors: there is no general rule that involuntary creditors should receive priority whereas several other categories of involuntary creditors are not entitled to any kind of priority. Worst off among these are tort creditors.

4. Incentivise governmental authorities to collect tax dues through more commercially viable means: the abolition of the priority enjoyed by tax authorities for tax claims should in theory provide a greater incentive to tax authorities to collect taxes in a commercially reasonable manner. The priority is counterproductive to the rehabilitation process because it provides an incentive to delay collection. Particularly in situations where the debtor is acting as tax collector, the tax authorities have better information available about the debtor's financial condition than general business creditors. Allowing tax debts to accumulate under those circumstances can unfairly disadvantage other unsecured creditors who go on trading with the debtor not knowing that there is a tax delinquency.

5. Fiduciary Obligations: the argument that a "trust" should be imposed on amounts withheld by the taxpayer on behalf of third persons in order to avoid a windfall to the general unsecured creditors or in order to avoid unfairness to employees obligated to pay income tax on their wages who have only received wages is neither persuasive nor conclusive. The imposition of a trust on the debtor's assets is arguably unfair to the unsecured creditors who have continued to do business with the debtor.

5.3.4 Rehabilitative Type of Reform – Company Rescue and Restructuring

5.3.4.1 Introduction to Debt Restructuring in Malta

As the law stands there are three (3) major debt restructuring mechanisms that are recognised in the Maltese legal system namely,

1. The corporate recovery procedure[692];

2. A private work-out in the form of an amicable process embarked upon by the debtor and creditor with the aim of reaching an out-of-court settlement; or

3. A compromise or arrangement which is a hybrid of the two mechanisms explained above, since the recovery process can be commenced out-of-court but can only be enforced once it is sanctioned by the Court[693].

What is being proposed is the possible introduction of a debtor-in-possession type mechanism or pre-packaged sale[694]. At the outset one must always keep in mind however that speed is not the be all and end all of legal procedures. In fact other equally important safeguards such as fairness and transparency must be ensured which at times are highlighted as the weak point of the proposed mechanism. It is to be said that another effective mechanism that is being proposed is a so-called alert mechanism which places an onerous obligation on the directors of a debtor company to sound an alarm bell to creditors once a company is in financial distress.

[692] Article 329B, Companies Act.
[693] Article 327, Companies Act.
[694] *Vide* Nicholas Mizzi, '"Pre-packaged" Reorganisations: Introducing an Alternative Debt Restructuring Mechanism Within the Maltese Insolvency Law and Practice.' LL.B. Research Project, University of Malta, 2016.

5.3.4.2 Contextualising the Trend of Corporate Rehabilitation

Some of the major changes that are being undertaken in the realm of insolvency introduce certain new rights granted to insolvent companies under which such companies may opt to rehabilitate themselves[695]. These new rights include the introduction of a number of protective measures for bankrupt persons, including but not limited to provisions allowing for a bankrupt person to stay bankruptcy proceedings for the purpose of rehabilitation. The latest trend for companies in financial distress is to avail themselves of rehabilitation avenues via recently proclaimed bankruptcy and insolvency legislation. In fact it is only when there is no other legal alternative that companies will proceed to a dissolution and consequential winding up as a final response. In either case, the creditors of these companies are the ones who "pay" the ultimate price in an unhealthy economic environment that can no longer support businesses in which they have invested money, time, goods and services[696].

To his credit, Sir Kenneth Cork had already recognised the principle that business is a national asset meaning that *"all insolvency schemes must be aimed at saving businesses[697]"*. He rightly pointed out that *"when a business becomes insolvent it provides an occasion for a change of ownership from incompetent hands to people who not only have the wherewithal but also hopefully the competence, the imagination and the energy to save business"[698].* To my mind this clearly demonstrates that although corporate insolvency law has developed dramatically during the last century, especially since the publication of the Cork Report[699], there has always been a recognition that rehabilitation was the way forward.

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[695] M Inglefield, 'Navigating Unchartered Territory in Guava Season: Secured Creditors' Right on Insolvency' (March 2017) Hamel-Smith Forum, Volume 9 Issue 7.

[696] Giselle Romain, '"Unequally equal" – Circumventing the *Pari Passu* Rule' (March 2017) Hamel-Smith Forum, Volume 9 Issue 7.,

[697] Kenneth Cork, *Cork on Cork: Sir Kenneth Cork Takes Stock* (Macmillan, 1988) 202-203.

[698] It was also noted that *"With the concept of the administrator and voluntary arrangements taking its place in Britain's insolvency law, the chances look bright for more and more businesses being saved in the years that lie ahead[698] …"* - Kenneth Cork, *Cork on Cork: Sir Kenneth Cork Takes Stock* (Macmillan, 1988) 202-203.

[699] Report of the Review Committee on Insolvency Law and Practice (1982) Cmnd 8558.

A number of member states of the European Union have adopted new rescue procedures in order to save companies that are profitable but financially distressed. The main difference being that unlike traditional insolvency proceedings, these novel restructuring schemes usually begin before insolvency. They are moreover conducted by the debtor without the appointment of an insolvency practitioner, feature minimal court involvement and very often affect only certain creditors or group of creditors[700].

5.3.4.3 Corporate Rehabilitation in the Maltese Context

According to the World Bank Group's 2019[701] data, while Malta is ranked 103rd out of 190 countries in terms of ease of starting a business, its insolvency recovery ranking stands at 121. This low ranking may be linked to the increased difficulty in getting credit. There definitely seems to be a consensus that the way forward is through the promotion of rescue culture which in itself embodies numerous important aspects of the *pari passu* principle. According to this ranking exercise in all of the top twenty economies, the insolvency framework stipulates that a creditor has the right to object to decisions, accepting or rejecting creditors' claims thus providing strong safeguards to creditors in insolvency proceedings.

It is interesting to point out that in a study commissioned by the Central Bank of Malta[702] one of the proposals calls for, *"An improved corporate insolvency regime that facilitates the rehabilitation of viable firms and speeds up the exit of non-viable entities. This implies increased profitability for the banks as a result of reduced*

[700] EU Legislation in Progress, *New EU Insolvency rules give troubled businesses a chance to start anew* (EPRS 2018).

[701] http://www.doingbusiness.org/en/data/exploreeconomies/malta. The Doing Business data are based on a detailed reading of domestic laws, regulations and administrative requirements as well as their implementation in practice as experienced by private firms.

[702] Joseph Darmanin and Etienne Goffin, 'Market Failures in the Maltese Banking Sector' (2015) Central Bank of Malta - <https://www.centralbankmalta.org/file.aspx?f=11232> accessed on 11 July 2020.

provisioning needs as well as gain of output for the real economy arising from more efficient allocation of resources."

In this study certain amendments introduced in the Latvian corporate insolvency regime[703] were cited by way of support – even though the example referred to happens to be a bit dated. These measures included for instance the actions mentioned hereunder namely:

(i) Court approval of debtor rehabilitation plans is accelerated;
(ii) The threshold for initiating debt restructuring proceedings is reduced to encourage debtors to act in the early stages of their financial difficulties;
(iii) The voting threshold is decreased for unsecured creditors to approve a rehabilitation plan;
(iv) The rehabilitation period is increased to give financially distressed firms more time to restructure;
(v) Priority repayment status is granted to creditors that provide new financing. These measures seem to yield results, as the ratio of Non-Performing Loans and doubtful loans fell from 18.37% in 2010 to 6.54% in 2011 in Latvia.

5.3.4.4 The Maltese legal provisions on Company Reconstruction

The legal provisions regulating company reconstructions[704] were introduced in the Companies Act in 2003[705]. This was an important step intended to address the need for a complex body of rescue provisions and one that is in line with the modern trend in company law towards a culture that promotes the "rescue" of companies in financial distress. It involves a Court procedure regulated by the Companies Act offering a valuable tool to companies in distress that are unable to settle outstanding

[703] Passed in 2009-2010.
[704] Compromise or arrangements.
[705] Act IV of 2003.

debts as they fall due. The corporate recovery procedure[706] comes to the fore when directors become aware of the inability of the company to pay its debts[707]. The directors of a company are bound by law to take positive action in an attempt to curb the financial loss sustained by the company and minimising the loss suffered by creditors. Thus, in situations where a company is unable to pay its debts or is imminently likely to become unable to pay its debts and the directors become aware of this situation, the directors are required to convene a general meeting by means of a notice to that effect[708].

In the above-mentioned situation, a "company recovery application" may be made to the Court with a request to place the company under the recovery procedure and to appoint a special controller to take over, manage and administer its business for a period to be specified by the Court. Such period shall not exceed twelve (12) months and may be extended by the Court upon good cause being shown. The maximum extension allowed is for an aggregate total of a further twelve (12) month period.

Although the company recovery procedure already forms part of the Companies Act, it has not been used very often. This lack of use is rather surprising considering that the procedure was intended to help a company in distress to recover even if with the outside help of a special controller[709]. The alternative would be going into insolvent liquidation. Possibly this non-use of this recovery procedure could be attributable to a lack of knowledge on the part of company directors who instead continue to trade with the business in dire straits until it is at a point of no return and corporate recovery is no longer an option.

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[706] Article 329B, Companies Act.

[707] As defined in article 214(2)(a)(ii), Companies Act.

[708] *Inter alia* a director must ensure that all recommendation for remedial action made by other directors and or any dissenting opinion from any undesirable actions or inactivity advocated by other directors are properly and fully minuted or otherwise placed on record. Furthermore, a director who just resigns without having taken every step he should have taken to minimise the potential loss to creditors will not of itself escape liability. *Vide* Andrew Muscat, 'Measures to mitigate the risk of personal liability for company directors' *Times of Malta* (22 April 2020).

[709] Celia Mifsud and Edward Meli, 'Covid19 Hastens the Setting Up of a New Corporate Recovery Fund' *Times of Malta* (2020).

From time to time other sporadic but nonetheless significant measures were put into place by the Maltese legislator to strengthen and expedite company recovery procedures:

5.3.4.4.1 Companies (Amendment) Act, 2017

In 2017 significant amendments were made to the Companies Act[710]. The main provision dealing with the company reconstruction procedure[711] was buttressed by a number of far-ranging amendments. Of particular interest is the new possibility of appointing a mediator[712]. When a compromise or arrangement is proposed between a company and its creditors, or any class of them, or between the company and its members, or any class of them, the company or any creditor, with the sanction of not less than two-thirds (2/3) of the creditors or class of creditors, may request the appointment of a mediator. The said mediator must call a meeting of the creditors, or class of creditors as the case may be, in order for the creditors and the company to reach a compromise or arrangement. If all creditors, as a result of the mediation process, execute a written agreement, such arrangement shall be binding on all creditors, and also on the company or, in the case of a company in the course of being wound up, on the liquidators[713]. More importantly, a new provision has been introduced that clearly stipulates that creditors with different interests are to be treated in separate classes reflecting those interests. What this effectively means is that where both secured and unsecured creditors exist, they are treated as separate classes. In such cases, the principles under the Mediation Act[714] apply.

[710] Part VI of the Companies Act - Companies (Amendment) Act, 2017 [Act XI of 2017].
[711] Article 329B, Companies Act.
[712] Article 20, Mediation Act, Chapter 474, Laws of Malta.
[713] See Stephanie J Coppini, 'Recent 2017 Amendments to the Companies Act' (26 April 2017)- < https://ganadoadvocates.com/resources/publications/recent-2017-amendments-to-the-companies-act/> accessed on 20 November 2019.
[714] Chapter 474, Laws of Malta.

5.3.4.4.2 The Companies Act (Company Reconstructions Fund) Regulations 2020

One unmistakable and tangible way of helping a company in distress due to a sudden and unforeseen occurrence – the Covid19 outbreak is very much a case in point – is to inject funds with the aim of giving the company a breathing space for it to recover by overcoming its financial difficulties. For this to happen a fund must be made available accompanied by a mechanism and office-holders to manage the fund distribution and monitor the rescue operation together with the special controller. The Covid19 pandemic attracted enough concern in the commercial sector as to induce the Minister for the Economy, Investment and Small Business to issue a Legal Notice in May 2020[715] to create and regulate the administration of a special fund "to facilitate company recovery procedures" instituted in terms of article 329B of the Companies Act. The fund is managed by the Official Receiver in consultation with the Malta Business Registry, with the latter operating as an Agency[716] together with special controllers who will receive money from the fund as stipulated in the Regulations. The special controller may submit a claim at any time during the recovery procedure or within twelve months from the order of the Court ending the recovery procedure. The total amount of the fund is set at EUR 500,000 annually payable by the Agency. The fund must not at any time exceed this amount and it may only be used to make payments to the special controller to cover remunerations and disbursements, these are initial payments attributable and recoverable from the respective company. It is up to the Court's discretion to decide whether such payment is to be made or not. As fund administrator the Official Receiver is required to certify claims for compensation made by special controllers. There are specific circumstances in which the financial limits may be increased. The Regulations also specify the eligibility requirements and causes for disqualification.

[715] The Companies Act (Company Reconstructions Fund) Regulations 2020 passed by means of Legal Notice 192 of 2020 dated 12 May 2020.
[716] Set up in virtue of Article 3 of the Malta Business Registry (Establishment as an Agency) Order, S.L. 595.27.

5.3.4.5 The Impact of the EU's Second Chance Measures on Malta's Corporate Reconstruction Initiatives

It goes without saying that Malta is expected to keep abreast at all times with other developments happening at EU level. For example, the EU's second chance measures have a direct impact on Malta's corporate reconstruction initiatives. By and large the EU new common framework for cross-border insolvency proceedings shifts the focus away from liquidation in favour of rescue and recovery procedures. In fact it covers both bankruptcy proceedings as well as hybrid and pre-insolvency proceedings, including debt discharges and debt adjustments[717]. The European Commission proposed a directive on preventive restructuring frameworks and second chance, that would allow viable businesses in distress to be rescued[718].

The proposed directive[719] contains certain similarities to Chapter 11 of the US Bankruptcy Code[720]. McCormack[721] suggests that the proposal is Europe's answer to Chapter 11 but is a work in progress rather than a fully finished product. He recognises that similarities do exist between the proposed directive on business restructuring and Chapter 11, in particular with:

- the provisions of the debtor in possession;
- the provision on the stay on claims against the debtor to facilitate the restructuring process;
- the treatment of executory contracts; and
- the conditions for having a restructuring plan approved and for receiving protection for new financing.

[717] Reinhard Bork and Kristin van Zwieten, 'Commentary on the European insolvency regulation' (OUP 2016).
[718] EU Legislation in Progress, 'New EU Insolvency rules give troubled businesses a chance to start anew' (2018) EPRS.
[719] Proposed EU Directive on Preventive Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and amending Directive 2012/30/EU which has been amended on various occasions most recently by means of Directive (EU) 2019/1023 and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).
[720] 11 U.S.C. Bankruptcy Code.
[721] G McCormack, 'Corporate Restructuring Law – A second chance for Europe?'(2017) European Law Review 42 (4), pp. 532-561.

However, there are also significant departures on the level of details between the proposal and Chapter 11. For example, while Chapter 11 provides for a stay as an automatic effect of restructuring proceedings, the stay provided in the EU proposed directive is discretionary. Chapter 11 also contains a much wider regime for new financing than that provided for in the proposed directive. The principal objectives of the proposed directive is *"to reduce the most significant barriers to the free flow of capital stemming from differences in Member States restructuring and insolvency frameworks."* The proposal pursues this aim by focussing on three core areas:

1. common principles on early restructuring tools, which would help companies continue their activity and preserve jobs[722];

2. rules to allow entrepreneurs to benefit from a second chance through debt discharge[723];

3. targeted measures for member states to increase the efficiency of the insolvency, restructuring and discharge procedures[724].

It also includes minimum rules on the monitoring of restructuring, insolvency and discharge procedures[725].

On the other hand it should be pointed out that critics of Chapter 11 have argued that:

- it is too easily available;
- it allows debtors too much control; and
- it is characterised by a relatively low success rate and endless delay.

[722] Title II.
[723] Title III.
[724] Title IV.
[725] EU Legislation in Progress, 'New EU Insolvency rules give troubled businesses a chance to start anew' (2018) EPRS.

This negative view however is discredited by others[726] who observe that large samples of Chapter 11 cases filed in 1994 and 2002 show that this generalisation is wrong and reveal that in practice Chapter 11 offers a tangible hope for businesses in distress to turn around their operations and rebuild their financial structures. In fact, the authors opine that the amendments to Chapter 11 introduced in 2005 have led to a modest reduction of delay but at the price of blocking the reorganisation of many small businesses[727].

It is relevant to note that by virtue of the new Harmonisation Directive[728] each Member State is expected to include in its respective insolvency and restructuring laws a US Chapter 11-style debtor-in-possession regime by 17 July 2021. This puts on serious onerous obligations on Malta's future in the restructuring market which must be radically changed.

5.4 Proposals for Reform and Reformulation of the Maltese legal framework on insolvency with special reference to the *pari passu* principle

5.4.1 Proposed alternatives to the Pari *Passu* Principle

Simply saying that the *pari passu* principle does not always achieve its desired objective and purpose is hardly enough - alternative distribution systems should be explored. In order to find other alternatives, however, one must also consider a change in approach when it comes to the rationale underpinning the insolvency regime dealt with in the introductory chapters. If, as is currently the case, the insolvency system is solidly based on the notion of collectivity it will be difficult to

[726] Elizabeth Warren and Jay Westbrook, "'The Success of Chapter 11: A Challenge to the Critics'(2019) Michigan Law Review 603(4).
[727] Ibid (No 693).
[728] Directive (EU) 2019/1023 of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

truly steer away from the *pari passu* principle but not entirely impossible to seek out other alternatives.

Four possible alternative approaches to *pari passu* distribution have been identified[729]:

1. The Chronological Ranking of Debts;
2. "Ethical" Distribution of Assets;
3. Ranking of Debts on the basis of Size; and
4. Ranking in accordance with the Nature of the Debt.

5.4.1.1.1 The Chronological Ranking of Debts

The first instance occurs where creditors would be paid out of available assets for distribution according to their date of accrual. In this way debts of an insolvent company would be paid out on a first come first served basis with those with debts established at the earliest dates would, accordingly, be paid first. It is to be observed at the outset that this goes against the very heart of the collective distribution of assets. Such an approach would involve keeping a register of creditors in a chronological order. It is a system that would allow a creditor full access and information to a company's debt records. This way of doing things would represent a significant tool in the creditor's hand when choosing to do business with a particular company. On the flip side, however, it could possibly increase the additional resort to security mechanisms which in itself could stifle the system. In so doing the position for unsecured creditors might worsen. But the question remains whether it would work in Malta? It is hard to imagine how it would pan out in reality. It would be impractical to envisage a situation where a potential creditor would analyse the financial position of the company to which it intends to supply goods. What seems to be a good idea would be to keep an updated creditor register.

[729] Vanessa Finch and David Milman, *Corporate Insolvency Law: Perspectives and Principles* (3rd edn, Cambridge University Press, 2017) 569.

Such a step would most definitely be beneficial to company directors to keep abreast with the credit position of the company at all times and would thus put them in a position to provide information to creditors as required. Although on paper having debts in a chronological order seems to be conducive to logical and easy distribution, in reality however an orderly distribution of assets could easily be thwarted, for example, by the presence of numerous privileges and hypothecs.

5.4.1.2 "Ethical" Distribution of Assets

What could well be described as a philosophical approach involves the payment of unsecured creditors according to their or society's needs. Repayments would thus be organised on an ethical basis with the aim of maximising "human happiness"[730]. In a way it represents a utilitarian type of solution which is fundamentally weak due to its somewhat ethereal nature. Again it begs the question as to whether the notion of happiness can really be quantified? And for that matter, whose happiness is going to be reckoned or factored in?[731] Another weak point is that it goes against the most basic legal principle of the necessity of legal certainty as its level of subjectivity, in determining what is "human happiness", is too great. It goes without saying that creditors must be able to have clear parameters which enable them to carry out a risk assessment. Can such an approach ever be contemplated or rendered applicable within a Maltese legal context? Frankly, it is difficult to see how it would work. How would the liquidator and/or the Court determine which of the creditors is the most deserving for repayment? Whose concerns are to be weighed in: those pertaining to the individual creditor or to that of a class of creditors? As things stand today under the Maltese corporate insolvency system certain classes of creditors, especially employees, are afforded special protection which is clearly set out in law. However, having a case-by-case ethical distribution would be difficult to apply in practice in the Maltese legal system.

[730] Jukka Kilpi, *The Ethics of Bankruptcy* (Routledge, London 1998).
[731] Philip Shuchman, 'An Attempt at a "Philosophy of Bankruptcy"' (1973) 21 UCLA L Rev. 403.

5.4.1.3.1 Ranking of Debts on the basis of Size

Another approach would be the ranking of debts on the basis of size where a small creditor would be paid in preference to other creditors who have for example loaned larger sums to troubled firms. Those who support this approach would argue that small creditors are more vulnerable than others and should therefore be afforded a higher level of protection. The logistical problem here concerns the manner in which a liquidator or a Court is to correlate the size of the loan with the vulnerability of the creditor. Ingenious lenders might even be tempted to spread their risk over many smaller loans and thereby obtain a greater return to the prejudice of other creditors.

5.4.1.4 Ranking Debts in accordance with the Nature of the Debt

A fourth approach is ranking debts in accordance with the nature of the debt where different ordinary creditors would be paid out at different rates. The main distinction that is made in this context is between creditors who are consumer creditors as opposed to trade creditors. Also the position of involuntary creditors, especially tort creditors, is to be considered. The proponents of this method would argue that trade creditors should, at least in theory, be more accustomed and have a heightened awareness of the risks involved in extending credit to the company. Furthermore it is argued that consumer creditors would suffer disproportionate hardship upon the debtor's insolvency. In point of fact however trade creditors depend greatly on the recovery of their debt for their business to succeed. In the final analysis a system based on a case-by-case assessment is time-consuming and would cause unwanted delays in the settlement of claims and is for that reason undesirable.

5.4.2 Conclusions

Can any of one these four different approaches be grafted onto the current Maltese corporate insolvency system? Would they work out? Most certainly it is difficult to envisage such a possibility ever happening when one considers that the Maltese system is strongly rooted in a mandatory collective regime. Each one of the four approaches above-mentioned would entail the thrusting of a burdensome system that would have to take into account individual vulnerabilities, business acumen and assessments of an ethical nature. To my mind adopting any one of such approaches would be prone to give rise to many uncertainties, increasing costs and longer delays. This is not to say that other proposals to tweak the current system based on *pari passu* should never be considered or entertained at all. For example having a creditor register would certainly be beneficial and desirable to render the company more accountable and transparent. Moreover, the need for more training on the part of the directors and managerial team is something that ought to be further explored and encouraged with a view to decreasing the chances of a company entering into insolvent liquidation. Also, the idea of having some sort of reserved portion to assist vulnerable creditors needs to be actively studied and taken on board.

With a view to improving the current Maltese corporate insolvency legislation a set of proposals is being submitted below.

5.5 Introduction to Proposals

The proposals set forward have been carefully considered in light of research and material referred to and examined in depth in the preceding chapters. Some proposals are in the form of substantive or procedural amendments to the existing legal framework while others contain rehabilitative measures intended to facilitate the possibility of rescue and restructuring of companies in distress. All reforms are intended to strengthen areas found to be lacking or simply inadequate for purpose be they substantive, procedural or institutional in nature. Explanatory remarks

accompany each proposal in justification thereof and for a better understanding of that particular amendment. A schematic draft in the form of a series of organograms for a proposed new Code embodying all relevant aspects of insolvency and bankruptcy has been drawn up in the hope that it will serve as a basis for an Insolvency and Bankruptcy Code separate and distinct from the Maltese Companies Act.

It is amply clear that a thorough consideration of the wider aspects of insolvency law generally give added value to the current analysis of the practical application of the *pari passu* principle. Throughout the thesis it has been illustrated that the *pari passu* principle permeates all aspects of corporate insolvency and thus a complete overhaul is being strongly recommended. To this end the proposals that are being made are very extensive and far-reaching. It is my considered opinion that it is only through a holistic reformulation of the current corporate insolvency and debt-restructuring regime that the true objectives of the *pari passu* principle may be achieved. It has been shown, particularly in Chapter 2 wherein the legislative developments of the principle have been outlined that in the past our legislator has opted for a piecemeal and fragmented approach which unfortunately is ineffective to cater for the ever-growing needs of companies in financial distress. It therefore follows that what is required is that the entire corporate insolvency framework be strengthened and improved. The principle does not apply in a vacuum but within a framework of laws and procedures enshrined in a plethora of special laws mostly notably the Companies Act. For these reasons it is of the utmost importance to contextualise the principle within the wider context of insolvency law.

In order that the principle continues to evolve and keep abreast with developments that are occurring within the realm of debt-restructuring, the Courts must rigorously apply the provisions dealing with judicial shielding. Liquidators investigating pre-liquidation transactions and rank creditors in accordance with their ranking at law are to be provided with proper training and comprehensive rules relating to insolvency proceedings. Unsecured creditors could be given a 'fall-back' option through the setting up *ad hoc* funds. With this in mind all-encompassing proposals

have been put forward in Chapter 5. Furthermore, in order to ensure tangible and realistic results a road map has been proposed.

These reforms can be conveniently listed as hereunder follows:

1. A proposal amending the juridical nature of the winding up order;

2. A proposal abolishing tax preference in the ranking of creditors;

3. A proposal for the setting up of a prescribed part fund;

4. A proposal for the establishment of an insolvency fund;
5. A proposal amending the provisions on judicial shielding;

6. A proposal amending the provision relating to the provisional administrator;

7. A proposal amending the provisions relating to the ineligibility of liquidators;

8. A proposal for a new provision on the staying or sisting of winding up proceedings;

9. A proposal for the institution of licensed Professional Insolvency Practitioners;

10. A proposal amending the debt-restructuring mechanisms;

11. A proposal for a new provision on insolvency set-off *ipso iure;*

A proposal for the establishment of an Insolvency and Bankruptcy Code – distinct and separate from the Companies Act – and including a set of organograms of a draft model Code in schematic form.

An action plan for the actuation of the above proposals is being recommended. The said reforms can be further classified for the purpose of distinguishing between those that are most pressing and urgent from others that are either less important or that can be considered and implemented in the medium term. The list of proposed reform that is being submitted has been formulated in light of these considerations.

The first proposals listed immediately below, which will be subsequently elaborated upon in more detail, are pressing in nature and at the same time have the advantage of being relatively easy to be inserted in the apposite body of law. To further justify and facilitate this point, I have endeavoured to draft each amendment the way it should be worded. These list is as follows:

- Proposal 5.5.1: Proposal amending the juridical nature of the winding up order.
- Proposal 5.5.2: A proposal abolishing tax preference in the ranking of creditors.
- Proposal 5.5.5: Proposal Amending the Provisions on Judicial Shielding.
- Proposal 5.5.6: Amending the Provision relating to the Provisional Administrator.
- Proposal 5.5.7: Amending the Provisions relating to the Ineligibility of Liquidators.

The second category of proposals that have been drafted would entail greater time to be put into practise since they involved the setting-up of special funds to attain their intended objective or the establishment of a new class of insolvency practitioners.

Said proposals are:

- Proposal 5.5.3: Proposal for the Setting Up of a Prescribed Part Fund.
- Proposal 5.5.4: Proposal for the Establishment of an Insolvency Fund.
- Proposal 5.5.9: A proposal introducing the institution of licensed Professional Insolvency Practitioners.

The third category of proposals have a direct specific bearing in insolvency proceedings *per se*:

- Proposal 5.5.8: Proposing Provisions for the Staying or Sisting of Winding Up Proceedings.
- Proposal 5.5.10: A proposal amending the Debt-Restructuring Procedures.
- Proposal 5.5.11: A proposal for a new provision on insolvency set-off *ipso iure*.

The fourth and final category is in a class of its own because it involves the establishment of a Bankruptcy and Insolvency Code.

5.5.1 Proposal amending the juridical nature of the winding up order

In the course of winding up proceedings before the Maltese Courts, problems have often come to the fore in the past and still recur arising from the fact that the juridical nature of a winding up order and a number of other type of orders and/or decisions regarding winding up proceedings suffer from a lack of proper definition. In Maltese law the Companies Act contains a part that specifically deals with the dissolution and consequential winding up of companies[732]. In this section the Civil Court (Commercial Section) is expressly empowered to issue "orders" but it remains unclear whether a winding up order amounts or not to an interlocutory decree or a definitive judgment determining a particular issue. This lack of definition has in practical terms led to problems whenever an aggrieved party wants to lodge an appeal from an "order" given by the Court. When a winding up order is delivered by the Court, would it be possible for one of the parties to lodge an appeal? It is a

[732] Part V, Title II, Companies Act entitled "Dissolution and Consequential Winding Up of Companies".

general rule of civil procedure that an aggrieved party does have a right to appeal provided certain conditions are met. If a right of appeal does exist, the question still remains as to how and at what stage such a right could be exercised. It is a *lacuna* of a procedural nature that needs to be addressed.

The instances mentioned in the Companies Act containing provisions for the issue of an order or decision to be taken by the Court can arise in the case of: a winding up order[733]; rectification of the scheme of distribution[734]; in matters regulating the restoration of a company's name on the company registers[735]; in an action for fraudulent preference and the consequent liabilities and rights with respect to fraudulent preferences[736]; in matters dealing with the responsibility for fraudulent trading and wrongful trading respectively[737]; in matters relating to defunct companies[738] and in matters providing for the protection of shareholders against unfair prejudice[739].

In all the above instances it is being proposed that any such final order or decision delivered by the Court is to be considered a "judgment". Furthermore, such a judgment can be appealed before the Court of Appeal as defined in Article 41 of the Code of Organisation and Civil Procedure[740]. To this end a new general provision is being proposed as per attached Schedule Proposal 5.A.

5.5.2 A proposal abolishing tax preference in the ranking of creditors

The focus throughout has been on the practical application of the *pari passu* principle. It has been shown that its efficacy can be best demonstrated through an analysis of the interpretation and application given to the principle by the Courts. The thorough examination of salient judicial pronouncements delivered by the

[733] Article 214.
[734] Article 300A.
[735] Article 300B.
[736] Articles 303 and 304.
[737] Articles 315 and 316.
[738] Article 325.
[739] Article 402.
[740] Chapter 12, Laws of Malta.

Maltese Courts evidenced *ictu oculi* that in the great majority of cases the exercise of ranking of creditors was completely distorted through an apparent imbalance created by the plethora of tax privileges enjoyed by the different tax authorities under a number of special laws. Thus it has been conclusively shown that through government's tax authorities preferential right to recover unpaid taxes the grand majority of the assets of the company in liquidation are wiped out to the prejudice of the interests of the general body of creditors.

It is for this reason that a thorough rethink of the manner in which tax privileges are to be regulated by Maltese corporate insolvency regime is being proposed. Unless this class of security interests, that is tax privileges are properly regulated then the *pari passu* principle will never evolve or properly achieve its goals. Proper attention to this vital and pivotal conundrum is a *sine qua non* for a truly teleological approach to the set-backs of the principle. There are obviously other important security interests that have a role to play in any ranking of creditors exercise but evidently tax privileges are a sore point that needs immediate attention. It is about time for the Maltese legislator to consider adopting a system akin to that found under English law where the Crown preference was removed or at least curtailed. Valid alternatives to the current regime regulating tax privileges are being proposed. One of the proposals being made is for the setting up of a Prescribed Part Fund wherein the tax authorities would be entitled to enjoy a reserved portion. Furthermore, the tax authorities would also be entitled to have their claims satisfied in part from a proposed Insolvency Fund that is to be established.

The imbalanced reality favouring tax authorities that clearly emerged from judgments delivered by the Maltese Courts advocated towards special emphasis being placed on tax privileges. It follows therefore that certain issues are given special treatment due to the manifest practical problems that occur repeatedly during court proceedings in the application of certain security interests, most notably tax privileges in winding up proceedings. It is expressly for the reasons set out above that I chose to concentrate on certain security interests (primarily tax privileges) rather than, and to a lesser extent to other security mechanisms.

Striking the right balance among competing interests in insolvency is certainly not an easy matter. However, If Malta takes the bold step of abolishing government tax privileges it would be following the leading trend in Europe in line with the approach taken in the EU Restructuring Directive[741].

This amendment seeks to remove the lawful causes of preferences currently found in the tax legislation listed hereunder:

1. Article 116(3) of the Social Security Act[742];

2. Article 23(11) of the Income Tax Management Act[743];

3. Article 62 of the Value Added Tax[744];

4. Articles 49(b) and 66(4) of the Duty of Documents and Transfers Act[745].

5.5.3 Proposal for the Setting Up of a Prescribed Part Fund

It is also proposed that these government tax authorities should partake in the prescribed part fund as explained below. With respect to ranking order, once the abolition of governmental tax privileges is approved, it would then follow that these claims would form part of the class of unsecured creditors. On the strength of this proposal, unsecured creditors will have the benefit of the prescribed part fund. The manner in which this prescribed part fund operates is by having the office-holder of a company in liquidation ringfencing an amount of money from corporate assets for

[741] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L 172, pp. 18-55).
[742] Chapter 318, Laws of Malta.
[743] Chapter 372, Laws of Malta.
[744] Chapter 406, Laws of Malta.
[745] Chapter 364, Laws of Malta.

the satisfaction of unsecured debts or part thereof. Thus the rationale underpinning the proposal is to give parity between claims put forward by the Maltese government tax authorities and trade creditors, and thus hopefully making the restructuring of a business easier. This reformulation is being sought since understandably government would not want to give all of the benefits of priority of ranking to secured creditors. Achieving a happy middle ground is being suggested whereby an amount of money - that would have otherwise been available to the secured creditor - will now statutorily be ringfenced in a fund and used by the liquidator to pay an amount to the unsecured creditors. It is to be presumed that in this reformulated position the most significant secured creditors would be the banks. As things stand today, banks suffer delays and incur expenses in coordinating judicial sales by auction but then end up getting little or no return on their usually significant claims, since all available assets would be already taken up by the various government tax authorities.

The prescribed part will be a percentage share of the company's net property to go to unsecured creditors. It will not be necessary for the office-holder to distribute funds to unsecured creditors if they are less than the prescribed minimum, and he or she thinks that the cost of making a distribution would be disproportionate to the benefits. Where the prescribed part is greater than or equal to the minimum, but the costs of distribution are disproportionate to the benefits, the office holder will be able to apply to the court to waive the requirement. By "prescribed minimum" one understands the amount or percentage of the assets of the company in liquidation which are to be ringfenced for the purposes of the prescribed part fund.

The proposed provisions regulating the set-up of the prescribed part fund are as per attached Schedule marked Proposal 5.B.

5.5.4 Proposal for the Establishment of an Insolvency Fund

An alternative to the Prescribed Part Fund would be the establishment of an Insolvency Fund. Although a model for a specialised Insolvency Fund already exists, it is limited to a package travel insolvency fund and is regulated by the Package Travel Insolvency Fund Regulations[746] and more recently by means of the Corporate Recovery Fund Act[747]. What is being proposed hereunder is the enactment of subsidiary legislation that would regulate the setting up of an insolvency fund that could be used to make payments to unsecured creditors whose claims would have remained unpaid out of the assets of the company in liquidation. The justification for this proposal is to render the application of the *pari passu* principle more efficacious.

A draft of the proposed Regulations by means of a Legal Notice has been drawn up as per attached Schedule marked Proposal 5.C.

5.5.5 Proposal Amending the Provisions on Judicial Shielding

The Companies Act provides for several instances[748] wherein the company undergoing winding up proceedings is shielded from multiplicity of individual creditor enforcement actions which would further dissipate the assets of the company with an accompanying detrimental effect on the application of the *pari passu* principle. Although the current provisions in the Companies Act are adequate and bolster the efficacy of the *pari passu* there is room for improvement as was evidenced in the cited Court judgments. Firstly, as things stand the provisions relating to judicial shielding are directly applicable to compulsory winding up but are only indirectly made applicable to voluntary winding up through the application of article 292 of the Companies Act which gives the power to the liquidator, member, contributor or creditor to make a request to the Court for it to apply provisions relating to compulsory winding up to a voluntary winding up. The situation is not an

[746] Subsidiary Legislation 409.18.
[747] Legal Notice 192.2020.
[748] Most notably articles 220, 221, 222 and 224(2), Companies Act.

ideal one. For this reason a proposal has been drawn up whereby the provisions dealing with judicial shielding are made applicable to all modes of winding up. Furthermore, a discrepancy between the Maltese and English text of article 220 was highlighted thus a redrafting of the English version of said article is being proposed. Finally, one other proposal seeks to address a trend which emerged from the cited Maltese judgments wherein the Court chose to apply the general principle of law of *ius superveniens* to this area of law. This practice ought to be discouraged by the application of the maxim *lex specialis derogat generalis.* The Companies Act is a special law and for this reason those conditions detailing the legal mechanisms enhancing judicial shielding and thereby applying *pari passu* are to be observed *ad unguem.*

I therefore propose to amend the provisions on judicial shielding in this regard in three ways to read as follows:

1. Judicial Shielding provisions are to be made expressly applicable to all modes of winding up through appropriate legislation. The provisions found in articles 220, 221, 222 and 224(2) of the Companies Act are to be moved to the general part expressly applicable to all modes of winding up. In view of the pivotal importance of judicial shielding, legal certainty is crucial.

2. The discrepancy existing between the English and Maltese text also needs to be addressed:

    - Proposed Amendment: In order to avoid any conflicting interpretations the phrase *"carried into effect"* is to be substituted by *"requested to be brought against"* in the English version of article 222 as follows,

        "When a company is being wound up by the court, any act or warrant, whether precautionary or executive, other than a warrant of prohibitory injunction, issued or ***requested to be***

brought *against the company after the date of its deemed dissolution, shall be void."*

3. In relation to the above, the point as to whether the principle of *ius superveniens* be made applicable to the provisions regulating to judicial shielding should be examined in order ensure the proper application of these shielding provisions.

5.5.6 Amending the Provision relating to the Provisional Administrator

At present, article 228(1) states that in a compulsory winding up the Court may issue an order appointing a provisional administrator provided that this is done at any time after the presentation of a winding up application and before the making of a winding up order. The only requirement relating to the eligibility criteria is that he should be *"either the official receiver or any other competent person*[749]". Seeing the increased scrutiny on the appointment criteria of liquidators and special controllers it is recommended that these requirements should also be satisfied by the provisional administrator. For this reason eligibility criteria are being proposed for provisional administrators too. Subsequently, article 228(2) deals with functions and powers of the provisional administrator, leaving it to the full discretion of the Court appointing him to specify what these should be. However, it would also be advisable that the general parameters of the powers to be entrusted to the provisional administrator ought to be clearly stated in the law. This is especially important when the Court appointing the provisional administrator fails to include provisions for his functions and powers. In this way there would be a default position laid out in the law. Finally, article 228(3) of the Companies Act specifies that the provisional administrator holds office until such time as the winding up order is made or the winding up application is dismissed, unless of course he resigns before or is removed by the Court upon good cause being shown. Since winding up proceedings may protract over a considerable length of time it is being proposed that at regular intervals the provisional

[749] Article 228(1), Companies Act.

administrator will have the duty to convene a creditors meeting to keep them updated. These creditor control mechanisms are all important aspects of the application of the *pari passu* principle.

Furthermore, a set of additional provisions is being proposed to existing article 228 of the Companies Act in order to address the current *lacunae* in the law as above outlined as per attached marked Schedule 5.D.

5.5.7 Amending the Provisions relating to the Ineligibility of Liquidators

The ineligibility criteria of liquidators should be increased in order to enable them to be in line with the stricter obligations that are required for the office holders of a company. As things stand today it is not permissible for an individual to act as a liquidator even if he fulfils those criteria set out by law[750] if he has held the office of director or company secretary or has held any other appointment with the company at any time during the four (4) years prior to the date of dissolution of the company[751]. The need to update the criteria is also felt in light of the recent eligibility conditions that have been introduced vis-à-vis the office of the special controller[752]. Although safeguards are in place for auditors, accountants and lawyers since they must be in possession of a valid professional warrant, the additional criteria being proposed are intended to cover those potentially eligible to act as liquidators in terms of the umbrella provision *"… or is registered with the Registrar as fit for purpose to exercise the function of liquidator[753]."*

For this reason I am proposing new eligibility requirements and additional safeguards to the apposite legal provision as per attached marked Schedule Proposal 5.E.

[750] *Vide* article 305(1), Companies Act.
[751] *Vide* article 305(2), Companies Act.
[752] Legal Notice 192.2020 entitled "Companies Act (Company Reconstructions Fund) Regulations, 2020".
[753] *Vide* article 305(1), Companies Act.

5.5.8 Proposing Provisions for the Staying or Sisting of Winding Up Proceedings

This new provision is being proposed to address an anomalous situation that could arise before the Maltese Courts where in the course of winding up proceedings the circumstances of the company in liquidation changed dramatically due to the intervention of a serious investor. Owing to a *lacuna* in Maltese law it would not be possible to revoke *contrario imperio* a winding up order, even though there is a consensus to this effect among all the parties to the proceedings. It is a well-known fact in the realm of insolvency law that once the train of liquidation is set into motion its effects are said to be catastrophic and irreversible. However, it is being proposed that in extraordinary circumstances - for example, a significant capital injection - provision should be made in our law to allow for a stay or sisting of proceedings. This is especially important in view of the fact that the way forward in this area of law is geared upon the notions of corporate rescue and giving businesses in distress the possibility of a second chance.

Although we are familiar with the notion of staying of proceedings, the idea of "sisting" is a somewhat novel concept. "Sist" is defined as a court order stopping or suspending proceedings[754]. This shift in terminology is inspired by Section 147 of the English Insolvency Act 1986 which allows the Court, after a winding up order has been granted, to make an order permanently sisting the liquidation. Generally speaking there are some grounds that the Court will need to be satisfied about before a permanent sist is granted. By and large, in exercising its discretion as to whether or not grant an order to stay or sist proceedings, the Court *inter alia* would be expected to consider the following:

1. The Court needs to be convinced that the company's creditors will not be left out-of-pocket by such an order. A serious business plan must be drawn up by virtue of which all of the company's creditors are paid in full;

[754] Collins Online English Dictionary (Copyright © HarperCollins Publishers).

2. The Court must make provision for the liquidator's remuneration and expenses; and

3. The Court must take into account the public interest, meaning that the Court will need to consider if it is appropriate for the company to be returned to its directors.

In view of the above, it is being proposed that article 248 of the Companies Act should read as per attached Schedule marked Proposal 5.F.

5.5.9 A proposal introducing the institution of licensed Professional Insolvency Practitioners

An insolvency practitioner is a key institution of the insolvency process. He plays an important role in the various stages of corporate insolvency proceedings: administration, verification, reporting, liquidation and distribution. Irrespective of the state or level of insolvency a distressed company is in, his role is essential, not to say pivotal. Although it is the Court that ultimately decides matters, his contribution for the determination of the case is undeniable. In Malta there are no licensed professional insolvency practitioners as such. Normally, liquidators and special controllers are appointed by the Court from among practising lawyers or accountants or persons registered for the purpose with the Registry of Companies with proven skill and experience in the area of insolvency. While this state of affairs is not wrong in itself and can even be affirmed that it has worked sufficiently well through the years, this is not the same as saying that it is the best system or practice or that it cannot be improved upon.

Ideally there should be in place a certification programme or a course of study specifically designed and tailor-made to attract qualified persons from a variety of backgrounds including of course legal practitioners and accountants but not exclusively so. For example, persons qualified in banking or financial advisors can likewise be suitable to become licensed professional insolvency practitioners after

having successfully followed a specialised course. This can also take the form of study modules at tertiary level dealing with areas of insolvency law and procedure. Whatever method is chosen the time is ripe for Malta to have licensed professional insolvency practitioners from among persons who have successfully followed a course of studies in this area. Once this new norm is well-established all future appointees by the Court as office-holders will be selected from anyone of those qualified persons licensed to do so.

5.5.10 A proposal amending the Debt-Restructuring Procedures

A set of proposals is being made to bolster the existing provisions in the Maltese Companies Act[755] relating to debt-restructuring mechanisms. The aim behind these proposals is to identify ways how to recover the debtor's productive capacity through compositions with the creditors as has been suggested in other foreign jurisdictions like for example Italy. These procedures would facilitate the continuation of the business activity with the added possibility of splitting the debts into classes as a result of these arrangements. At the same time the interests of creditors are safeguarded by imposing certain restrictions on the compositions with creditors in the form of minimum payment thresholds, "concurrent bids" and specific informational obligations, in particular in the "blank compositions". In this way both debtor and creditor will gain new protections[756]. Anticipating the moment in which both the company and the creditor become aware of the crisis of the company and thereby allow a possible restructuring while maintaining the value of the business represents a highly important aspect to be included in the legal framework. The liquidation of a company would thus be the last option to be resorted to and activated only when other options are no longer feasible.

[755] Part VI of the Companies Act - Companies (Amendment) Act, 2017 [Act XI of 2017].
[756] "The International Comparative Guide to Corporate Recovery and Insolvency 2019 – Italy", ICLG, 13th Ed., 2019, Chapter 19 pg. 112.

5.5.10.1 A proposal for introducing an out-of-court alert procedure

This proposal, partly inspired by the new Italian Crisis and Insolvency Code, consists of an out-of-court and confidential procedure designed to promptly identify alarm signals of an incoming crisis and to provide appropriate measures to overcome it. It may be described as an early warning tool and a crisis management mechanism based upon prompt action being taken by the company's supervisory bodies like the internal and external auditors looking into the business affairs of the company. The procedure applies to those debtors conducting entrepreneurial activity of a company but excluding listed companies, large enterprises as defined by EU law, and institutions. A new non-judicial organ for composition of companies in distress has to be established to overlook the whole procedure together with a panel of experts to monitor and report on the state of affairs of the company in distress.

The supervisory bodies of the company, normally consisting of its internal and external auditors, are obliged to promptly notify the company's management and directors whenever a state of crisis is detected. The management is given a reasonable timeframe to report back on those initiatives already taken or still to be taken to reverse the crisis. In the absence of an adequate response the supervisory bodies are to notify such a failure to the Organ for the Composition of Companies in Distress (OCCD). The OCCD will in turn appoint a panel of experts before whom the debtor shall appear to explain the company's position. Those in charge of the company's management are under an obligation to promptly identify and report any signals of crisis showing that the company is in distress and experiencing a loss of business continuity. It is their duty to find ways and means to address the crisis and restore business continuity. The company directors are also duty bound to call a shareholders meeting if the share capital of the company is reduced by more than one third (1/3) as a result of the losses sustained.

The efficacy and particular relevance of this early warning mechanism is that it sounds an alarm signal before it is too late and in time to take remedial action promptly by imposing certain additional duties on directors and those managing

companies in distress. The procedure avoids the necessity of going to court and at the same time makes it more cost effective and expeditious.

Non-compliance with the above-mentioned obligations imposed *ex lege* on the debtor comes at a price. Otherwise, the element of a mandatory obligation would lose its effect. It is a legal and not a moral obligation that is imposed upon the debtor and for this reason if he is non-compliant this should give rise to civil or even corporate criminal liability. With respect to civil liability the directors of the debtor company may be liable for damages suffered by the company, its creditors and/or its shareholders.

5.5.10.2 A proposal for a new debt restructuring process in the form of a "debtor-in-possession' type of financing

Another proposal consists of a hybrid form of debt restructuring process that lies between a court ordered company recovery procedure and an out-of-court private workout. The overriding benefit of this novel debt restructuring mechanism is that it facilitates the swift sale of a business' assets in order to wipe out the company's debts. 'Debtor-in-Possession' type of financing is derived from Chapter 11 of the US Bankruptcy Code. They are referred to as "pre-packaged administration" in England and in the new Italian Crisis and Insolvency Code two forms of debtor-in-possession financing are recognised[757]. Chapter 11 of the US Bankruptcy Code requires creditors to be designated into classes and for each class whose rights have been impaired to vote in favour by a majority of two-thirds of those present and voting. The minority is bound by the class vote, provided that the plan provided to each creditor is at least what it would have received in a liquidation of the debtor. This is known as the "best interest" test. Some variation in treatment among creditors having a *pari passu* right against the debtor is allowed, provided that such difference does not unfairly discriminate against a class of creditors.

[757] *Vide* Article 99 and 101, Italian Crisis and Insolvency Code.

Is this debt-restructuring mechanism required in Malta? First and the foremost it should be pointed out that the EU through the Restructuring Directive[758] is seeking to introduce a minimum standard among EU Member States for preventive restructuring frameworks available to debtors in financial difficulty and to provide measures to increase the efficiency of restructuring procedures. Malta is therefore, under an obligation to ensure that the required legislative framework is in place to ensure the proper application of its obligations in terms of the EU law. The obvious advantage in respect of these pre-packaged sales or reorganisations is that the employees and overall structure of the company remain the same. Therefore the flexibility offered by this restructuring mechanism is definitely a point in its favour.

5.5.11 A proposal for a new provision on insolvency set-off *ipso iure*

The proposal for a new provision is intended to address the *lacuna* in Maltese law in respect of insolvency set-off *ipso iure*[759]. The Maltese Companies Act of 1995[760] is silent on insolvency set-off *ipso iure.* The Civil Code[761] merely provides the general principles governing set-off. Although a special law does exist namely, the Set-off and Netting on Insolvency Act[762], its application has been interpreted as being limited to contractual obligations[763]. In England insolvency set-off is expressly regulated in the Insolvency Rules[764]. A similar position in domestic corporate legislation is desirable. Legal certainty is imperative as the operation of set-off is deemed to constitute a serious incursion on the application of the *pari passu* principle. Thus a provision is being proposed to cater for insolvency set-off *ipso iure* as per attached Schedule 5.G.

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[758] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

[759] See point 1.6 in Chapter 1.

[760] Chapter 386, Laws of Malta.

[761] Chapter 16, Laws of Malta.

[762] Chapter 459, Laws of Malta.

[763] See Dr Andrew Chetucti Ganado *et noe* vs Gollcher Company Limited**,** First Hall Civil Court, 16 November 2010. Although not confirmed on appeal (Court of Appeal, 7 February 2012) as the Set-off and Netting on Insolvency Act had not yet entered into force).

[764] See Rule 14.24, Insolvency Rules 2016, SI 2016/1024.

5.5.12 A draft model Act for the Establishment of the Insolvency and Bankruptcy Code

The relevant provisions relating to the local law concerning insolvency are found mainly in the Companies Act[765] and other articles forming part of the Commercial Code[766]. The Maltese insolvency law regime distinguishes between bankruptcies of a person or those of a commercial partnership other than a company. The bankruptcy of a person or a commercial partnership, other than a company, is regulated by the Commercial Code[767] while company insolvency is regulated in Title II of Part V of the Companies Act. Moreover, the Set-off and Netting on Insolvency Act[768] regulates the set-off and netting on bankruptcy and insolvency. It is more than evident that having such an important aspect of company law scattered among different parts of Maltese legislation is far from being ideal and therefore this state of affairs should be remedied and the relevant legal framework be improved upon in the best possible way. A similar exercise has been done elsewhere, in other jurisdictions, and Malta is no exception.

The drawing up of an Insolvency and Bankruptcy Code, as the title itself indicates, brings together all the existing insolvency and bankruptcy legal provisions in Malta under one roof. In addition and equally important is the inclusion of novel features in the Code establishing new out-of-court proceedings providing for specific alert mechanisms, assisted negotiations with creditors, and preventive measures to counter crisis situations leading to insolvency. The Code also purports to strengthen certain areas by introducing alert measures that are meant to identify and respond to the stress situations at an early stage and by providing better mechanisms designed to facilitate the restructuring framework. The Code aims at providing a one-stop solution for resolving corporate insolvency and individual bankruptcy as the case may be. It sets forth new rules for the stay of creditors' actions and other

[765] Chapter 386, Laws of Malta.
[766] Chapter 13, Laws of Malta.
[767] Articles 477 *et seq.* of Chapter 9, Laws of Malta.
[768] Chapter 459, Laws of Malta which came in force on 1 June 2003.

innovative mechanisms/ proceedings that enable the restructuring of corporate entities. The model Code does not cover or regulate cross-border restructuring which should remain regulated EU Regulation. The new Code consolidates all the provisions of the current legal framework relating to winding up and bankruptcy. This would make it easier for debtors and creditors to resolve insolvency issues in a clear, timely and effective matter. The smooth operation of the proposed system depends also on the proper functioning of additional bodies such as professional insolvency practitioners.

The Code also aims to further enhance the shift in emphasis of the insolvency regime from winding up and liquidation proceedings towards a culture favouring prevention, crisis containment, company rescue and debt-restructuring mechanisms. One new aspect proposes putting in place a system that involves monitoring and reporting upon the financial condition of the company. A company that finds itself in a crisis situation is put under a duty to follow an alert procedure together with other bodies to help it identify promptly existing problems and to provide ways how to manage the situation of financial distress. In addition, the Code includes a system of non-judicial procedures to facilitate the handling of the crisis between debtors and creditors.

For this purpose a draft model Code has therefore been drawn up as an integral part of the thesis as per attached Schedule marked Proposal 5.H which includes a set of organograms. The Code outlines in schematic form the main areas dealing with corporate insolvency and corporate restructuring as well as personal bankruptcy.

Conclusions

A thorough examination of the constitutive elements and practical application of the *pari passu* principle in the wider context of a winding up process was carried out. More particularly an in-depth analysis as to whether the application of the *pari passu* principle as an asset distribution mechanism is adequate to enable the efficient achievement of the goals of corporate insolvency proceedings was undertaken. A comparative exercise was conducted with a view to furnish sufficient relevant material drawn from leading academic contributions on the subject and other pertinent sources based on actual practice and experience, all leading to a number of sound and, in some instances, innovative proposals and recommendations for reforms and a possible reformulation of Maltese insolvency law and corporate restructuring.

The existence of a thriving body of company law in a given country is very often a reflection of a national interest in attracting foreign business investment. A closer look into corporate insolvency and restructuring legislation would show how true and valid this statement is. Prime examples that readily come to mind in this context are the United Kingdom, Italy and Malta, the three of which rely heavily on the corporate form to facilitate and boost trade and business investment. Evidently, unduly protracted insolvency proceedings significantly reduce the creditors' chances of recovering outstanding debts and could create unnecessary uncertainty for the parties involved and the business community at large. Expeditious and efficient insolvency proceedings on the other hand are prone to increase debt recovery by making it more difficult for a company in distress to sell its assets at an unreasonably deflated price.

As one would expect corporate insolvency is regulated to a large extent by the obtaining domestic legislation. However there has been a proliferation of international instruments that seek to harmonise different insolvency laws and restructuring mechanisms amongst States. Malta is no exception to these

developments at international level meaning that having in place a robust, effective and an all-providing legal regime relating to insolvency and restructuring is a must. The way forward relies most definitely upon having a holistic special law dealing exclusively with matters of corporate insolvency, restructuring and bankruptcy of the individual[769].

Delving into the historical background and evolution of the *pari passu* principle should certainly help us to demonstrate that it is a well-rooted and still valid principle, very much ingrained in corporate legislation[770]. There are those who consider the principle as a basic requirement for the ranking of creditors[771] while others, to put it mildly, fail to share such an optimistic view and are not so enthusiastic about its worth[772]. For this reason the validity, utility and practicality of the *pari passu* principle remain arguable. One good way to better evaluate and assess its efficacy or otherwise is to see how it works in practice by putting it to the test. On the positive side the true success of the principle can be best demonstrated through the application of those provisions that deal with judicial shielding[773] as well as in the rescission of pre-liquidation transactions that either constitute a transaction at an undervalue or a fraudulent preference[774]. It is so because insolvency is inherently a collective process which should work for the benefit of creditors[775]. In this respect it is markedly different from ordinary procedural law dealing with litigation with its strong adversarial nature. A significant number of court judgments highlight this positive role of insolvency which aims at avoiding as far as possible from

[769] *Vide* Chapter 5, "Proposals for Reform and Possible Reformulation of the *Pari Passu* Principle in the wider context of the Ranking of Creditors and Asset Distribution".
[770] *Vide* Chapter 2, "Significant Historical Antecedents Shaping the *Pari Passu* Principle".
[771] *Vide* Chapter 1, "Introduction to Basic Principles of the Maltese Winding Up Asset Distribution System"
[772] *Vide* Chapter 3, "The Application of the *Pari Passu* Principle: A Critical Analysis and Appraisal."
[773] Dr Michael Zammit Maempel *noe* vs European Insurance Group Ltd, Court of Appeal, 25 January 2013.
[774] Dr Andrew Borg Cardona *noe* vs CSMR (1994) Limited (C-16452)[774], First Hall Civil Court, 5 October 2015.
[775] Panta Contracting Limited vs D.A. Holdings Limited *et*, First Hall Civil Court, 8 February 2018; Il-Kummissarju Taxxa Fuq il-Valur Mizjud vs Rees Furniture Company Limited, First Hall Civil Court, 25 October 2002; Emanuel Azzopardi *et* vs Sea Malta Company Limited, First Hall Civil Court, 6 June 2006; Re Lines Bros Ltd [1983] Ch 1, 20; Parmalat Capital Finance Ltd v Food Holdings Ltd [2008] UKPC 23.

crippling an insolvent debtor irretrievably and possibly for life[776]. One unfortunate realisation that emerges from the various judgments that have been reviewed is that the corporate recover procedure has not been that much widely taken up in Malta, even though it embraces very important aspects of the *pari passu* principle. More recent judgments, it is apt to point out, have shown a greater propensity towards recognising the undoubted worth of rescue and recovery for the benefit of both creditor and debtor company. On the opposite and downward side of the spectrum there are various judgments that show that in the process of ranking of creditors it is often the case that unsecured creditors end up with no piece of the pie – with the net result being that *pari passu* principle is rarely achieved. If one were to identify an Achilles heel for the principle this would be it. So long as the principle remains only available only in theory but not in practice its worth and efficacy remain weak. One way how to make it work is by removing those hurdles that shackle it.

There is a growing judicial trend in Maltese Courts whereby the element of fairness inherent in the *pari passu* principle is being given more prominence since it is difficult to apply it in practice due to various creditors enjoying prior ranking rights. It is for this reason that a teleological review of the current situation relating pre-eminently to tax privileges is required in order to address *lacunae* in the domestic corporate insolvency regime.

Part of the problem stems from the fact that the local system confers what can be described as an excessive financial advantage upon government tax authorities. As a result there is a distinct feeling of an imbalance of power in asset distribution that ultimately translates itself in producing minimal or nil returns for ordinary unsecured creditors. Two opposite camps come to the fore where ideally, this should never happen. On the one hand, there are government tax authorities (sometimes even vaunting competing claims against each other), commercial banks and other financial institutions all claiming the benefit in their favour of a high-level debt security. At

[776] *Vide* Chapter 4, "Judicial Pronouncements on the Application and Interpretation to the *Pari Passu* Principle".

the other end, there are unsecured creditors whose prospects of realising any financial recovery is virtually non-existent. To a certain extent one would expect finding it difficult to identify an ideal *modus operandi* when there are competing claims in litigation. However, this is not the same as saying that establishing a fair and equitable system of ranking of creditors is an unattainable goal.

Another ugly side to special fiscal laws with regard to tax collection is that they tend to complicate and prolong insolvency proceedings more than strictly necessary. Such delays inevitably lead to further dissipation of assets that would otherwise be still available for distribution. This evident deleterious effect on proceedings should be avoided at all costs and whatever the circumstances. Anything perceived as delaying and complicating proceedings is inimical to an effective and efficient insolvency process. Time is of the essence and providing a sure and rapid solution to an ailing company is no exception. The need to identify weak areas and make pertinent proposals for future legislative and institutional reforms in Maltese insolvency law should by now be clear enough.

The various proposals set out in the final Chapter are primarily intended to address a number of shortcomings in Maltese insolvency law that became apparent from the cases and relevant material reviewed in the preceding Chapter[777]. The main areas identified for purposes of reform and reformulation include the following:

(i) Complexities in the procedural elements found in various special laws of a fiscal nature which necessarily prolong court proceedings thereby resulting in further dissipation of assets available for distribution[778]. For this reason these special laws need clarity and harmonisation.

[777] *Vide* Chapter 4

[778] Bank of Valletta plc vs Crown Hotels Ltd, Court of Appeal, 28 March 2014; Ranking of Creditors of Carmelo Gauci, Court of Appeal, 29 February 2009; Ranking of Creditors of Testing Limited, Court of Appeal, 3 March 2006.

(ii) Owing to the intricacies and possible difficulties relating to modern liquidation there is an increasing need for liquidators to be properly trained, regulated and protected.

(iii) Likewise, the feasibility of providing specialised training for members of the judiciary sitting on the Civil Court (Commercial Section) should be seriously considered with all the interested stakeholders.

(iv) The role, functions and powers of the provisional administrator need to be further clarified in the law.

(v) The need to strengthen the duties of directors in order to ensure the preservation of the company's assets to eliminate the existing weaknesses and loopholes in domestic corporate legislation[779].

(vi) Judicial shielding provisions need to be improved in order to address a number of inconsistencies that emerged from a review of a number of Court judgments[780].

(vii) Provide clarification regarding the operation of insolvency set of *ipso iure.*

(viii) The need for a sound and efficient corporate rehabilitation system which would be beneficial to both creditors and debtors was explained.

(ix) Clear provisions are required to determine the juridical nature of the winding up order[781] and for the possibility to stay or "sist" winding up proceedings[782].

[779] It is strange in this regard that a request for a disqualification order of a company director as provided in the Companies Act is simply overlooked and never invoked.
[780] Mediterranean Flower Products Limited vs Flower Power (Sales) Limited *et*, Court of Appeal, 30 July 2010; Mediterranean Flower Products Limited vs Flower Power (Sales) Limited *et*, First Hall Civil Court, 9 December 2009; Nicholas Sammut et vs Flower Power (Sales) Limited *et*, First Hall Civil Court, 8 January 2014.
[781] Panta Contracting Limited vs D.A. Holdings Limited *et*, First Hall Civil Court, 8 February 2018.
[782] Ibid.

(x) The need for a holistic special legislation dealing exclusively with insolvency, restructuring and bankruptcy.

The overall challenge that lies ahead is to secure and have in place a functional and efficient body of laws regulating insolvency proceedings which whilst garnering universal support among the interested stakeholders would also be capable of having enough resilience to deal with, adapt to and adequately respond to the demands of a rapidly changing world.

Schedule Proposal 5.A

"a) Any final order or decision given by the court in a cause instituted in terms of article 214, article 300A, article 300B, article 303, article 304, article 315, article 316, article 325 or article 402 of the Act shall be deemed to be a judgment.

b) That judgment is subject to appeal directly to the Court of Appeal as defined in article 41 of Chapter 12.

c) The appeal shall be filed by application within twenty (20) days from the date of that judgment."

Schedule Proposal 5.B

"(1) This section applies where privileges and hypothecs attach to property of a company:

(a) which has gone into dissolution and consequential winding up;

(b) which is under a company recovery procedure;

(c) of which there is a provisional administrator; or

(d) of which there is an official receiver.

(2)The liquidator, special controller or official receiver:

(a) shall make a prescribed part of the company's net property available for the satisfaction of unsecured debts, and

(b) shall not distribute that part to the holder of the privilege or hypothec except in so far as it exceeds the amount required for the satisfaction of unsecured debts.

(3) Subsection (2) shall not apply to a company if:

(a) the company's net property is less than the prescribed minimum, and

(b)the liquidator, administrator or receiver thinks that the cost of making a distribution to unsecured creditors would be disproportionate to the benefits.

(4) Subsection (2) shall also not apply to a company if:

(a) the liquidator, administrator or receiver applies to the court for an order under this subsection on the ground that the cost of making a distribution to unsecured creditors would be disproportionate to the benefits, and

(b) the court orders that subsection (2) shall not apply.

(5) In subsections (2) and (3) a company's net property is the amount of its property which would, but for this section, be available for satisfaction of claims of holders of debentures secured by, or holders of, any floating charge created by the company.

(6) The minimum value of the company's net property is EUR 10,000.

(7) The prescribed part of the company's net property to be made available for the satisfaction of unsecured debts of the company shall be calculated as follows:

(a) where the company's net property does not exceed EUR 10,000 in value, 50% of that property;

(b) subject to paragraph (2), where the company's net property exceeds EUR 10,000 in value the sum of:

(i) 50% of the first EUR10,000 in value; and

(ii) 20% of that part of the company's net property which exceeds EUR10,000 in value.

(8) The value of the prescribed part of the company's net property to be made available for the satisfaction of unsecured debts of the company shall not exceed EUR 600,000."

Schedule Proposal 5.C

“Legal Notice_____ [Date]

Companies Act

(Cap. 386)

Companies Act (Insolvency Fund) Regulations, [Date]

1. Citation

The title of these regulations is the Insolvency Fund Regulations.

2. Scope

The purpose of these regulations is to set-up an Insolvency Fund to provide security for the payment of unsatisfied claims owed to unsecured creditors in the dissolution and consequential winding up.

The Fund shall be managed and administered by a Managing Board as set-up by virtue of these regulations.

3. Interpretation

(1) In these regulations, unless the context otherwise requires:

"Act" means the Companies Act;

"Board" means the Insolvency Fund Managing Board established under regulation 4;

“Dissolution and Consequential Winding Up” shall be construed in accordance with article 214 *et seq.* of the Act;

"Fund" means the Insolvency Fund referred to under regulation 8;

"Liquidator" means the person appointed by the Minister pursuant to article 305 of the Act.

"Minister" means the Minister responsible for Economy, Investment and Small Businesses;

"Registry" means the Malta Business Registry established by article 3 of the Malta Business Registry (Establishment as an Agency) Order;

"Unsecured creditors " means creditors that enjoy no preference or privilege;

(2) Words and expressions used in these regulations and which are also used in the Act, shall have, unless the context otherwise requires, the same meaning as in the Act.

4. Appointment of the Insolvency Fund Managing Board.

(1) The Minister shall appoint a Board, to be known as the Insolvency Fund Managing Board, which shall be composed of five-voting members.

(2) The five voting members of the Board shall be:

(a) two persons to be nominated by the Registry;

(b) two persons to be nominated by the Chamber of Commerce; and

(c) one person to be nominated by the Minister.

(3) A person shall not be qualified to be appointed as, or to remain, a member of the Board if he is a member of the House of Representatives.

(4) The Chairman, who shall preside the said Board, shall be appointed by the Minister in consultation with the Chamber of Commerce.

(5) The members of the Board shall hold office for a period of three (3) years, and shall be eligible for re-appointment.

(6) Any member of the Board may, before the expiration of his term of office, resign by a letter addressed to the Minister.

Provided that any member may be removed from the Board prior to the expiration of his term of office on any of the following grounds:

(a) the member has been guilty of misconduct;

(b) the member is unable and, or incompetent to perform the duties of his office;

(c) the member has acted in gross negligence;

(d) any other acts or omissions unbecoming on a member of the Board.

5. Functions of the Board

The Board shall have the following functions and any ancillary functions thereto:

(a) to set-up the Fund;

(b) to administer and manage the day-to-day affairs of the Fund;

(c) to decide and examine the current business performance and decide who shall be deemed as a contributor to the Fund;

(d) to monitor and control that contributors are contributing to the Fund;

(e) to report regularly to the Registry on any matter affecting and, or relating to the Fund and the Fund's contributors;

(f) to pay unsecured creditors in accordance with these regulations;

(g) to annually publish the contributions made by all contributors;

6. Costs of the Board

(1) The Board shall ensure that the administrative costs in relation to the carrying-out of its functions are kept to a minimum. In addition, the Registry will provide administrative support through its offices. The Board shall authorise the reimbursement of relative administrative costs borne by the Registry.

(2) The Board's administrative costs shall be paid from the Fund itself, provided that such costs transpire from a budget approved by the Board.

7. Terms of reference of the Board

(1) The Board shall draw its own terms of reference.

(2) The terms of reference, and any amendments thereto, shall be approved by the Registry and endorsed by the Minister prior to coming into effect.

(3) The terms of reference of the Board shall be published on the Registry's website.

8. The Fund

(1) The Board shall set-up a fund, which fund shall be used to make payments towards unsettled claims of unsecured creditors.

(2) All commercial partnerships which the Board deems as contributors, shall contribute to the Fund.

(3) All contributors are to annually submit audited financial statements to the Board.

(4) The Board and/or the Registry may request any contributor to submit audited financial statements more frequently than indicated in the previous sub-regulation and the Board and/or the Registry may request any contributor to provide them with any other documentation they may deem necessary.

(5) All contributors shall remain obliged to contribute to the Fund until they relinquish their licence with the Registry and settle all pending claims over the said Fund.

(8) The Fund shall at all times be kept at a minimum threshold of five hundred thousand euro (€500,000), or any other higher amount as shall be determined by the Ministry and the Registry from time to time.

(9) The Board shall be entitled to request any or all contributors to contribute further to the Fund, should the Fund be below the minimum threshold established in the previous sub-regulation or for any other reason whatsoever.

(10) Should the Board consider that accumulated funds are in excess of what it considers necessary to cover unsecured creditors' exposure but not less than the minimum amount established under sub-regulation (8), any excess amounts may be distributed back to the contributors, subject that the approval of the Registry, on the advice of the Board, is obtained:

Provided that the funds shall be distributed in such a manner as the Board shall deem fit.

(11) In the event that one of the contributors becomes insolvent, any claims made by the unsecured creditors of the insolvent contributor shall be paid first from the insolvent contributor's share of the contributions made under the Fund:

Provided that should the insolvent contributor's share not suffice in order to cover all claims, then the balance shall be paid from the net funds collected:

Provided further that the Board may request the other contributors to increase their bond to cover any shortfall of funds to settle the outstanding claims and ensure the minimum threshold is kept."

Schedule Proposal 5.D

New proposed provision regarding the qualifications of a provisional administrator:

"The Official Receiver shall keep an updated list of persons admitted to act as Provisional Administrator, which shall be made available to the Registrar of Courts.

Any person having the requisites to act as a Provisional Administrator in accordance with article 228 of the Act shall apply to the Official Receiver in the prescribed form, or in such form as the Official Receiver accepts, submitting a curriculum vitae and all documentation required by the Official Receiver in order to be admitted to the list held for the purposes of article 228.

A person is qualified to act as provisional administrator if he is an advocate or is an individual who is a certified public accountant or certified public accountant and auditor, or is registered with the Registrar as fit and proper to exercise the function of provisional administrator.

A person shall not be qualified for appointment as Provisional Administrator if:

(a) he is interdicted or incapacitated or is an undischarged bankrupt;

(b) he has been convicted of any of the crimes affecting public trust or of theft or of fraud or of knowingly receiving property obtained by theft or fraud, provided that the period for disqualification shall be in terms of the limits mentioned in sub-article (1) of article 142 of the Act;

(c) he is subject to a disqualification order under article 320 of the Act;

(d) during the time he has been a director or a secretary of a company, he has breached the provisions of this Act for the third consecutive time in a period of two (2) years to be reckoned from the first breach;

(e) he has been convicted of any of the offences under the Prevention of Money Laundering Act;

(f) he does not possess a minimum of five (5) years proven experience in the administration of companies; or

(g) he has held the office of director or company secretary or has held any other appointment with or in connection with that company, at any time during the four years prior to the date of dissolution of the company as determined in accordance with the provisions of this Act.

For the purposes of this sub-article, director includes a person in accordance with whose directions or instructions the directors of the company are or have been accustomed to act."

New proposed provision regarding the duties to convene creditors:

"In the event of the winding up application pending for more than twelve months, the provisional administrator shall summon a meeting of the creditors at the end of the first period of twelve months from the commencement of the winding up, and of each succeeding period of twelve months, or at the first convenient date within three months from the end of the period of twelve months, or within a longer term as the Registrar may allow, and shall lay before the meetings an account of his acts and dealings and of the conduct of the affairs of the company pending winding up during the preceding twelve months, including a summary of receipts and expenditure."

Provision amending article 228(2) regarding the functions and powers of the provisional administrator:

"The provisional administrator shall generally carry out such functions and powers in relation to the administration of the estate or business of the company to preserve the current assets of the company and more specifically as the court may specify in the order appointing him in order to ensure that in the case of an issuance of a winding up order the creditors are at the same starting point and that each creditor is paid according to their ranking order."

Schedule Proposal 5.E

"A person shall not be qualified for appointment as liquidator if:

(a) he is interdicted or incapacitated or is an undischarged bankrupt;

(b) he has been convicted of any of the crimes affecting public trust or of theft or of fraud or of knowingly receiving property obtained by theft or fraud;

(c) he has been convicted of any of the offences under the Prevention of Money Laundering Act; or

(d) he has held the office of director or company secretary or has held any other appointment with or in connection with that company, at any time during the four years prior to the date of dissolution of the company as determined in accordance with the provisions of this Act.

For the purposes of this sub-article, director includes a person in accordance with whose directions or instructions the directors of the company are or have been accustomed to act."

Schedule Proposal 5.F

"(1) The court may at any time after an order for winding up, on the application either of the liquidator or the official receiver or contributory, and on proof to the satisfaction of the court that all proceedings in the winding up ought to be stayed or sisted, make an order staying or sisting the proceedings, either altogether or for a limited time, on such terms and conditions as the court thinks fit.

(2) The court may, before making an order, require the official receiver to furnish it with a report with respect to any facts or matters which are in his opinion relevant to the application.

(3) A copy of every order made under this section shall forthwith be forwarded by the company or otherwise as may be prescribed to the registrar of companies who shall enter it in his records relating to the company."

Schedule Proposal 5.G

"Insolvency Legal Set-Off

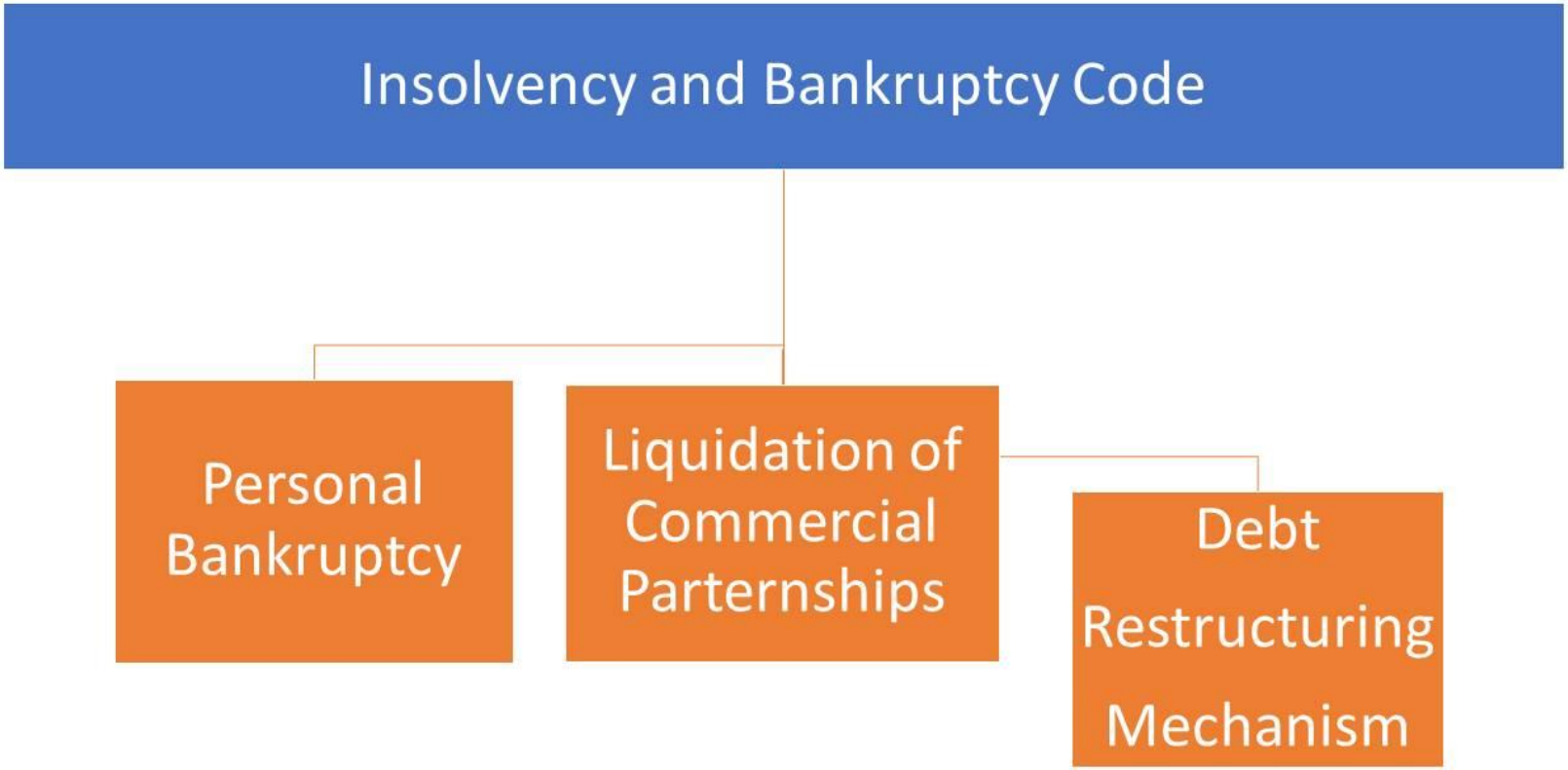
(1) Notwithstanding anything provided in any other law, where before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation, the provisions of this article shall ipso iure apply.

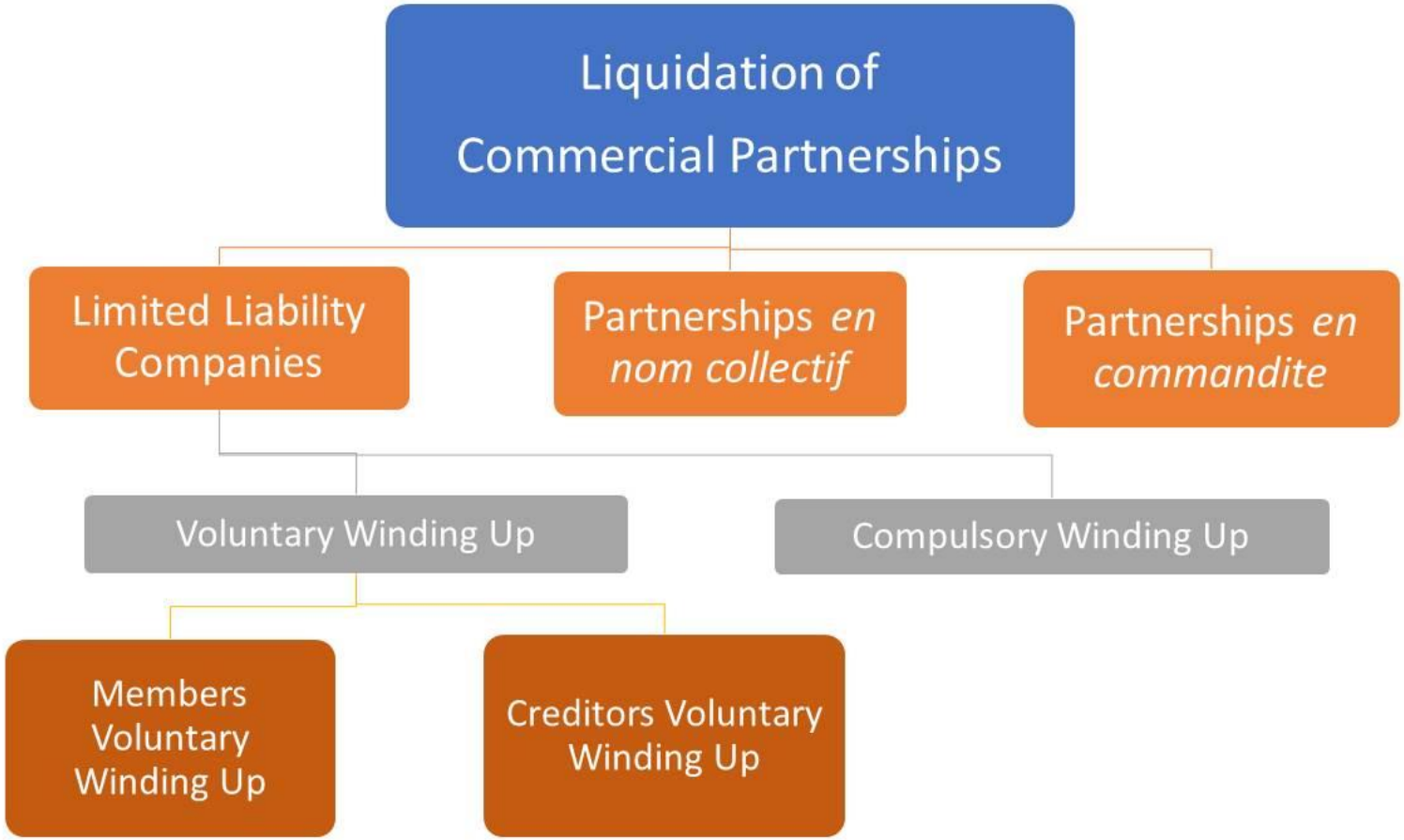
(2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other.

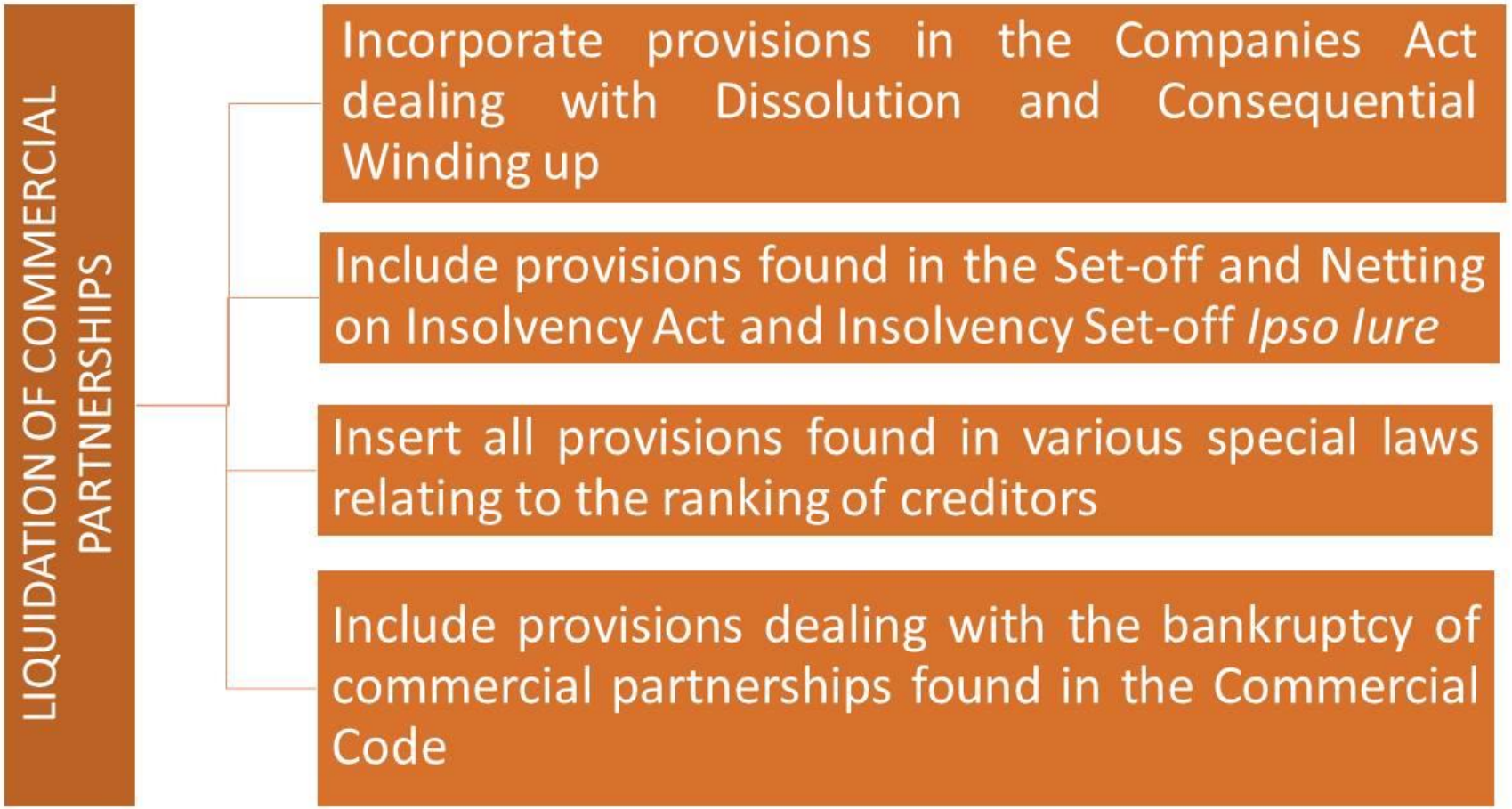
(3) Sums due from the company to another party shall not be included in the account taken under paragraph (2) if that other party had notice at the time they became due that a meeting of creditors had been summoned or an application for the winding up of the company was pending.

(4) Only the balance (if any) of the account is provable in the liquidation. Alternatively (as the case may be) the amount shall be paid to the liquidator as part of the assets."

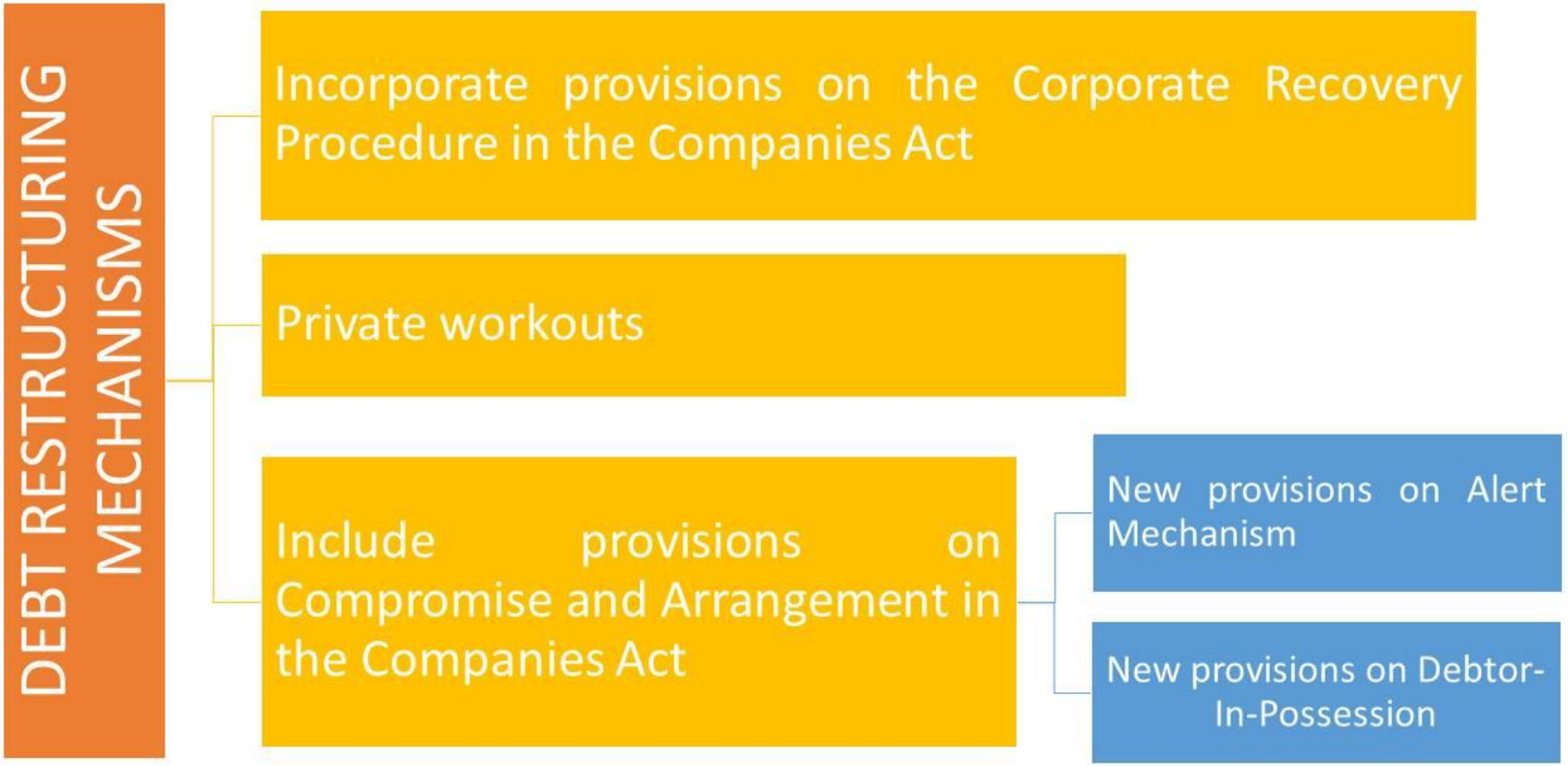
SCHEDULE PROPOSAL 5.H




Liquidation of Commercial Partnerships
Limited Liability Companies
Partnerships *en nom collectif*
Partnerships *en commandite*
Voluntary Winding Up
Compulsory Winding Up
Members Voluntary Winding Up
Creditors Voluntary Winding Up


LIQUIDATION OF COMMERCIAL PARTNERSHIPS
Incorporate provisions in the Companies Act dealing with Dissolution and Consequential Winding up
Include provisions found in the Set-off and Netting on Insolvency Act and Insolvency Set-off *Ipso Iure*
Insert all provisions found in various special laws relating to the ranking of creditors
Include provisions dealing with the bankruptcy of commercial partnerships found in the Commercial Code


Debt Restructuring Mechanisms
1.Corporate Recovery Procedure
2. Private Workout
3. Compromise or Arrangement
4. Alert Mechanism
5. Debtor-In-Possession


DEBT RESTRUCTURING MECHANISMS
Incorporate provisions on the Corporate Recovery Procedure in the Companies Act
Private workouts
Include provisions on Compromise and Arrangement in the Companies Act
New provisions on Alert Mechanism
New provisions on Debtor-In-Possession


PERSONAL BANKRUPTCY
INCLUDE PROVISIONS IN THE COMMERCIAL CODE DEALING WITH THE BANKRUPTCY OF THE PERSON
BOLSTER PROVISIONS ON THE REHABILITATION OF THE PERSON

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