UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

DIRECTORS' CIVIL LIABILITY DURING CORPORATE INSOLVENCY: THE LEGAL FRAMEWORK, RELEVANCE AND EFFICACY OF THE WRONGFUL TRADING RULE IN MALAWI

by

FELIX EBINET MIPANDE

A thesis submitted in partial fulfillment of the requirements for the degree of

DOCTOR OF LAWS (LLD)

AT THE FACULTY OF LAW

UNIVERSITY OF PRETORIA

21 APRIL 2021

Supervisor: **Professor Andre Boraine**
Co-Supervisor: **Professor Harry Rajak**

© University of Pretoria

TABLE OF CONTENTS……………….…………………………………………………2

Chapter 1: General orientation…………………………………...……………………..11

1.1 Introduction………………….……………..……………………………………....11
1.2 Insolvency law in Malawi…………………….……..…………………….……...13
1.2.1 Background of director's civil liability
During corporate insolvency in Malawi…………...……………………....16
1.2.2 The wrongful trading rule and its place
under Malawian insolvency law………………...……………………17
1.3 Purposes of the study…………………………………………………..…………20
1.3.1 Primary purpose ……………………………………………………..…20
1.3.2 Secondary purpose ……………………………………..……….……21
1.4 Research questions…...……………..…………………………………………..21
1.5 Methodology………………………………………………………………..…23
1.5.1 United Kingdom: The primary comparable jurisdiction……………..24
1.5.2 Secondary comparable jurisdictions………………..………………...25
1.5.2.1 South Africa……………………………………………………..25
1.5.2.2 Australia……………………………………………………...25
1.5.2.3 Other jurisdictions…………………………………………....25
1.6 Reasons for and significance of the study……..……………….……………...26
1.6.1 Reasons for the study…………………………………………………26
1.6.2 Significance of the study……………………………………………...29
1.6.2.1 Malawi………………………………………………………..30
1.6.2.2 United Kingdom……………………………………………...…30
1.6.2.3 South Africa……………………………………………………..31
1.6.2.4 Australia……………………………………………………...32
1.6.2.5 Doctrinal significance of the study: Creditor protection
and deterrence to director-indifference………………………33
1.7 Scope and limitations of the study…………………………….………………34
1.8 Chapter conclusion……………………….……………………….………......36

Chapter 2: Conceptual justification of the wrongful trading rule………………………..38

2.1 Introduction……………......………………………………………………………..38

© University of Pretoria

2.2 Origin of the wrongful trading rule ……………………………………………………40
2.3 The doctrine of separate legal personality
and the aims of the wrongful trading rule ……………………………………………..45
2.3.1 The doctrine of separate legal personality……………………………45
2.3.2 Effect of the doctrine of separate legal personality
on creditors of a company…...………………………………...……47
2.3.3 The *Salomon* decision ……………………………..………………48
2.3.4 Common law response to the *Salomon* decision……………………...52
2.3.5 Legislative response to the *Salomon* decision………..……..…..……54
2.3.6 Lifting of the corporate veil and whether or not it is
a justifiable exception to the *Salomon* principle..…………..……..…..55
2.4 Aims of the wrongful trading rule and whether or not they are a justifiable
basis for imposition of personal liability on directors of companies……………57
2.4.1 Creditor protection…………………………………………………....57
2.4.1.1 Are creditors not already sufficiently protected under law?.....60
2.4.1.2 Why a sudden global change of attitude
in favour protection of creditor-interest?................................68
2.4.2 Penalizing directors for opportunistic behaviour towards creditors…..70
2.5 Relevance of economic theory to directors' liability…………..……………….…77
2.6 Chapter Conclusion………………...……………………………………………..79

Chapter 3: Meaning of "director" for purposes of the wrongful trading rule in Malawi..83

3.1 Introduction…………………………………………..…………..…………83
3.2 Meaning of the term director in Malawi and in the comparable jurisdictions….….84
3.2.1 Malawi………………………………………………………………..84
3.2.2 United Kingdom……………………………………………………...85
3.2.3 South Africa………………………………………………………….85
3.2.4 Australia…………………………….………………………..86
3.3 Who can be a director in Malawi? 86
3.4 Types of directors in Malawi and their liability for wrongful trading……………..88
3.4.1 *De jure* directors………………….……………………………………88
3.4.1.1 Temporary directors and their liability for wrongful trading…89

© University of Pretoria

3.4.1.2 Nominee directors and their liability for wrongful trading …..90
3.4.1.3 Puppet directors and their liability for wrongful trading ……..93
3.4.1.3.1 Liability of puppet directors for their acts…………..94
3.4.1.4 *Ex-officio* directors and their liability for wrongful trading…..95
3.4.1.5 Alternate directors and their liability for wrongful trading …..96
3.4.2 *De facto* directors…………...……………………………………...…..96
3.4.2.1 Validity of acts of de facto directors……………..…………....101
3.4.2.2 Liability of *de facto* directors for wrongful trading ………..…104
3.4.3 Shadow directors …..……………………..………...…….…………...105
3.4.3.1 Difference between *de facto* directors
and shadow directors………………………………………..108
3.4.3.2 Liability of shadow directors for wrongful trading ………..109
3.5 Other persons who may be adjudged to be directors of companies
for purposes of wrongful trading……………………….……………..….…..…..110
3.5.1 Shareholders and their liability for wrongful trading …………….……110
3.5.2 Independent companies and their liability
for wrongful trading of other companies………………..……...………111
3.5.3 Parent companies and their liability for wrongful trading
of their subsidiaries……………………………………………………112
3.5.4 Banks and their liability for wrongful trading of their customers..…….113
3.5.4 Persons occupying positions lower than that of a director
and their liability for wrongful trading…………………….…….……115
3.5.5 Professional advisors and their liability
for wrongful trading of their clients……………………………………..115
3.6 Chapter conclusion……………………..…..……………………………...……116

Chapter 4: Directors' obligations when a company is in the vicinity of insolvency and when a company has become insolvent………..………119

4.1 Introduction……………………..………………………………………………120
4.2 Meaning of vicinity of insolvency ………………...…………………….……121
4.3 Origin of the notion of vicinity of insolvency……………………………..…..122
4.4 Meaning of vicinity of insolvency under common law…………….…………....125

© University of Pretoria

4.5 Meaning of vicinity of insolvency under statutory law in Malawi
And in the comparable jurisdictions ……………………………….…..…...128
4.5.1 Inability to pay debts as the measure of insolvency……………………128
4.6 Shift of directors' focus from shareholders
to creditors when a company is insolvent..……………………….……….….132
4.7 Shift of a directors focus from shareholders to creditors when
a company is in the vicinity of insolvency …………………..………………..133
4.8 Rationale for the directors' shift of focus from
the company and its shareholder to the creditors…………………….………..136
4.9 Shifting of directors' focus to creditors and what it entails for directors……..….140
4.10 Nature of obligations of directors when a
company is in the vicinity of insolvency………………………..…………..141
4.11 Nature of obligations of directors when a company becomes insolvent …....…..147
4.11.1 Obligation to place a company under
corporate rescue or liquidation in Malawi………….…………....…147
4.12 Corporate rescue in Malawi and in the comparable jurisdictions……......…....149
4.12.1 Malawi……………………………………………………………149
4.12.2 United Kingdom……………………………………………………150
4.12.3 South Africa………………………………………………….………153
4.12.4 Australia…………………………………………………………155
4.13 Justification for imposition of personal liability on directors of companies…..155
4.14 Chapter conclusion…..………………..…………………………………....158

Chapter 5: Defences in wrongful trading proceedings ………………………………..163

5.1 Introduction……..……………………………………………………....163
5.2 The "no step" defence…………………..……………………………..……..165
5.3 The "every step" defence…………...……………………………………….....167
5.3.1 Meaning of: "at some point before the commencement
of winding up"……………………………………………….………..168
5.3.2 What if financial records are unavailable at the relevant time? 169
5.3.3 Meaning of "taking every step"……………………………..……....172
5.3.4 "Every step" and minimisation of losses to creditors as a whole………183

© University of Pretoria

5.3.5 What if "taking every step" is practically impossible? 184

5.3.6 Does the absence of professional warning entail absolution from liability?...185

5.3.7 Are directors not prejudiced by the court's hindsight bias in the "every step"defence?...186

5.3.8 Some of the steps that are likely to impress the courts in the "every step" defence……………………….. ………………....188

5.3.8.1 Seeking professional advice…………………………………....188

5.3.8.2 Resignation…………………………………………………….190

5.3.8.3 Cessation of business…………………………………………..191

5.3.8.4 Placing the company into a formal insolvency process..…… 193

5.3.9 Continuing to trade when company is insolvent and the "every step" defence..…………………..…………………….……195

5.3.10 Can directors rely on the business judgement rule as a defence in wrongful trading proceedings? …………….…......197

5.3.10.1 The business judgement rule………………………….…...198

5.3.10.2 Rationales of the business judgement rule ……….………199

5.3.10.3 Applicability of the business judgement rule in wrongful trading proceedings…………..…….………….....207

5.4 Chapter conclusion……………………………….……………………..…………..210

Chapter 6: Remedies in wrongful trading proceedings……………………..….……..214

6.1 Introduction……………..………………………..………………..…...…….214

6.2 The contribution order as the sole remedy in wrongful trading proceedings ……215

6.3 Purpose of the contribution order…………………………….……………………....216

6.4 Court's discretion to make a contribution order………………………………….217

6.5 The contribution sum: Calculation of the increase in the net deficiency of the assets of the company……………………………….218

6.5.1 Can the court take into account the fact that the director's conduct was culpable when making a contribution order?....................221

6.5.2 Court's discretion even where the increase in net deficiency is proved……………………………………………….223

© University of Pretoria

6.6 Secured creditors benefitting from the contribution sum……………………...……224

6.6.1 Whether a holder of a floating charge is entitled to benefit from the contribution order ……………….…………………………..225

6.7 Post-wrongful trading creditors and pre-wrongful trading creditors benefiting equally from the contribution sum ……………………...……….....…229

6.8 The contribution order where liability has attached more than one director…….231

6.9 Director offsetting the contribution sum with sums owed to him by the company..……………..……………………………….…232

6.10 Chapter conclusion…..……………………...………………………….….…233

Chapter 7: Funding of wrongful trading proceedings ………………..……………..…..236

7.1 Introduction……………………………..……………………………………....236

7.2 The funding problem……………………………….……………………...…….237

7.3 Funding by the company …….……………………………...………………..240

7.3.1 The position in the United Kingdom…………………………………..241

7.3.2 The position in Malawi…………………………………………..…245

7.4 Funding by private third parties: maintenance and champerty…………………..246

7.4.1 Public policy against champerty and maintenance …………………....247

7.4.2 The insolvency exception to champerty and maintenance……………249

7.4.3 Reforms enabling funding by third parties under English law……..….252

7.5 Funding by creditors…………………………..……………………………...254

7.6 Chapter conclusion………..…………………..………..…………………..…..254

Chapter 8: Relevance of the Malawian wrongful trading rule…………………………258

8.1 Introduction…………………………………..……………………………..258

8.2 The UNCITRAL Legislative Guide in insolvency law……………………...259

8.3 Compliance of the legal framework of the Malawian wrongful trading rule with the key issues in UNCITRAL's legislative guide in insolvency law…...260

8.3.1 The nature and extent of the obligations and the time at which they arise……………………………………………261

8.3.2 The persons to whom such obligations would attach…….…..………262

8.3.3 Liability for breach of the obligations and how the

© University of Pretoria

said obligations may be enforced……………………………...............264
8.3.4 Applicable defences (during proceedings to enforce the said obligations) …………………………………………...264
8.3.5 Remedies (when the said obligations have been breached) …………268
8.3.6 Who may bring up the action? (to enforce the said obligations) ……270
8.3.7 How the proceedings (to enforce the said obligations) may be funded……………………………………………………….271
8.4 Chapter conclusion……………………………………………………….272

Chapter 9: Efficacy of the wrongful trading rule in Malawi……………..…….…..………………274

9.1 Introduction………………………………………………..……………..…275
9.2 Problems likely to affect the efficacy of the wrongful trading rule in Malawi……………………………………………………………….280
9.2.1 Drafting problems……………………………………………….....280
9.2.1.1 Use of the word "wrongful" in the marginal note of the provision…………………………………………..280
9.2.1.2 Use of the words "at some time" in the provision …………285
9.2.1.3 Use of the words "reasonable prospect" in the provision...…..288
9.2.1.4 Use of the phrase "ought to have concluded" in the provision.293
9.2.1.4.1 The phrase is imprecise…………………………293
9.2.1.4.2 The phrase deprives directors of the "every step" defence……………………………295
9.2.1.5 Use of the words "every step" in the provision………………296
9.2.2 The rule is too wide that it fails to serve intended purposes and serves unintended purposes…………………………300
9.2.3 The funding problem……………………………….………………304
9.2.4 The liquidation restriction of the wrongful trading rule rule………..308
9.2.4.1 Availability of the remedy only during insolvent liquidation of companies……………………........................308
9.2.4.2 Availability of the remedy only through a liquidator………..312
9.2.5 Absence of protection from wrongful trading for directors who do their best………………………………………319

© University of Pretoria

9.2.6 Absence of director disqualification under the wrongful trading rule.321

9.2.7 The rule presumes solvency of directors……………………………324

9.2.8 The negative impact of corporate rescue on the vibrance of the wrongful trading rule in Malawi…………………………….....326

9.2.9 Applicability of the wrongful trading rule in Malawi during the current COVID-19 pandemic *viz a viz* the efficacy of the rule………328

9.3 Chapter conclusion………..…………………………………………………330

Chapter 10: Recommendations of reforms to enhance the efficacy of the wrongful trading rule in Malawi and the expected gains of the reforms……339

10.1 Introduction…………..……………...………………………..……………340

10.2 Recommendations of reforms to enhance the efficacy of the wrongful trading rule………..…………………..…………....344

10.2.1 Prohibiting multiplicity of debts when the company is insolvent…......344

10.2.2 Replacement of the "every step" defence with elaborate alternative defences………….……………..…....…..346

10.2.3 Renaming the rule the Insolvent Trading Rule……………………....347

10.2.4 Extending the scope of permissible claimants to administrators, creditors, third parties and a public officer………………...……..….348

10.2.5 Introducing a safe harbour carve-out under the rule…........................351

10.2.6 Introducing director disqualification under the rule…………..…......353

10.2.7 Enabling assignment of wrongful trading causes of actions and proceeds………………………………………354

10.3 Other problems of the current wrongful trading rule which will be automatically rectified by the proposed reforms……..…..…355

10.3.1 Problem of the rule not serving its intended purpose………...……….355

10.3.2 Doing away with the practical impossibility inherent in the rule….....356

10.3.3 Doing away with the negative impact which corporate rescue has on the vibrance of the wrongful trading rule in Malawi……………..357

10.4 An inherent problem which cannot be rectified by the proposed reforms….….358

10.5 Summary of reform proposals……………………..…...………………....……359

10.6 Outlook of the recommended reformed wrongful trading rule…..……..………360

© University of Pretoria

10.7 The expected gains of reforming the wrongful trading rule
in Malawi in the recommended ways……………………………….………..…….364
10.8 Recommendation on the applicability of the wrongful trading rule
in Malawi during the current COVID-19 pandemic……………….…………..366

Bibliography……………………………...…………………………………...……………368
Books…………………………………………………………………………..368
Articles……………………………………………………………...…………369
Theses...377
Cases………………………………………………………………………...…378
Legislation………………………………………………………………….….387
Reports………………………………………………………………..……...…388
Other…………………………………………………………………………...390

© University of Pretoria

CHAPTER 1

GENERAL ORIENTATION

SUMMARY

1.1 Introduction……………………………………………………………11

1.2 Insolvency law in Malawi………………………………………………… 13

1.3 Purposes of the study…………………………………………………… 20

1.4 Research questions………………………………………………………21

1.5 Methodology……………………………………………………………...23

1.7 Reasons for and significance of the study……………………………………26

1.8 Scope of and limitations of the study………………………………………33

1.9 Chapter summary……………………………………………………...33

1.1 INTRODUCTION

Insolvency law is one of the areas of law which refuses to remain static, and the continuing development of new rules under it sometimes raises concerns of unification with its own fundamental rules. In making a similar observation, Armour and Waters[1] use an imagery of insolvency law as having 'developed in a haphazard manner of a medieval building, with new parts being added to the existing ones without much concern for the coherence of the resulting edifice or whether the foundations will take the weight.'[2] According to the learned commentators, the continuous development of new rules in insolvency law, a lot of which upset the well settled positions in corporate

[1] Armour, J and Walters, A "Funding Liquidation: A Functional Review" (2006) *Law Quarterly Review*, 1.

[2] Ibid.

© University of Pretoria

law, has sometimes resulted in confusion even of the most basic matters among judges, legislators and commentators.[3]

It is almost elementary that there are two facts that are constant in insolvency law. First, insolvency of individuals and corporations will always occur.[4] The basis of this assertion was well put by Jackson[5] in the words that "when firms or people borrow, things sometimes do not work out as hoped because ranging from bad luck, crop failure, unexpected tort liability, dishonesty or whatever reason, it is inevitable that some debtors will not be able to repay what they owe."[6] For this reason and, as Jackson added, in a world where creditors can call on the state to take a debtor's assets from it if they fail to pay what they owe, it is necessary to prepare for what must be done when insolvency approaches.[7]

Second is the fact that during insolvent liquidation of corporations, the assets of the insolvent will usually not be sufficient to cover all claims by creditors. For this reason, and as far as possible, mechanisms need to be devised on how to maximize the said assets for the benefit of the creditors. As some of the mechanisms, a liquidator may investigate and determine that transactions entered into by the company before commencement of the winding up, such as preference payments and transactions at an under value, should be challenged as transactions which might be adjusted.[8]

Apart from the foregoing, a fairly recent rule known as the "wrongful trading" rule has been invented under insolvency law to supplement the already existing mechanisms

---

3 Ibid.

4 With respect to insolvency of corporations, Boraine A and van Wyk J "The application of the 'repealed' Companies Act 61 of 1973 to liquidation proceedings of insolvent companies" (2013) *De Jure* v46 644-683 at p 653 available online at https://UnivofPretoria.on.worldcat.org/oclc/8598486759 accessed on November 23 2020 have said that the failures of companies are economic realities, citing the published statistics for liquidations in the Republic of South Africa available at http://statssa.gov.za/Publications/P0043/P0043June2013.pdf

5 Jackson, T *The Logic and Limits of Bankruptcy Law* (1986) Havard University Press, 3-4.

6 Ibid.

7 Ibid, 4.

8 Keay, A "Wrongful Trading: Problems and Proposals" 65 *N.Ir. Legal Q.* 63 (2014) 63.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

available to liquidators in investigating conduct detrimental to creditor-interests during a period leading to insolvent liquidation of companies.

The wrongful trading rule, which is provided for in section 187 of the Insolvency Act of 2016 in Malawi,[9] serves the interests of creditors in two ways. First, the rule attempts to maximize the assets of the company available for distribution to creditors during insolvent liquidation of the said company.[10] Secondly, the rule deters directors from being indifferent in the running of the affairs of a financially distressed company by penalizing them through the imposition of personal liability against them should they fail to arrest the company's precarious financial situation during a period leading to the insolvent liquidation of the company.[11]

1.2 INSOLVENCY LAW IN MALAWI

Until the advent of the Insolvency Act of 2016,[12] insolvency law in Malawi was governed by several pieces of legislation. Firstly, the repealed Companies Act of 1984[13] used to govern the winding up of companies.

9 Note that the phrase "wrongful trading" does not appear in the main text of section 187 of the said Insolvency Act, but that it is only a marginal note of the said provision. A detailed discussion of the implications that stem from this scenario is provided in Chapter 8 of this study.

10 Section 187(1) of the Insolvency Act of 2016 in Malawi is to the effect that the remedy available to a liquidator in wrongful trading proceedings is a contribution by the respondent director to the assets of the company available for distribution to the company's creditors.

11 As it is argued in chapter 2 of this study, the imposition of personal liability on directors of companies for debts which are incurred by the company and which were ordinarily payable by the company itself is clearly intended to penalize directors for their lack of regard to the plight of creditors when running the affairs of financially distressed companies.

12 Act No. 9 of 2016.

13 Act No. 19 of 1984 (s 204 - 305) which repealed its predecessor Companies Act, and the application thereby to Malawi of the Companies (Consolidation) Act, 1908 (8 Edward VII, Cap. 69) and the Companies Act, 1913 (3 and 4 George V, Cap. 25) of the United Kingdom.

© University of Pretoria

Secondly, the Financial Services Act[14] governed and continues to govern[15] statutory management and winding up of prudentially regulated financial institutions.[16] To the extent that the provisions of the Insolvency Act of 2016 are consistent with the provisions of the said Financial Services Act, the provisions of the former may also be applicable in the winding up of prudentially regulated financial institutions.[17]

Thirdly, the Bankruptcy Act[18] and, lastly, the Deeds of Arrangement Act,[19] both of which used to govern individuals' insolvencies. These two Acts have since been repealed by the Insolvency Act of 2016.[20]

Apart from the statutory sources, it is important to note that English common law, customary law and international law, where relevant, are all possible sources of insolvency law in Malawi.[21]

14 Cap. 44:05 of the Laws of Malawi, Sections 68 to 72.

15 Section 3 of the Insolvency Act of 2016 provides that the Act is not applicable to financial institutions unless the Financial Services Act itself provides otherwise, and Section 115 of the said Financial Services Act provides that wherever the provisions of the Act are inconsistent with the provisions of the Companies Act [now the Insolvency Act], the provisions of the Act will prevail to the extent of the inconsistency.

16 According to Section 2 of the said Act, prudentially regulated financial institutions include banks, microfinance institutions, securities exchange, depositories, brokers, insurers, Savings and Credit Cooperative Organizations, pension funds and medical aid funds, among others.

17 Section 115 of the Financial Services Act.

18 Enacted in 1928, this Act was a replica of the English Bankruptcy Act of 1914.

19 Cap. 11:02 of the Laws of Malawi. In the United Kingdom, where the Malawian Deeds of Arrangement Act was adopted from, deeds of arrangement between insolvent debtors and their creditors became a a cause for concern during the 19th century because they usually resulted in fraud against the majority of creditors. These arrangements usually contemplated that the debtor gives up virtually the whole of his or her assets to a trustee for the benefit of creditors in return for a release from their claims. Unscrupulous persons frequently induced insolvent debtors to execute deeds of arrangement in their favour as trustees and then they deliberately failed to make proper distribution of the assets to the creditors; See Tolmie F, *Corporate and Personal Insolvency Law*, Cavendish Publishing (2003) p. 78. In order to ensure adequate publicity for these arrangements and better protection for creditors in Malawi, the deeds were required to be registered with the Registrar General of Malawi for public inspection. In practice, however, deeds of arrangements were a rare occurrence in Malawi.

20 Section 354 of the Insolvency Act of 2016.

21 See Sections 10(2), 11(2)(c), 200 and 211 of the Constitution of the Republic of Malawi 1994.

© University of Pretoria

In Malawi, the 2016 Insolvency Act came about out of frustration that emanated from the rigidity of the pre-2016 insolvency framework[22] which was also found to be disjointed.[23] The rigidity of the pre-2016 insolvency framework entailed protracted insolvency proceedings which were costly and therefore depleted the already meagre resources available to creditors.[24] Rescue culture was also not adequately promoted under the pre-2016 insolvency framework, nor were the international standards of best practices in insolvency law, such as those currently recommended by the United Nations Commission on International Trade Law, hereinafter referred to as UNCITRAL.[25]

The Insolvency Act of 2016, which came into force in Malawi on 20th May 2016,[26] provides for both individual and corporate insolvencies. The Act is based mostly on the Mauritius Insolvency Act of 2009, and partly on the UK Insolvency Act of 1986 as well as the cross-border insolvency provisions of the UNCITRAL.[27] By reason of the

22 For instance, under the Bankruptcy Act, the process of commencing the proceedings required proof of an 'act of bankruptcy,' a bankruptcy notice and a receiving order, all of which have now been condensed.

23 For instance, the regulation of all insolvencies in Malawi is now centralized in the office of the Director of Insolvency who also regulates Insolvency Practitioners in Malawi.

24 See report by Burdette D, *Malawi Insolvency Framework Report,* dated 15th March 2010. The Report was prepared under the Doing Business Reform Advisory (DBRA) team within the Investment Climate Department of the World Bank Group in preparation of the insolvency law reform process.

25 United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April2013).

26 Gazette dated 22nd July 2016 – Government Notice No. 16 under Cap. 11:01 of the Laws of Malawi. It must be noted that there was an anomaly in the sense that the notice of commencement was issued on 22nd July 2016 and provided for commencement of the Act way before the date of the notice i.e. 20th May 2016. This anomaly has given rise to the question as to what was the applicable law between the said dates; See *Kumbatira t/a Taringa Enterprises v FDH Bank* Bankruptcy Cause No. 3 of 2016.

27 Established in 1966, the United Nations Commission on International Trade Law (UNCITRAL) is a subsidiary body of the General Assembly of the United Nations, of which Malawi is a member. The general mandate of UNCITRAL is to further the progressive harmonization and unification of international trade law. UNCITRAL has since prepared a wide range of conventions, model laws and other instruments dealing with the substantive law that governs trade transactions or other aspects of business law which have an impact on international trade. Relevant to this study is UNCITRAL's publication by its Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April 2013).

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

foregoing fact, it will be noted that the 2016 Insolvency Act in Malawi embraces a number of internationally accepted best practices in corporate insolvency law.[28]

1.2.1 Background of directors' civil liability during corporate insolvency in Malawi

As far as directors' civil liability for breach of obligations to the company was concerned, it must be noted that only the Companies Act of 1984[29] came closer to making provision for this area of law. While the said Act did not specifically provide for the liability of directors or any officers entrusted with the management of companies incorporated pursuant to the said Act for wrongful trading, Section 4 of the said 1984 Companies Act provided for liability to pay damages on the part of an "officer" of a company for delinquency, misfeasance breach of trust or breach of duty within a period of two years prior to the inception of winding-up of the company.

Although the term "officer" in relation to a company under the 1984 Companies Act included a director,[30] liability in that regard could only attach if the said officer received any money or property during the two years preceding the commencement of the winding up as a result of the said delinquency, misfeasance, breach of trust or breach of duty. Further, the remedy under the above provision was restricted to the money or property so received by the offending officer, be it by way of salary or any payment deemed by the court to be unfair or unjust.[31]

The 1984 Companies Act was repealed in Malawi by the current Companies Act of 2013. The 2013 Companies Act provides, under section 329 and section 330, that matters relating to insolvency of companies incorporated and registered in accordance with the said Act are to be regulated by the 2013 Insolvency Act, which is basically the same 2016 Insolvency Act, given that it was scheduled to be enacted in 2013 but it was

[28] Chimpango, B "The Insolvency Act 2016: Towards Embracing Corporate Rescue Culture in Malawi" *Chase Cambria* Vol 14, Issue 2 (2017) p. 105.

[29] Cap 46:03 of the Laws of Malawi.

[30] Section 2 of the 1984 Companies Act.

[31] Section 299 (2) of the Act.

© University of Pretoria

delayed and it was only enacted and came into force in 2016. Matters relating to insolvency of companies in Malawi are therefore regulated by the Insolvency Act of 2016 as well as the Companies Act of 2013.

1.2.2 The wrongful trading rule and its place under Malawian insolvency law

Section 187 of the Insolvency Act in Malawi, which is the wrongful trading provision, stipulates as follows:

> *(1) Subject to subsection (3), if in the course of the winding-up of a company it appears that subsection (2) applies in relation to a person who is or has been a director of the company, the Court, on the application of the liquidator, may declare that the person is to be liable to make such contribution to the company's assets as the Court thinks proper.*
>
> *(2) This section shall apply in relation to a person if –*
>
> > *(a) the company has gone into insolvent liquidation;*
> >
> > *(b) at some time before the commencement of the winding-up of the company, the person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and*
> >
> > *(c) the person was a director of the company at the time.*
>
> *(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that, after the condition specified in subsection (2)(b) was first satisfied in relation to him, the person took every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken.*
>
> *(4) For the purposes of subsection (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having–*

© University of Pretoria

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

(5) The reference in subsection (4) to the functions carried out in relation to the company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

(6) For the purposes of this section, a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for payment of its debts and other liabilities and the expenses of the winding-up.

(7) In this section, "director" includes a shadow director.

(8) This section shall apply without prejudice to section 186.[32]

The wrongful trading rule is new to the Malawian jurisprudence and, at the time of conducting this research, there was no reported case authority which showed that the courts in Malawi had handled a wrongful trading claim. As such, the legal framework for the operation of the wrongful trading rule in Malawi remains to be defined. If a wrongful trading claim were to be filed in a Malawian court today, the court would face a difficult task of having to research and define the essential elements that must be considered for a successful prosecution of the claim before proceeding to consider whether or not the claim is made out in the circumstances.

---

32 Section 186 of the Insolvency Act of 2016 in Malawi provides for fraudulent trading as follows:

> (1) This section shall apply if in the course of a winding-up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company, or creditors of any other person, or for any fraudulent purpose.
>
> (2) The Court, on the application of the liquidator, may declare that any persons who were knowingly parties to the carrying on of the business in the manner referred to in subsection (1), are to be liable to make such contributions to the company's assets as the court thinks proper.

The inclusion of subsection 187(8) in the provision means that a liquidator is at liberty to open proceedings for fraudulent trading against a director irrespective of the fact that the director already has wrongful trading proceedings opened against him on the same facts.

© University of Pretoria

Further, the court would have to undertake thorough research in order to understand the mischief which the wrongful trading rule was designed to remedy so as to ensure that its interpretation of some key words and phrases under the rule is consistent with giving effect to the intention of parliament when enacting the rule.

The courts would equally need to conduct a broader research in order to ascertain whether the wrongful trading rule is consistent with the international standards of best practices in insolvency law, such as those recommended by UNCITRAL,[33] among others, in order for them to appreciate the need to give effect to the said standards in the implementation of the wrongful trading rule. The same task will befall the legal practitioners wishing to prosecute or defend a wrongful trading action in Malawi, as well as other researchers who may be interested on the subject.

Apart from the absence of a defined legal framework for the operation of the wrongful trading rule in Malawi, the efficacy of the wrongful trading rule in Malawi also remains to be tested. As it would be readily admitted, the fact that the wrongful trading rule remains untested in the Malawian courts and the fact that no research on the rule has so far been done in Malawi entails that there has not been an in-depth discussion regarding the origin of the rule, the aims of the rule and whether or not those aims are achievable given the statutory frame of the rule in Malawi and also considering the context of Malawi's legal environment.

Further, the current COVID-19 pandemic has taught the world that some global phenomena, such as the said COVID-19 pandemic, can cause massive collapses of the businesses of companies in circumstances where director-indifference in the management of the affairs of financially distressed companies (which is the main liability trigger for wrongful trading actions) is greatly subdued by the effects of the COVID-19 pandemic. For this reason, it is being proposed in this study that there ought to be a reconsideration of directors' liability for wrongful trading during the currency of the pandemic in Malawi.

[33] United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April2013).

© University of Pretoria

This is due to the fact that it has become difficult or impossible to isolate which corporate insolvencies that are occurring during the currency of the present COVID-19 pandemic in Malawi are attributable to director-indifference in the running of the affairs of the company and not due to the effects of the pandemic or a mixture of the said effects and the said indifference as for the wrongful trading rule to apply only in cases where the insolvencies emanate from pure director indifference in the running of the affairs of the companies, as was the intention behind the enactment of the rule.

1.3 PURPOSES OF THIS STUDY

In view of the foregoing, this study has two purposes, namely the primary purpose, and the secondary purpose.

1.3.1 Primary purpose

The primary purpose of this study is to define or establish a legal framework for the operation of the wrongful trading rule in Malawi. In fulfilling this purpose, this study will firstly discuss the origin of the wrongful trading rule and the mischief which the rule was designed to remedy. The study will then discuss the conceptual justifications of the rule, as well as the basis of the intention inherent in the rule to upset the well settled principle of separate legal personality by allowing personal liability actions against directors of companies rather than the companies themselves. The study will then discuss the meaning of the term director for purposes of wrongful trading.

Further, the study will discuss the difference between vicinity of insolvency and insolvency. This discussion will be undertaken with the aim of highlighting the fact that liability for wrongful trading arises for beach of the directors' obligations to the company both when the company is navigating the vicinity of insolvency as well as when the company has become insolvent. The study will then discuss other key issues relevant in the legal framework for a successful prosecution of a wrongful trading claim, such as who has standing to commence wrongful trading claims; what are the defences available in the proceedings; what are the remedies available in the proceedings as well as how the wrongful trading actions can be funded.

© University of Pretoria

Having defined the complete legal framework of the wrongful trading rule, the study will then assess whether the said framework complies with the international standards of best practice in insolvency law, such as those recommended by the United Nations Commission for International Trade Law (UNCITRAL) in its legislative guide on insolvency law.

1.3.2 Secondary purpose

The secondary purpose of this study is to interrogate the efficacy of the wrongful trading rule in Malawi. The wrongful trading rule having primarily been enacted as a mechanism for the achievement of creditor protection through the eradication or reduction of preventable insolvent liquidations of companies and through the maximization of the assets of the insolvent estate where insolvent liquidation occurs, the study will interrogate whether, in its current statutory frame, and also during the currency of the present COVID-19 pandemic, the wrongful trading rule is capable of achieving that purpose.

In doing this, the study will isolate the problems that are associated with the wrongful trading rule which are likely to hinder the rule in achieving its intended purpose, as stated above. The study will wind up by making recommendations as to how the identified problems of the wrongful trading rule may be removed or reduced by way of reforming the rule and thereby enhancing its efficacy.

1.4 RESEARCH QUESTIONS

Bearing in mind the purposes of this research as outlined in the foregoing paragraphs, the research questions for this study are the following:

1.4.1 How should directors' civil liability during corporate insolvency be treated under Malawian law in view of the newly enacted wrongful trading rule? Under this grand question, this study will be addressing the following sub-questions;

© University of Pretoria

1.4.1.1 What are the conceptual justifications of the wrongful trading rule?

1.4.1.2 What is the meaning of the term "director" for purposes of the wrongful trading rule in Malawi?

1.4.1.3 What is the difference between vicinity of insolvency and insolvency?

1.4.1.4 What is the nature of directors' obligations to the company when the company is navigating the vicinity of insolvency?

1.4.1.5 What is the nature of directors' obligations to the company when the company has become insolvent?

1.4.1.6 What are the defences available to directors during wrongful trading proceedings?

1.4.1.7 What are the remedies available to a liquidator in wrongful trading proceedings?

1.4.1.8 How are wrongful trading proceedings funded?

1.4.2 Does the Malawian wrongful trading rule have any international relevance? Under this question, the study will be considering whether the wrongful trading rule in Malawi complies with the best practices in insolvency law as recommended by UNCITRAL.

1.4.3 Is the Malawian wrongful trading rule efficacious? Under this broad question, the study will isolate and discuss the problems that are likely to prevent the wrongful trading rule in Malawi from achieving its intended purpose. The discussion will dwell on drafting problems as well as conceptual problems of the rule. The discussion will also, briefly,

© University of Pretoria

discuss the continued applicability of the wrongful trading rule in Malawi during the current COVID-19 pandemic as having the effect of dampening the vibrance of the rule.

1.4.4 Is further law reform required in order to enhance the efficacy of the wrongful trading rule in Malawi? The study will be answering this question in the affirmative and by virtue of this, ways will be recommended through which the problems identified as likely to impact negatively on the efficacy of the wrongful trading rule in Malawi may be remedied by way of reforming the rule.

1.4.5 What are the expected gains of reforming the wrongful trading rule in Malawi? Under this question, the study will provide a projection of the expected gains of reforming the wrongful trading rule in Malawi in the manner recommended in the study. At the very end, and for the reason that this is not a recommendation for reforming the wrongful trading rule, the study will make a recommendation on the applicability of the wrongful trading rule in Malawi during the current COVID-19 pandemic to preserve the rule's vibrance.

1.5 METHODOLOGY

The research was entirely desk-based and it reviewed both primary and secondary sources. Primary sources include legislation relating to corporations as well as insolvency in Malawi. The study also relied on the international standards of best practice on insolvency law, such as the UNCITRAL Legislative Guide on Insolvency law,[34] as well as other law reform reports from comparable jurisdictions.

The secondary sources consulted in this study include journals, articles, theses, books, commentaries, and other forms of scholarly literature from Malawi and the comparable

[34] The United Nations Commission for International Trade Law (UNCITRAL) under its Working Group V (Insolvency Law) *Insolvency Law: Directors' obligations in the period approaching insolvency*: 43rd Session, New York, 15-19 April 2013.

© University of Pretoria

jurisdictions which have corporate law regimes similar to that of Malawi. As Keay and Murray observed,[35] a comparison among jurisdictions with similar corporate law regimes enables a focus on the differences in the respective laws without the impediment of having to consider differences in the structure of the respective legal systems.

The research methodology used in this study will entail an analysis of all the various aspects of the wrongful trading rule under the Malawian law in order to provide a proper basis and understanding of these aspects in view of a comparison of a number of rules similar to the wrongful trading rule in the comparable jurisdictions.

Owing to the fact that the wrongful trading rule is new in Malawi and that the Malawian courts are yet to hear a case based on the rule, and also considering that no research has been done on the rule in Malawi, there is no literature on the wrongful trading rule in Malawi. In view of this fact, a comparative study of this research will consider sources from the following jurisdictions and for the following reasons:

1.5.1 **United Kingdom; The primary comparable jurisdiction**

The wrongful trading rule in Malawi was copied verbatim from section 214 of the UK Insolvency Act of 1986 where the rule is similarly referred to as the wrongful trading rule. The wrongful trading rule has been in existence in the United Kingdom for over the past three decades. The origin of the wrongful trading rule in the United Kingdom can be traced back to the recommendations of the Cork Committee in 1982.[36] Over the past three decades, the wrongful trading rule in the United Kingdom has been tremendously litigated on, researched on and written upon. The rule has also undergone a number of reforms in the United Kingdom. In view of the foregoing, United Kingdom is the primary comparable jurisdiction in this study.

35 Keay, A and Murray, M "Making Company Directors Liable: A comparative analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" (2005) *Int. Insolv. Rev*. Vol 14, 28 available online at www.interscience.wiley.com (accessed on 1st July 2018).

36 For a detailed discussion of the origin of the wrongful trading rule, see chapter 2 of this study.

© University of Pretoria

1.5.2 Secondary comparable jurisdictions

1.5.2.1 South Africa

This study has also relied on sources from South Africa. Apart from the fact that the study was conducted at the University of Pretoria in South Africa, and therefore that it was relatively easy to find South African sources, South Africa was also chosen based on the need to have a comparative study from an African jurisdiction, particularly one that belongs to the same regional trade community with Malawi. South Africa and Malawi belong to the Southern African Development Community (SADC).

1.5.2.2 Australia

Australia was chosen as a common law jurisdiction whose equivalent of the wrongful trading rule, known as the insolvent trading rule, is drafted differently from the wrongful trading rule in Malawi and the United Kingdom, although it embodies the same purpose of creating personal liability against directors of financially distressed companies for their breach of duties towards the companies when the companies are eventually liquidated. Having been enacted in 2001 under the Corporations Act,[37] and having been heavily litigated on and written upon, as well as having undergone a number of reforms to this date, the Australian insolvent trading rule provided a useful comparison to the wrongful trading rule in Malawi.

1.5.3 Other jurisdictions

There were instances in the conduct of this study where the material that was needed could not be found from the United Kingdom, South Africa or Australia or indeed where, although the material could be found from these three jurisdictions, an interesting position from jurisdictions other than these three was worth noting. Based on this, the study also consulted material from other jurisdictions, notably the United States of America, New Zealand, Canada and the Republic of Ireland.

As it would be noted, the jurisdictions chosen for comparison in this study have the historic origins of their corporate insolvency law in English common law since the

[37] Act No. 50 of 2001.

© University of Pretoria

Malawian law is steeped in the English law principles – especially regarding its commercial laws. In the study of legal origins and finance, it was established that there tends to be differences as to how rights in economic transactions are approached in systems based in English common law and those based on French civil law, for instance.[38] When insolvency law systems were considered, it was found that insolvency law systems originating from French civil law are characterized by "excessive formalism" when compared with those based on English common law origins and they were, therefore, deemed not to be suitable for comparative work envisaged by this thesis.[39]

1.6 REASONS FOR AND SIGNIFICANCE OF THE STUDY

1.6.1 **Reasons for the study**

A study of the wrongful trading rule in Malawi is important and vital for the establishment of a legal framework for the operation of the rule in Malawi as well as for the determination of the efficacy of the rule in Malawi. Much as it could be argued that when copying the rule from the UK Insolvency Act, the desire was to let the English legal framework of the rule to apply *mutatis mutandis* in Malawi, this is not fully achievable considering that the legal environment in the United Kingdom is different from the Malawian legal environment and therefore the legal framework of the UK wrongful trading rule cannot fit perfectly into the Malawian legal environment. Some of the reasons why the UK legal framework of the wrongful trading rule cannot fit into the Malawian legal environment are as follows:

First, although the wrongful trading rule in Malawi was copied verbatim from the UK Insolvency Act, the UK wrongful trading rule has recently undergone a number of reforms so that presently, the UK rule is different from the Malawian rule.[40] For

38 Rafael La Porta and others, 'Law and Finance' (1998) 106 Journal of political economy 1113; Thorsten Beck, Asli Demirgüç-Kunt and Ross Levine, 'Law and Finance: Why Does Legal Origin Matter?' (2003) 31 Journal of comparative economics 653.

39 Simeon Djankov and others, 'Debt Enforcement around the World' (2008) 116 Journal of political economy 1105.

40 On 26th March 2016, the Small Business, Enterprise and Employment Act 2015 ("the SBEEA") obtained Royal Assent in the United Kingdom. The SBEEA introduced a number of changes to the UK Insolvency

© University of Pretoria

instance, one of the changes brought by the recent reforms to the UK rule is that the rule is no longer restricted to companies that go into insolvent liquidations, but that it is also available to companies that go into administration.[41] Further, another recent reform to the UK rule is to the effect that a liquidator is now at liberty to assign wrongful trading causes of actions and proceeds thereof to third parties who may be willing to provide funding for the prosecution of wrongful trading claims.[42]

These recent changes to the UK wrongful trading rule, which are not in the Malawian wrongful trading rule, entail that Malawi cannot fully adopt the legal framework of the English wrongful trading rule as the rules are now shaped differently although they primarily serve a similar purpose.

Second, there is a fundamental difference in the meaning of "insolvency" between the UK Insolvency Act and Malawian Insolvency Act. Under the UK Insolvency Act, the fact of assets of a company being fewer than its liabilities is taken to be proof of insolvency of a company,[43] while the same fact is not taken to be proof of insolvency under the Insolvency Act in Malawi but rather a mere indication that the company is navigating the vicinity of insolvency.[44] This difference entails that the directors' creditor-regarding duties in the UK and Malawian companies arise at different times.

Making this observation about the UK definition of insolvency, Davies[45] has contended that in the present state of the UK legal framework, the creditor-regarding duties under wrongful trading which are triggered only when the company is insolvent operate too late. According to the learned commentator, the creditor-regarding duties should be

Act of 1986 which were predicated on the need to streamline insolvency processes and removing unnecessary administrative hurdles.

41 Section 246ZB (2)(1) of the Insolvency Act of 1986.

42 Section 246ZD of the Insolvency Act of 1986 as read with Section 246ZD (2)(b) of the Act.

43 Section 123(2) of the Insolvency Act 1986.

44 Section 107(4)(b) of the Insolvency Act in Malawi which deals with winding up of insolvent companies is to the effect that a company in Malawi can be wound up if it is unable to pay its debts as they fall due, and not when its assets are fewer than its liabilities.

45 Davies, P "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency" (2006) 7 *European Business Organization Law Review* 329.

© University of Pretoria

imposed at the time at which the directors' incentives to adopt overly risky strategies become effective, which is; the time when the shareholders' equity has become negligible or is likely to do so,[46] namely, the time when the company is approaching insolvency, and not when it is already insolvent.

Wrongful trading being a mechanism which imposes liability on directors of companies for their failure to fulfil their creditor-regarding duties from the moment their companies begin to navigate the vicinity of insolvency, it is clear that the difference in the definition of insolvency between Malawi and the United Kingdom as observed above entails that the liability triggers of the wrongful trading rule in the UK and in Malawi are different, hence the legal framework and the efficacy of the wrongful trading rule in the two jurisdictions cannot be the same.

Thirdly, the UK position, where creditor-regarding duties of directors of companies arise when the company is insolvent rather than when it is of doubtful solvency, is also not in keeping with the international standards of best practice in insolvency law, such as those recommended by UNCITRAL.[47] Under the UNCITRAL recommendations, the said creditor-regarding duties of directors are required to arise from the moment a company begins to navigate the vicinity of insolvency, and not when the company is insolvent as is the case under the UK Insolvency Act. The title of the UNCITRAL *Guide* which makes the above recommendations is even self-explanatory as it reads: "*Directors' obligations in the period approaching insolvency"* and not in the period of insolvency.[48]

Other jurisdictions seem to favor the Malawian position as opposed to the English position. In the American case of *Credit Lyonnais Bank Nederland NV vs Pathe*

---

46 Ibid. See also Bachner, T "Wrongful trading – A new European model for creditor Protection?" (2004) 5 *European Business Organization Review*, 293, who equally argues that the creditor- regarding duties under the English framework of wrongful trading operate too late into the company's economic decline.

47 United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April2013).

48 Ibid.

© University of Pretoria

Communications Corp.,[49] the court emphatically remarked that the creditor-regarding duties of company directors need to be triggered when the company is operating in the vicinity of insolvency and not when a company is insolvent. It is interesting to note the willingness of New Zealand courts to let these creditor-regarding duties to trigger even further back into the solvent life of companies as was the case in *Nicholson vs Permakraft (NZ) Ltd*[50] where the court held that these duties must be triggered at any time in the solvent life of the company where a contemplated course of action by the directors would jeopardize the company's solvency.

Cognizant of the fact that the UK insolvency law has been overtaken by the modern trends in insolvency law as observed above, on 26th August 2018, the Government of the United Kingdom announced that it will legislate to update the restructuring and insolvency systems. The UK Government announced that these intended reforms are a response to international developments and some domestic corporate collapses which have put the United Kingdom system under stress. Among the areas of intended reforms in England is the introduction of a new stand-alone restructuring procedure and the introduction of a greater accountability for directors of distressed companies.[51] This makes it clear that even the UK legal framework of the wrongful trading rule is bound to change very soon, and therefore Malawi cannot depend on it.

In view of the foregoing, it would be clear that Malawi needs to define its own legal framework for wrongful trading and assess the efficacy of its own wrongful trading rule based on its statutory frame of the rule, its definition of insolvency, its compliance with the internationally recommended standards of best practice in insolvency law and its general legal environment, all of which factors are different from those obtaining in United Kingdom from where the rule was copied.

1.6.2 Significance of the study

---

49 Printed in Delaware Journal of Corporate Law (1992) p. 1009.

50 (1985) 1 NZLR 242.

51 Nick Moser; reporting for Taylor Wessing, available online and accessed on 18th February 2019 at http://united-kingdom.taylorwessing.com/en/insights/rcr-update/major-uk-restructuring-and-insolvency-reforms-announced

© University of Pretoria

This study is significant as it contributes to the development of a robust insolvency system, particularly on the treatment of directors of financially distressed companies in Malawi. As it has been observed by Boraine and van Wyk,[52] a suitable insolvency system is necessary for economic growth and business development.[53] The study is also significant as it promotes two important theories of insolvency law, namely, creditor protection and deterrence to director indifference in the running of the affairs of financially distressed companies. The study also has specific significances to Malawi and the comparable jurisdictions as follows:

1.6.2.1 Malawi

This study is significant for Malawi as it seeks to define a legal framework for the operation of the wrongful trading rule in the country. The study is also significant in that it assesses the efficacy of the wrongful trading rule in Malawi. It is submitted that defining a legal framework of the wrongful trading rule and assessing the efficacy of the rule in Malawi results in a valuable contribution to the development of the Malawian insolvency law.

Further, as it will be discussed in chapter 8 herein, the wrongful trading rule is in keeping with the modern trends in insolvency law, such as the UNCITRAL recommendations on the treatment of directors of financially distressed companies.[54] In this vein, the study is also significant in that it highlights Malawi's compliance with the internationally recommended standards of best practice in insolvency law.

---

52 Boraine, A and van Wyk, J "Various Aspects to Consider with Regard to Special Insolvency Rules for Small and Medium-Sized Enterprises in South Africa" (2016) *International Insolvency Review*, v25 3-35, 11 accessed online on 13th May 2017 at https://UnivofPretoria.on.worldcat.org/oclc/5982844292

53 It has been observed that "a robust bankruptcy system functions as a filter, ensuring the survival of economically efficient companies and reallocating the resources of the inefficient ones. Fast and cheap insolvency proceedings result in the speedy return of businesses to normal operation and increase returns to creditors. By improving the expectations of creditors and debtors about the outcome of insolvency proceedings, well-functioning insolvency systems can facilitate access to finance, save more viable businesses and thereby improve growth and sustainability in the economy overall."; World Bank Doing Business 2014: Understanding Regulations for Small and Medium-size Enterprises. Washington, DC: World Bank Group (country profile: South Africa) 2013 (DOI: 10.1596/978-0-8213-9615-5)http://doingbusiness.org/reports/globalreports/~/media/giawb/doing%20business/documents/profiles/country/ZAF.pdf accessed on 13th May 2017, page 92.

54 The United Nations Commission for International Trade Law (UNCITRAL) under its Working Group V (Insolvency Law) *Insolvency Law: Directors' obligations in the period approaching insolvency*: (43rd Session, New York, 15-19 April 2013), p 5.

© University of Pretoria

1.6.2.2 United Kingdom

The study is equally significant for United Kingdom. Much as the UK wrongful trading rule has recently been reformed so that it is currently slightly different from the Malawian rule, the UK rule, when considered along with the UK definition of insolvency as it has been observed above, is not in keeping with the internationally recommended standards of best practice in insolvency law.

This fact has been admitted by the UK Government and it is a reason why the Government announced plans to reform its insolvency law particularly the aspect of the treatment of directors of financially distressed companies.[55] On this basis, this study, which is based on the wrongful trading rule which is in keeping with the internationally recommended standards of best practice in insolvency law, may provide a useful guidance in UK's quest to reform its wrongful trading rule.

1.6.2.3 South Africa

The study is also significant for South Africa where it was conducted. Apart from the South African corporate insolvency laws being heavily influenced by English law and therefore sharing a number of corporate law principles with Malawi, United Kingdom and Australia, South Africa has a provision, loosely referred to as the reckless trading provision, which, although crafted differently, has similar purposes with the wrongful trading provision in Malawi, namely, to provide for personal liability for director-indifference in the running of the affairs of a company.

The South African reckless trading rule comes from section 424 of the repealed 1973 Companies Act and it is still applicable by virtue of part of the repealed Act, Chapter 14, having been saved.[56] South Africa will not carry on using an old provision in a

---

55 Nick Moser; reporting for Taylor Wessing, available online and accessed on 18th February, 2019 at http://united-kingdom.taylorwessing.com/en/insights/rcr-update/major-uk-restructuring-and-insolvency-reforms-announced

56 It must be noted that the entire provisions relating to corporate insolvency procedures in the repealed 1973 Companies Act in South Africa were retained by the 2008 Companies Act, s 224 it 9 sch 5. The reason for this was the desire to have these provisions incorporated into a comprehensive legislation regulating insolvency and business rescue. This is clear from the 2004 policy framework; Department of Trade and Industry *South African Company Law for the 21st Century: Guidelines for Corporate Law*

© University of Pretoria

partly repealed Act forever. The new South African Companies Act of 2008 does not have any provision imposing liability on directors for their conduct during a period leading to insolvent liquidation of their companies.[57] From this, it becomes clear that the South African reckless trading rule is an old rule and it is due for reform.[58] In this vein, this study is significant for South Africa as it may illuminate a reform option that takes account of the internationally recommended standards of best practice in insolvency law.[59]

1.6.2.4 Australia

The study is also significant for Australia as a common law jurisdiction which shares some corporate law principles with Malawi, United Kingdom and South Africa.

Reform May 2004 (2004) 10, available online and accessed on November 23 2020 at http://0-discover.sabinet.co.za.innopac.up.ac.za/webx/access/policydocuments/policies04/DD078362.pdf

57 Note, however, that section 22(1) of the Companies Act 71 of 2008 simply prohibits the carrying on of the business of a company recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose. Section 22(2) of the said Act empowers the Companies and Intellectual Property Commission to issues a notice to the company which engages in the above prohibited conduct to show cause why the company should be permitted to continue carrying on its business. Where the company fails to show cause as required in section 22(2) of the Act, the Commission may, under section 22(3) of the Act, issue a compliance notice to the company requiring it to cease carrying on its business. As it will be appreciated, these three provisions have nothing to do with the liability of a director in the company that engages in the said prohibited conduct, and therefore the provisions are outside the scope of this study.

58 In 2004, the Department of Trade and Industry in South Africa released a policy document titled *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform,* 3 and s7(a) available online and accessed on November 23 2020 at http://0-discover.sabinet.co.za.innopac.up.ac.za/webx/access/policydocuments/policies04/DD078362.pdf. In that document, the Department of Trade acknowledged that South Africa has no extensive statutory dispensation that covers the duties of directors and their accountability where they fail to discharge such duties. The document recognized the need to bring South African company law in tandem with international trends and to reflect and accommodate the changing environment of business both locally and internationally while maintaining, encouraging and promoting compliance with the Bill or Rights enshrined in the South African Constitution. Further, as it has been observed by Havenga, M "Creditors, Directors and Personal Liability under section 424 of the Companies Act" 1992 *SA Merc LJ* 63 69, the uncertainty that exists with regard to the party to whom the court may order the compensation envisaged by the reckless trading rule in South Africa shows that the rule is in need of amendment in this respect in order for it to 'become a truly effective remedy in the hands of company creditors.'

59 Boraine, A and van Wyk, J "The application of the 'repealed' Companies Act 61 of 1973 to liquidation proceedings of insolvent companies" (2013) *De Jure* v46 644-683 at p 650 available online at https://UnivofPretoria.on.worldcat.org/oclc/8598486759 accessed on November 23 2020, have argued that the provisions of Chapter 14 of the repealed 1973 Companies Act pertaining to liquidation of insolvent companies cannot be read in isolation and that, practically, reliance may be placed on the provisions of the 1973 Companies Act which were not saved by the 2008 Companies Act. It is submitted that the predicament which South Africa is in, by having to be relying on provisions of a repealed Act, go a long way to show that the South African corporate insolvency law is in need of reform.

© University of Pretoria

Further, Australia has its own version of the wrongful trading rule, the insolvent trading rule, which is crafted differently from the Malawian and the UK rule, but which is predicated on the same goal with the rule in Malawi, UK and South Africa, namely, the imposition of personal liability on directors for their indifference in the running of the affairs of financially distresses companies.

Apart from defining the legal framework of the wrongful trading rule in Malawi, this study assesses the efficacy of the rule and in the end, it makes recommendations on how the rule may be improved to enhance its efficacy. The recommendations derive from parts of the insolvent trading rule in Australia, as well as parts of the UK and the Malawian rules. The recommendations may therefore be significant as they may give an insight on how the Australian insolvent trading rule may equally be improved if the need is felt in future.

1.6.2.5 Doctrinal significance of the study: creditor protection and deterrence to director-indifference.

As it will emerge clearly, this study promotes two important theories of insolvency law. Firstly, the study promotes the theory that insolvency law should not only seek to realize assets of a company during insolvent liquidation and distribute them among creditors, but that it should also seek to investigate if the conduct of the directors during a period leading to the said insolvent liquidation was geared towards rescuing the company from liquidation or minimizing potential losses to creditors where the company could not be rescued from insolvent liquidation.

Secondly, apart from providing for mechanisms on how the insolvent estate may be increased for the benefit of creditors, the study promotes the theory that where the conduct of the directors during the period leading to the insolvent liquidation is found not to have been geared towards rescuing the company from liquidation, or minimizing the potential losses to the company's creditors, insolvency law must provide sanctions to the said directors by imposing personal liability against them for the loss suffered by the creditors by virtue of the insolvent liquidation.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

While the first theory stands for creditor protection, the second theory has the potential of achieving deterrence to director-indifference in the running of the affairs of companies, a fact which may breed effective management of companies and, ultimately, the prevention of avoidable insolvent liquidations of companies.

1.7 SCOPE AND LIMITATIONS OF THE STUDY

The scope of this study is limited to defining the legal framework for the operation of the wrongful trading rule in Malawi as the main purpose, and to assessing the efficacy of the wrongful trading rule in Malawi as the secondary purpose. In defining the legal framework of the rule, the study will discuss the basis of liability for wrongful trading, namely, breach of directorial duties that arise both when a company is approaching insolvency and when it has become insolvent. The study will then discuss the meaning of directors for purposes of wrongful trading, the defences available to the directors during the wrongful trading proceedings, the remedies in the proceedings as well as the question of funding of wrongful trading proceedings.

In assessing the efficacy of the rule, the study will go back to the origin of the rule, namely the recommendations of the Cork Committee in the United Kingdom in 1982.[60] This will be done in order to discover the mischief which the Cork Committee intended to remedy by recommending the enactment of the wrongful trading rule in the United Kingdom. The rule having been adopted in Malawi, it will be assumed that the wrongful trading rule in Malawi is intended to address the same concerns which were felt when the rule was conceived by the Cork Committee in the United Kingdom. For this reason, the study will assess the efficacy of the wrongful trading rule by considering whether, in its current statutory form in Malawi, and considering the legal environment that surrounds the rule in Malawi, the rule is capable of achieving its intended purposes.

If the rule is found to be lacking in some material respects, the study will make recommendations on how the rule may be improved to enhance its efficacy. If the said recommendations are made, the study will wind up by giving a summary of the recommendations and an outlook of the reformed wrongful trading rule. At the very

---

60 "Insolvency law and practice: Report of the Review Committee" (Chairman, Sir Kenneth Cork) Cmnd. 8558 (1982), also known as The Cork Report.

© University of Pretoria

end, the study will discuss the expected gains of reforming the wrongful trading rule in the recommended ways.

As far as the availability of sources during this study was concerned, apart from the wrongful trading provision itself in section 187 of the Insolvency Act of 2016 in Malawi and the Companies Act of 2013 in Malawi, it has been impossible to find sources relating to the wrongful trading rule in Malawi. This is due to the fact that the wrongful trading rule is new to the Malawian jurisprudence as it only came with the 2016 Insolvency Act, and that prior to the coming into force of the said Act, Malawi did not have any rule providing for directors' civil liability for breach of their obligations to financially distressed companies. Further, since the enactment of the wrongful trading rule in Malawi, no wrongful trading case has been heard by the Malawian courts, and no research has been done on wrongful trading in Malawi.

By reason of the foregoing reasons, apart from the Insolvency Act of 2016 as well as the Companies Act of 2013 in Malawi, this study relied on sources from the comparable jurisdictions. The study primarily relied on sources from the United Kingdom from where the wrongful trading rule in Malawi was copied, and where the rule has been in existence for more than three decades. The study also relied on sources from South Africa and Australia which have rules serving a purpose similar to the Malawian wrongful trading rule, although their said rules are drafted differently with the Malawian rule. Where necessary, the study made use of sources from other jurisdictions other than the above, notably the United States of America, New Zealand, Canada and the Republic of Ireland.

Although reliance was made on sources from the said comparable jurisdictions, it remains to be highlighted that this area of law has not been heavily written on or litigated upon. For this reason, the researcher herein could not find more than the resources available in this area as consulted in this study.[61]

61 Even in South Africa, one of the jurisdictions from where a comparative study of this research is undertaken, the paucity of materials relevant to this study can be felt from the observation made in 2008 Van der Linde K, "The Personal Liability of Directors for Corporate Fault – An Exploration" (2008) 20 *SA Merc LJ* 439, who submits that there has not been, in South Africa, a systematic study of the nature and scope of directors' personal liability for corporate conduct.

© University of Pretoria

1.8 CHAPTER CONCLUSION

This chapter has set out the most important facts in insolvency law, namely, that insolvency of companies and individuals will usually occur and that in case of insolvency of companies, the assets of the company will usually be insufficient for distribution to all creditors. Based on the foregoing, it has been contended in this chapter that rather than wishing that insolvency never occurred, it is prudent to prepare for what happens when insolvency occurs.

The chapter has, then, introduced the wrongful trading rule as one of the mechanisms that must be employed when insolvency of companies occurs with the aim of maximizing the assets of the insolvent company for distribution to creditors, as well as penalizing directors for their indifference in the running of the affairs of the company when the company was faced with insolvency. The penalty provided by the wrongful trading rule is by way of imposing personal liability on the said directors for the loss suffered by the company's creditors once the company goes into insolvent liquidation. The chapter has then outlined the wrongful trading rule in full as it is in section 187 of the Insolvency Act of 2016 in Malawi, while highlighting the fact that the rule is new to the Malawian jurisprudence, having been copied verbatim from section 214 of the Insolvency Act of 1986 in the United Kingdom.

From this general overview, this chapter has gone on to outline the purposes of this study, namely, to define a legal framework of the wrongful trading rule in Malawi where the courts are yet to hear a wrongful trading case since the enactment of the rule, and to assess the efficacy of the rule, considering the statutory frame of the rule in Malawi and also considering the Malawian legal environment. The chapter has made it clear that the study will primarily rely on sources from the United Kingdom from where the rule was adopted and where the rule has been in operation since 1986. The chapter has then indicated that it will also rely on sources from secondary comparable

Further, in Australia, another jurisdiction from where a comparative study of this study is undertaken, the Corporations and Markets Advisory Committee (CAMAC) conducted an inquiry into the personal liability of company directors for corporate fault. The report: CAMAC *Personal Liability for Corporate Fault Report* (2006), accessed online on 26th June 2019 at www.camac.gov.au revealed that even under Australian corporate law, there exists a lack of coherence between the requirements and justifications for different instances of derivative liability sought to be imposed on directors of companies. This fact shows that the area of director liability during corporate insolvency, to which this study relates, is equally not fully developed in Australia and hence the paucity of materials even from this jurisdiction.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

jurisdictions, namely, South Africa, and Australia, as well as other jurisdictions where necessary.

In view of the purposes of the study outlined in the above paragraph, the chapter has provided the research questions that will be addressed across this study. The chapter has then provided the reasons for the study, which centre on the fact that although the expectation when adopting the wrongful trading rule from the United Kingdom was to let the UK legal framework of the rule to apply *mutatis mutandis* in Malawi, the UK legal environment is different from the Malawian legal environment and therefore that the UK legal framework of its wrongful trading rule cannot be adopted in Malawi and therefore that Malawi needs to define its own legal framework and assess the efficacy of its own wrongful trading rule.

The chapter has then discussed the significance of the study for Malawi, United Kingdom, South Africa, and Australia as well as the general doctrinal significance of the study. The chapter winds up by outlining the methodology employed in the study as well as the scope and limitations of the study.

The most important highlight on the limitations of this study is that the area of director liability during corporate insolvency has not been heavily written on or litigated upon. For this reason, there was, during the conduct of this study, a relative paucity of materials on the subject. However, all available materials relevant to the subject were consulted.

© University of Pretoria

CHAPTER 2

CONCEPTUAL JUSTIFICATIONS OF THE WRONGFUL TRADING RULE

SUMMARY

2.1 Introduction……………………………………………………………38

2.2 Origin of the wrongful trading rule……………………………...………40

2.3 The doctrine of separate legal personality

and the aims of the wrongful trading rule…………………………………45

2.4 Aims of the wrongful trading rule and whether they are a justifiable

basis for imposition of personal liability on directors of companies…..…57

2.5 Relevance of economic theory to directors' liability…...…………………..77

2.6 Chapter conclusion…………………………………………………….....79

2.1 INTRODUCTION

The main research question of this study being to answer the question of how directors' civil liability during corporate insolvency should be treated under Malawian law in view of the newly adopted wrongful trading rule, this chapter is dedicated to answering the first sub-question of the said main question, namely, "what are the conceptual justifications of the wrongful trading rule?" Answering this question is pertinent in this study as it highlights the importance of the wrongful trading rule under the Malawian insolvency law.

The wrongful trading rule is a recent mechanism under insolvency law and its notion is a departure from the traditional position that when a company incurs debts, only the company alone is responsible for the repayment of the said debts and that the creditors are precluded from looking to the directors or shareholders of the company for

© University of Pretoria

repayment of any of such debts or any shortfall arising as a result of the company's insolvency.[62]

As it will be clear, besides the wrongful trading rule being a new mechanism in corporate law, the rule also upsets a well settled corporate law principle of separate legal personality by permitting personal liability actions against directors who are mere agents of the companies on the basis of protecting creditor interests, which interests have all along been protected under other legal principles. For this reason, it is pertinent to discuss the place of the wrongful trading rule in corporate law generally as well as why it was felt necessary to enact such a rule at the expense of the well settled principle of separate legal personality and thereby allowing the lifting of corporate veils of companies to expose directors to liabilities which they would not be exposed to without the rule.

In doing this, this chapter will begin by discussing the origin of the wrongful trading rule with particular highlight being placed on the mischief which the rule was designed to remedy. The study will then discuss the rationale behind the enactment of the rule, namely, the concern on director indifference in the running of the affairs of financially distressed companies.

From the foregoing, this chapter will then discuss the doctrine of separate legal personality in corporate law in relation to the aims of the wrongful trading rule, namely, creditor protection and penalization of director indifference in the running of the affairs of financially distressed companies. The discussion will also touch on whether the wrongful trading rule does not seek to over-protect creditors who are already protected elsewhere under the law. The aim of this discussion will be to highlight the importance of the aims of the wrongful trading rule as a justification of the rule transcending the well-established principle of separate legal personality to permit personal liability actions against directors of companies even though the said directors are mere agents of the companies.

---

[62] Rajak, H "Director and officer liability in the zone of insolvency: A comparative analysis" (2008) *PER* Vol.11 n.1, 1.

© University of Pretoria

The discussion will commence with a general overview of the doctrine of separate legal personality as it was set in the case of *Salomon vs A Salomon & Co Ltd*[63] and the effect which the doctrine has had on the plight of creditors of companies. The chapter will then discuss the common law response to the *Salomon* decision as well as the legislative response to the decision. This discussion will be relevant as it will highlight the problem which was created by the *Salomon* decision and how both the courts and the legislature have, over the years, attempted to alleviate the effects of the problem.

On the part of the legislative endeavor to alleviate the problem created by the *Salomon* decision, this discussion will, most importantly, reveal that the enactment of the wrongful trading rule is one of the ways through which the legislature continues to grapple with the effects of the *Salomon* decision. From the discussion on the foregoing, the basis and the need for the wrongful trading rule to upset the doctrine of separate legal personality will become clear. At the very end, the relevance of economic theory to directors' liability will be briefly discussed.

2.2 ORIGIN OF THE WRONGFUL TRADING RULE

The wrongful trading rule originated from English law. The rule came about as a result of the desire to have a statutory rule that created liability against directors of companies for conduct that led to or contributed to the collapse of their companies. At the time when this was contemplated, English law already had a statutory provision that enabled a liquidator to seek contribution to the company's insolvent estate from directors whose actions prior to the insolvent liquidation amounted to what was termed fraudulent trading.

The fraudulent trading rule was first enacted under English law in 1929[64] and it is currently embodied in the 1986 Insolvency Act in the United Kingdom.[65] The fraudulent trading rule, however, proved to be unsatisfactory from its inception. Firstly, the drafting of the provision was perceived to be infelicitous and, secondly, the

63 (1897) AC 22 HL.

64 Section 275 of the Companies Act of 1929.

65 Section 186 of the Insolvency Act.

© University of Pretoria

requirement to prove dishonesty to the criminal standard on the part of a respondent in fraudulent trading proceedings proved to be unduly onerous.[66]

During the era when only the fraudulent trading rule existed under English law, directors of companies could allow a company to continue trading even when the company was insolvent, provided that they had a genuine belief that the clouds of financial distress would roll away and the sunshine of financial prosperity would resurface upon the company again.[67] As a result of this position, an owner-director, like the respondent in *Re Patrick Lyon Ltd*,[68] who had allowed his company to continue trading with full knowledge that the company was insolvent but with the sole aim of validating a floating charge in his own favour, could escape liability for fraudulent trading because his action, although improper, could not be shown to have been motivated by dishonesty.

Further, due to the difficulty in proving dishonesty to the criminal standard, many cases brought under the fraudulent trading provision failed and this left a burden of costs against the applicants of the unsuccessful proceedings.[69] Such expenses had to be shouldered by the whole body of creditors even though the action might have been taken by a liquidator, and in circumstances where creditors were applicants, the expenses were to be shouldered by the creditors themselves. According to Pasban,[70] the result of the foregoing was disappointing for the applicants in fraudulent trading proceedings as well as creditors who suffered loss through directors' delinquency and sought legal redress.

66 Odittah, F "Wrongful Trading" (1990) *L.M.C.L.Q.* 205, 206. See also *Re Patrick & Lyon Ltd* (1933) Ch. 786.

67 *Re White & Osmond (Parkstone) Ltd*. (1960) 30 July Unreported.

68 (1933) Ch. 786.

69 See for example *Re Patrick & Lyon Ltd* (1933) Ch. 786, 790; *Augustus Barnett & Son Ltd* (1986) BCLC 170; *Re Gerald Cooper Chemicals* (1978) 2 All ER 49,53.

70 Pasban, MR "*Directors' Duties and Liabilities in Corporate Insolvency in England and the US*" PhD Thesis, (1996) University of Sheffield, 66.

© University of Pretoria

Another hurdle with the fraudulent trading rule was the lack of clear guidelines for applicants seeking to establish dishonesty, which was the main liability element of the rule. As observed by Pasban,[71] it is not surprising that due to this hurdle, a judge could come up with contrasting decisions in two cases with almost similar facts as it happened in *Re William C. Leitch Brothers Ltd*[72] and in *Re Patrick and Lyon Ltd.*[73] The wrongful trading rule was therefore contemplated under English law out of frustration at the perceived failure of the fraudulent trading rule.[74]

Due to the problems that surrounded the fraudulent trading rule, the Cork Committee proposed an alternative route for the affected creditors to seek compensation which had to be based on unreasonable, rather than fraudulent, conduct of the directors.[75] For this reason, in 1962 the Jenkins Committee noted what was recorded as the:

> …widespread criticism that the Companies Act as a whole does not at present deal adequately with the situation arising from fraud and incompetence on the part of directors particularly directors of insolvent companies.[76]

While the fraudulent trading rule could be seen to combat fraud on the part of the directors in the running of the business of the company, although inadequately due to the challenges outlined above, the other part of the above quoted note, namely, *incompetence on the part of directors of insolvent companies*, was left unchecked thereby raising concerns about the success of corporations which were in financial distress. In view of the foregoing, the Jenkins Committee went on to recommend an extension of the law, to the effect that:

> Directors and others, who have carried on the business of the company in a reckless manner [should be] personally responsible without limitation of liability, for all or any of the debts or

---

71 Ibid.

72 (1932) 2 Ch. 71.

73 (1933) Ch. 78

74 Mokal, R "An agency cost analysis of the wrongful trading provisions: Redistribution, perverse incentives and the creditors' bargain" (2000) 59 *Cambridge Law Journal* 335 at 339.

75 Pasban, MR "*Directors' Duties and Liabilities in Corporate Insolvency in England and the US*" PhD Thesis, (1996) University of Sheffield, 67.

76 Report of the Company Law Committee, at par 497.

© University of Pretoria

> liabilities of the company if the court so declares on the application of the official receiver or the liquidator or any creditor or contributory of the company.[77]

The recommendation was not immediately acted upon by the British Government, but the issue was further discussed by the Cork Committee[78] which recommended as follows:

> The opportunity to implement these or any analogous proposals has never been taken, with the result that there is now universal dissatisfaction and frustration with this branch of the law. This is to be particularly deplored because it breeds both disrespect and contempt for the law in a context where there is need to enlist public support in an endeavor to promote the highest standards of business probity and competence.[79]

The Cork Committee also identified a further mischief in the position of the law as it stood then, namely, that it was very easy for directors and other officers of the company to continue to defraud creditors by trading through newly created companies, in which there was a possibility of them selling the few remaining assets of the failed company to the new company at "knock down" prices leaving creditors unpaid and the errant directors not only scot free, but also benefiting from their malpractice.[80] In view of the foregoing, the Cork Committee recommended the introduction, into the English law, of a statutory provision that would remedy all these mischiefs, observing that:

> It is right that it should be an offence to carry on a business dishonestly; and right, that, in the absence of dishonesty, no offence should be committed. Where, however, what is in question is not the punishment of an offender, but the provision of a civil remedy for those who have suffered financial loss, a requirement that dishonesty be proved is inappropriate. Compensation ought…to be available to those who suffer foreseeable loss as a result, not only of fraudulent, but also of unreasonable behavior.[81]

---

[77] Ibid, para 503 (b).

[78] Report of the Review Committee on Insolvency Law and Practice (1982) Cmnd 8558) 1782, also known as the "Cork Report." Note that this report, chaired by Kenneth Cork, followed an investigation on the reform and modernization of insolvency law in the United Kingdom. The recommendations set in the report were followed by a White Paper in 1984, "A revised framework for insolvency law, (Cmnd 9175 (1984), accessed on line on 13th May 2019 at https://www.amazon.co.uk/Revised-Framework-Insolvency-Law-Cmnd/dp/0101917503, and these led to the enactment of the Insolvency Act 1986.

[79] Ibid, para 1738.

[80] Ibid, para 741-743.

[81] Ibid, para 1777.

© University of Pretoria

According to Keay,[82] what the Cork Committee envisaged was a piece of legislation that would encourage company directors to satisfy themselves regarding the company's ability to discharge its financial commitments as it continued to trade. Where the company is unable to fulfil its financial obligations, the Cork Committee expected the said legislation to place an active duty on the directors to cause the company to cease trading and therefore cut on the losses to creditors. This is clear from the report of the Cork Committee when it said:

> …if the directors at any time consider the company to be insolvent, they should have a duty to take immediate steps for the company to be placed in receivership, administration or liquidation. Failure to do so would normally expose any director who is a party to the company's continued trading to civil liability.[83]

Having noted that the existing fraudulent trading rule did not provide sufficient incentives to directors of insolvent companies to take steps to prevent further loss to their companies' creditors,[84] and also that there was a gap in personal liability rules regarding directors who acted honestly in the management of the affairs of their companies so as not to be caught by the fraudulent trading rule, but who acted recklessly or unreasonably when faced with insolvency of their said corporations,[85] the Cork Committee observed that:

> No one wishes to discourage the inception and growth of businesses, although both are unavoidably attended by risks to creditors. Equally, a climate should exist in which downright irresponsibility is discouraged and in which those who abuse the privilege of limited liability can be made personally liable for the consequences of their conduct.[86]

---

82 Keay, A "Wrongful Trading: Problems and Proposals" 65 *N.Ir. Legal Q.* 63 (2014) 64.

83 Cork Report, para 1786.

84 Mokal, R "An agency cost analysis of the wrongful trading provisions: Redistribution, perverse incentives and the creditors' bargain" (2000) 59 *Cambridge Law Journal* 335 at 340.

85 Cork Report, Para 1782.

86 Ibid, para 1805.

© University of Pretoria

As a result of the recommendations in the Cork Report, the Department of Trade and Industry in the United Kingdom advocated for the introduction of measures to curb and penalize the activities of irresponsible directors of British companies, observing that:

> Directors of companies, unlike bankrupts who are personally liable for all their debts, are, in the absence of fraudulent trading, misfeasance or breach of trust, generally under no personal liability, even though the financial loss suffered as a result of the irresponsibility of a director is often much greater than the damage caused by a bankrupt.[87]

The totality of the foregoing led to the enactment of the wrongful trading rule in the 1986 Insolvency Act in the United Kingdom. The rule is provided for under section 214 of the said Insolvency Act. Malawi copied the rule verbatim from the said Insolvency Act of the United Kingdom.

2.3 THE DOCTRINE OF SEPARATE LEGAL PERSONALITY AND THE AIMS OF THE WRONGFUL TRADING RULE

2.3.1 The doctrine of separate legal personality

When company directors conduct the business of the company, they do not act in their personal capacities but as agents of the company.[88] In this vein, it is a well settled position under corporate law that the primary duty of directors of companies is to run the business of the company in the best interests of the company. The company in this regard is the ultimate beneficiary of the directorial duties.

Making this point, Rajak[89] has added that some, who are less pedantic about separation in legal terms of the company and its shareholders, would readily add shareholders as the other beneficiary of the directorial duties. According to Rajak, this separation of the company and its shareholders is important as it underlies the doctrine of separate legal

87 Department of Trade and Industry, *A Revised Framework for Insolvency Law* HMSO, London, Cmnd 9175, 1984 at para 14, accessed online at https://www.amazon.co.uk/Revised-Framework-Insolvency-Law-Cmnd/dp/0101917503 on 14th December 2018.

88 Cassim, FH (ed) et al *Contemporary Company Law* (Juta Law, 2012).

89 Rajak, H "Director and officer liability in the zone of insolvency: a comparative analysis" (2008) *PER* vol 11,1.

© University of Pretoria

personality in shifting the primary liability for the debts incurred in the running of the business of the company from the entrepreneur to the company which, in law, owns and carries on the business.[90]

In this corporate set up, Rajak argues, the company is the primary debtor while the legal status of the entrepreneur is that of being either a director of, or a shareholder with limited liability in, the company.[91] What this entails in principle is that the company, alone, is responsible for the debts it incurs in the running of its business affairs and the creditors are precluded from looking to the entrepreneur for payment of any sum or shortfall thereof which may arise by virtue of the company becoming insolvent.[92]

Prior to the decision in *Salomon vs Salomon & Co Ltd*,[93] the courts had been torn by competing schools of thought regarding the liability of shareholders and directors of companies where the running of the business of the company resulted into loss to creditors. One school of thought, supported by the High Tories, which was opposed to limited liability, subscribed to the view expressed by the court in *Waugh* v *Carver*[94] that "he who feels the benefit should also feel the burden" which was itself a restatement of Chief Justice Grey's dictum 18 years earlier in *Grace vs Smith*[95] that "every man who has the share of the profits of a trade ought to bear his share of the loss."

On the other hand, the school of thought that supported the notion of limited liability was propagated by the radical Whigs (the predecessors of today's UK Liberals) and utilitarian economists such as Jeremy Bentham and John Stuart. The *Salomon* decision, therefore, seemed to render support to the limited liability school of thought by strengthening the position of shareholders and directors at the expense of creditors.

---

90 Ibid.

91 Ibid.

92 Ibid.

93 (1897) AC 22 HL.

94 (1793) 126 ER 525, 2 Hy Bl 235.

95 (1775) 96 ER 587, 588

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

2.3.2 Effect of the doctrine of separate legal personality on creditors of a company

The protection offered by the doctrine of limited liability to incorporated companies entails that the members of the said companies are not personally liable for the debts of their companies beyond the amount of capital which they invested in the company.[96] While this doctrine is beneficial to the members of the company by offering protection from the debts of the company, the doctrine operates against the interests of the creditors of the company as it gives incentives for the directors of the company to exploit the limited liability protection as against the creditors of the company particularly where the company nears insolvency.[97]

This happens when the said directors, even with full knowledge of the financial difficulties of the company and of the possibility of the company proceeding into insolvent liquidation, will still want to gamble with the finances of the company by investing in risky business ventures in the hope of turning the company around, but knowing that in the event that the company collapses, they would not be liable personally.

---

96 This must however be understood in light of the doctrine of lifting the corporate veil discussed herein as, where the veil of a corporation is lifted by statute or common law, the protection afforded by the doctrine of limited liability ceases to exist thereby exposing the members of the said companies to personal liability for the debts of the company.

97 In *Chew vs NCSC (NO 2)* (1985) 3 ACLC 12 at 218, Onley J had the following to say with regard to the doctrine of limited liability:

> The making of laws in relation to companies and the persons who are involved in the formation and management of companies could be described as one of the contemporary growth industries. *I think it is fair to say, however, that since the introduction of the concept of limited liability the potential for companies and the dealing in interests in them to be used as a means of defrauding both the gullible and the greedy has been recognized.* So it is that over a long period of time as the wit of man has been applied to the pursuit of material gain through the use of companies it has been necessary for the law to become more and more complex to the extent that these times few if any could honestly claim to have a full understanding of all the intricacies of the regulatory provisions that now apply. Be that as it may, one theme which prevails throughout the whole complex structure of company law is that those in a position to take advantage of the special position they may exercise in the promotion or management of companies must always act with the utmost care, diligence and honesty so that those who are less well informed are not unfairly taken advantage of. (emphasis supplied).

© University of Pretoria

According to Hirt,[98] the separate legal personality doctrine promotes opportunistic behaviour involving the exploitation of limited liability particularly where the benefit of the limited liability and the control of the company are in the same hands, i.e. in circumstances where the directors are the shareholders or where the directors are mere puppets or dummies of the said shareholders. It has been argued that this incentive also operates where the directors are the persons who, either as directors or shareholders, are able to take a greater part of the company's profits.[99]

2.3.3 The *Salomon* decision

On the relevant facts of *Salomon vs Salomon & Co Ltd,*[100] Salomon had registered a company (A Salomon and Co Ltd) in which he was a majority shareholder and managing director. Subsequently, Salomon sold a business he ran as an individual trader to A Solomon and Co Ltd for '*a sum which represented the sanguine expectations of a fond owner rather than anything that can be called a business-like or reasonable estimate of value.*'[101] Within eighteen months, the business failed and A Solomon and Co Ltd went into insolvent liquidation.

During the said liquidation, the liquidator claimed that Salomon was obliged to indemnify all the creditors of the company. The basis of this claim, on the part of the liquidator, was that A Salomon and Co Ltd had merely been Salomon's agent or trustee and that Salomon, as the principal or the beneficiary, was liable for the acts and debts of his agent or trustee. The liquidator's claim succeeded in the court of first instance and this decision was upheld by the Court of Appeal. Lord Justice Lindley sitting in the Court of appeal made the following remarks in his judgement:

> The appeal raises a question of very great importance, not only to the persons immediately affected by the decision, but also to a large number of persons who form what are called 'one -

98 Hirt, HC "The wrongful trading remedy in UK law classification, Application and practical significance" (2004) 1 *ECFR* 71, 113.

99 Davis, P *Introduction to Company Law* (2002) Oxford University Press, 96-97 and 100.

100 (1897) AC 22 HL.

101 Per Lord Mcnaghten at p. 49.

© University of Pretoria

> man companies.' Such companies were unheard of until a comparatively recent period, but have become very common of late years.
>
> …
>
> There can be no doubt that in this case an attempt has been made to use the machinery of the Companies Act, for a purpose for which it was not intended. The legislature contemplated the encouragement of trade by enabling a comparatively small number of persons- namely not less than seven[102] to carry on business with a limited joint stock or capital, and without the risk of liability beyond the loss of such joint stock or capital. But the legislature never contemplated an extension of limited liability to sole traders or to a fewer number than seven…. Although in the present case, there were, and are, seven members, yet it was manifest that six of them are members simply in order to enable the seventh himself to carry on the business with limited liability.
>
> … The company in this case has been regarded by [the judge in the court below] as the agent of Aron Salomon. I should rather liken the company to a trustee for him – a trustee improperly brought into existence by him to enable him to do what the statute prohibits.[103]

From the foregoing sentiments, it does not come as a surprise that another judge in the said Court of Appeal decision found Salomon's conduct to have been a scandal that had to be stopped:

> It would be lamentable if a scheme like this could not be defeated. If we were to permit it to succeed we would be authorizing a perversion of the Joint Stock Companies Act. We would be giving vitality to what is a myth and a fiction. … To legalize such a transaction would be a scandal.[104]

On appeal to the House of Lords, the House of Lords unanimously overturned the decision of the Court of Appeal. The aggregate of the concurring speeches in the House of Lords was that Salomon had acted within the ambit of the law which authorized him to create a limited liability company which, upon creation, became a separate legal person and conducted its own business and entered into its own contracts (including the contract to acquire the business previously run personally by him). For this reason, the

102 As it happened in A Solomon and Co Ltd, Salomon and his wife and children made up the then minimum of seven persons for a registered company.

103 *Broderip v Salomon* (1895) 2 Ch at 336, 337, 338.

104 *Broderip v Salomon* (1895) 2 Ch at 340 – 341.

© University of Pretoria

House of Lords found nothing wrongful or scandalous in what Salomon had done. In the words of Lord Herschell in the House of Lords:

> It may be that a company constituted like that under consideration was not in the contemplation of the legislature at the time when the Act authorizing limited liability was passed; that if what is possible under the enactments as they stand had been foreseen a minimum sum would have been fixed as the least denomination of share permissible; and that it would have been made a condition that each of the seven persons should have a substantial interest in the company. But we have to interpret the law, not to make it; and it must be remembered that no one need trust a limited liability company unless he so please, and that before he does so, he can ascertain, if he so please, what is the capital of the company and how it is held.[105]

Reacting to the *Salomon* decision and its impact, Rajak[106] has contended that this was a most significant moment in the history of British corporate and commercial law as it shaped much that was to come, particularly the fact that the financial burden of corporate failure would befall the creditors of the corporation. Further, Rajak observes that the House of Lords decision in *Salomon* effectively invited entrepreneurs, particularly directors, executives and management to go out and trade without a threat of losing personal wealth as a result of business failure as they would be trading for all that their creditors were worth.[107]

From the foregoing, there is no doubt that the House of Lords decision in *Salomon* was seen as a threat to creditor interests in the running of the businesses of limited companies and, it is argued, that much of the decisions that followed this decision were only trying to digest the dispensation that was created by the *Salomon* decision and also

---

105 *Salomon v Salomon* (1897) AC 46. It has been observed by Sarra J, and Davis R, *Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations* (2002) Butterworths Canada Ltd at page 13 that:

> The limited liability doctrine, formulated in *Salomon v. Salomon & Co.,* was originally designed to protect shareholders from personal liability where they were merely investors of the corporation. This notion of limited liability was extended early in the development of company law to include directors. Generally, they are not personally liable for acts of the corporation. There are broadly accepted notions that the modern corporation is an integral part of society, that it generates economic wealth and, ultimately, that wealth is distributed to shareholders and lenders, in turn, generating greater economic activity. Directors and officers have an obligation to act in the best interest of the corporation, interpreted by Canadian courts primarily as shareholder wealth maximization.

106 Rajak H "Director and officer liability in the zone of insolvency: a comparative analysis" *PER* vol 11,4.

107 Ibid.

© University of Pretoria

seeking to restore or at least strike a balance between the ever-competing interests of shareholders and directors on one hand and creditors on the other hand.[108]

Most importantly, the House of Lords decision in *Salomon* prompted an urgent need on the part of creditors to ensure that the registered companies which they dealt with were solvent enough as it was now their responsibility to sufficiently secure their interests when dealing with the said companies, having been taught by the House of Lords that '[e]very creditor is entitled to get and hold the best security the law allows them to take.'[109]

Further, the House of Lords decision in *Salomon* having warned that no creditor needed to proceed to deal with a limited company on trust,[110] it became clear that the only redress which creditors who did not secure their interests sufficiently would receive from the court was a mere sympathy. This was clear in the dictum of Lord Macnaghten in reference to creditors of A Salomon and Co Ltd in the words that:

> The unsecured creditors of A Salomon and Co Ltd, may be entitled to sympathy, but they have only themselves to blame for their misfortunes. They trusted the company, I suppose because they had long dealt with Mr Salomon, and he had always paid his way; but they had full notice that they were no longer dealing with an individual and they must be taken to have been cognizant of the memorandum and of the articles of association.[111]

There seemed to be three options available to traders who wished to protect their interests as far as dealing with limited liability companies was concerned after the House of Lords decision in *Salomon*. For some traders, the best protection was to refrain from dealing with limited liability companies, but this was not the option for most of them. Some preferred to keep on investigating and monitoring the solvency of the company in the process of trading with it.

---

108 Ibid, at page 2.

109 Per Lord Macnaghten, *Salomon v Salomon (1897)* AC 52.

110 Per Lord Herschell, *Salomon v Salomon (1897)* AC 46.

111 At page 52-53.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

However, this was also fraught with the problem of being unable to access all relevant information, most of which had to be sourced informally as the company would not formally give out information adverse to its own trade and survival. Some traders indeed sought to protect themselves by taking advantage of instruments of credit and security such as the floating charge and receivership, although at that time, receiverships were not popular as a means of managing leased real property until the late nineteenth century.

It must be noted that in the *Salomon* case discussed above, Salomon himself had loaned some money to A Salomon and Co Ltd and had secured his loan by means of a floating charge.[112] The significance of this fact is that it shows not only that Salomon was not obliged to indemnify the company's creditors for their losses, but also that the floating charge entitled his claim against the company to rank in priority to all other creditors when insolvent liquidation commenced. This was obviously not taken kindly in the lower courts, as the dictum of Lord Macnaghten in the House of Lords seems to have been an attempt to rationalize the mindset of the court below when he said:

> For such a catastrophe as has occurred in this case some would blame the law that allows the creation of a floating charge. But a floating charge is too convenient a form of security to be lightly abolished. I have long thought, and I believe some of your Lordships also think, that the ordinary trade creditors of a trading company ought to have a preferential claim on the assets in liquidation in respect of debts incurred within a certain limited time before the winding-up. But that is not the law at present. Everybody knows that when there is a winding-up debenture-holders generally step in and sweep off everything; and a great scandal it is.[113]

2.3.4 Common law response to the *Salomon* decision

As it has been observed above, the House of Lords decision in *Salomon* appeared to strengthen the position of entrepreneurs (shareholders and directors) against the plight of creditors in limited companies. This impact was not only felt in the United Kingdom from where the *Salomon* decision was made, but it proliferated to other jurisdictions

[112] Note that of the nine judgements in all the three courts, the only judgement to mention of the floating charge is that of Lord Justice Kay in the Court of Appeal (*Broderip vs Salomon* (1895) 2 Ch at 343). All the other judgements speak of a debenture issued to Salomon. According to Rajak, H "Director and officer liability in the zone of insolvency: a comparative analysis" *PER* vol 11,5, it can only be assumed that during that time, a debenture was taken to include a floating charge.

[113] *Salomon vs Salomon* (1897) AC 46 at p. 53.

© University of Pretoria

that drew from the English common law including South Africa, Australia and Malawi, among others.

With this new dispensation came the need in all the affected jurisdictions to ensure that the new phenomenon, the limited liability trading in companies, was not abused. The first to be on guard were the courts. Prevention of fraud became one of the important reasons for which the courts, under common law, would want to interfere with the protection afforded to entrepreneurs by the limited liability mantle.

In doing this, a doctrine widely referred to as lifting or piercing of the veil of incorporation was devised under common law, enabling the courts to look to the individual entrepreneur and to strip him or her of the protection afforded by the limited liability status and make him or her responsible for the fraud or any sort of illegality perpetrated by him or her behind the veil of limited liability.

One of the early cases in the United Kingdom where this was done is the decision in *Re Darby*,[114] in which the court stripped the protection of limited liability to expose two fraudsters who had attempted to create a shield from the public which they had invited to subscribe for shares in the company being promoted when in fact they were undischarged bankrupts. There are several instances where the courts in their discretion lift corporate veils under common law.[115]

---

[114] (1911) 1 KB 95.

[115] At common law, the courts have lifted corporate veils for several reasons, such as: (a) where two or more corporations are only a single economic unit, see *The Roberta* (1937) 58 L. L. R. 159; *Holdsworth & Co vs. Caddies* (1955) 1 W. L. R. 352 HL; *Scottish Co-operative Wholesale Society Ltd vs. Meyer* (1959) AC. 324 HL; *DHN Food Distributors Ltd vs. Tower Hamlets LBC* (1976) 1 W. L. R. 852; *Revlon Inc. vs. Cripp & Lee Ltd* (1980) F. S. R. 85; (b) where the corporate structure is a mere sham concealing the true facts. See *Re Bugle Press* (1961) Ch. 270; *Kensington International Ltd vs. Republic of Congo* (2006)2 B. C. L. C. 296; (c) where a corporation acts as an agent of a parent company or of all or any of its members, but there is no presumption of such agency between a company and any of its shareholders. See *Southern vs. Watson* (1940) 3 All ER 349; *Rainham Chemical Works vs. Belvedere* (1912) 2 A C. 465 HL; (d) where the interests of justice demand that the veil be lifted – a very difficult ground to prove, see how this argument failed in *Adams vs. Cape Industries Plc*. (1990) Ch. 433, where the court held, on this point, that a justice qualification was an unstable and imprecise measure against which an issue of such fundamental importance should be decided; (e) where separate personality would result in impropriety, such as to carry out an unlawful activity; *Re H*, (1996) 2 All ER 291 CA, or where a company is used to avoid a court order, *Gilford Motor Co Ltd vs. Horn*, (1933) Ch. 935, CA.

© University of Pretoria

Although there were other undesired consequences stemming from the use of the protective veil of limited liability, anything less than fraud did not motivate the court so much as to try and pierce the corporate veil. The basis for this was clearly that the grant of limited liability to entrepreneurs had been designed to encourage the taking of risks, hence the courts were reluctant to punish commercial conduct that did not amount to fraud by stripping the entrepreneurs of the protection afforded by the limited liability status as it was believed that doing so would run counter to the purpose for which the principle of limited liability had been invented.[116]

In this vein, it could be seen that much as legal systems are opposed to negligence, just like they are to fraud, negligence on the part of the entrepreneurs, particularly directors, in the running of the business of the company, was not, of its own, a basis for the courts to seek to strip the entrepreneurs of the protective veil of limited liability even if the said negligence had resulted into an insolvent liquidation of the company and therefore losses to creditors. Rajak[117] has argued, in line with this point, that the other reason might have been that the line between negligence and legitimate risk-taking in business may also not be clear cut.

2.3.5 Legislative response to the *Salomon* decision

While the courts under common law continued in their quest for the best reaction to the shift in entrepreneur-creditor interests brought about by the House of Lords decision in *Salomon*, the legislature in the United Kingdom and in other jurisdictions such as South Africa and Australia also embarked on an expedition for solutions. For the United Kingdom, one of the important issues on which this solution was deemed necessary was the treatment of entrepreneurs, particularly directors, whose conduct in the running of the business of companies did not amount to fraud as for the common law courts to be able to trap them through piercing the corporate veil, but where the said conduct, although not fraudulent, was somehow blameable for the loss suffered to creditors during insolvent liquidation of the companies in question.

---

116 Rajak H "Director and officer liability in the zone of insolvency: a comparative analysis" *PER* vol 11,7.

117 Ibid.

© University of Pretoria

The United Kingdom Government therefore began looking for a statutory provision which could, in appropriate situations where the above was the case, lift the corporate veil of companies in order to impose personal liability on irresponsible directors of the said companies. As it has been discussed above, the proposal to enact such a provision went through various stages until finally in 1986, the UK Government enacted the wrongful trading rule under section 214 of the Insolvency Act as the statutory solution to this problem.

To this end, it will be noted that the wrongful trading rule is a statutory mechanism by which the courts are allowed, during insolvent liquidation of a company,[118] to lift a corporate veil of the company in order to impose personal liability on directors of the company whose behaviour in running the business of financially distressed companies, although not fraudulent, is shown to have been irresponsible resulting into losses to creditors by virtue of the said insolvent liquidation.

2.3.6 Lifting the corporate veil, and whether or not it is a justifiable exception to the *Salomon* principle

Davies and Worthington,[119] commenting on the doctrine of limited liability which was cemented by the House of Lords decision in *Salomon*, have argued that while the case for limited liability is strong, it is not so strong that there are no arguments against removing its protection in certain cases and that the costs of the doctrine, in terms of the opportunistic behaviour which it facilitates, should be reduced by law as far as possible.[120]

---

118 Note that the requirement that the company must have first gone into insolvent liquidation for a wrongful trading claim to arise is only tenable in Malawi. The UK position was amended and presently, apart from the company having proceeded into insolvent liquidation, a wrongful trading claim under the Insolvency Act of 1986 in the United Kingdom can arise even when a company has merely gone into administration.

119 Davies P, and Worthington S, *Gower and Davies Principles of Modern Company Law* (2012) Sweet and Maxwell, 213.

120 It has been observed by Sarra J, and Davis R, *Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations* (2002) Butterworths Canada Ltd at page 13 that efficiency concerns in the running of the affairs of a company dictate that directors and officers should not engage in conduct that leaves the corporation liable. In this context, the learned commentators have argued that:

> … the dominant paradigm has been that decision makers, acting in good faith, should not acquire personal liability. Given the notion of limited liability, directors' obligations were to the

© University of Pretoria

In *Re Rolus Properties Ltd,*[121] the court pointed out that while the privilege of limited liability is a valuable incentive to encourage entrepreneurs to embark on risky ventures without inevitable personal total financial disaster, it is nevertheless a privilege which must be accorded upon terms. In *Bernstein v. Bester,*[122] the Constitutional Court of South Africa had this to say in respect of the doctrine of limited liability:

> The establishment of a company as a vehicle for conducting business on the basis of limited liability is not a private matter. It draws on a legal framework endorsed by the community and operates through the mobilization of funds belonging to members of that community. Any person engaging in these activities should expect that the benefits inherent in this creature of statute will have concomitant responsibilities.

Cameron JA in another South African case of *Ebrahim and another v. Airport Cold Storage (Pty) Ltd*[123] said the following in respect of section 424 of the Companies Act of 1973 in South Africa in a reckless trading claim:

> "Although juristic persons are recognized by the Bill of Rights…it is an apposite truism that the close corporations and companies are imbued with identity only by virtue of statute. In this sense their separate existence remains a figment of law, liable to be curtailed or withdrawn when the objects of their creation are abused or thwarted. The section retracts the fundamental attribute of corporate personality, namely separate legal existence, with its corollary of

---

corporation, not to third parties. In exchange for directors' and officers' services to the corporation, direct indemnification, trust funds that indemnify or third-party insurance by the corporation provide financial protection to directors and officers for their errors and omissions, essentially their good faith but negligent acts. The notion of separate corporate personality has important functions, such as encouraging investment, and limiting the liability of shareholders who are frequently not the directing minds of the corporation. Accordingly, the corporate veil will only be lifted in exceptional circumstances to find directors and officers personally liable. However, the corporate veil can also be abused or misused, shielding directors from liability for conduct for which they would otherwise be liable.

121 (1988) 4 BCC 466.

122 (1996) 2 SA 751 at 796. See also the case of *S. vs. De Jager* (1965) 2 SA 616 (A) 624-625 where the court agreed with the opinion of the court in *In Re Cleadon Trust Ltd* (1938) 4 All ER 518 at 533 that 'the privilege of limited liability which parliament has given to members of companies registered under the Companies Act is given upon the footing of conditions the observance of which by directors is of general importance to the public,' and the case of *S v. Ressel* (1968) 4 SA 224 at page 233 in which the court cited with approval the case of *Cooper vs. Luxor (Eastbourne) Ltd* (1939) 4 All ER 411 where the court at page 418-419 said that 'The public policy on which the principle of limited liability is given to companies, private as well as public, is that Directors shall observe the trust which parliament has placed on them.'

123 (2008) 6 SA 585 (SCA) para 15.

© University of Pretoria

> autonomous and independent liability for debts, when the level of mismanagement of the corporation's affairs exceeds the merely inept and incompetent and becomes heedlessly gross or dishonest. The provision in effect exacts a quid pro quo: for the benefit of immunity from liability for its debts, those running the corporation may not use its formal identity to incur obligations recklessly, grossly negligently or fraudulently. If they do, they risk being made personally liable."[124]

From the foregoing, it will be seen that while the notion of lifting the corporate veil might be criticised on other fronts as negating the whole essence for which the doctrine of limited liability was invented, there seems to be consensus that this remains the best remedy particularly in circumstances where the corporate veil has been used to achieve ends that are detrimental to creditor interests, or indeed where fraud has been perpetrated with the aid of the limited liability protection.

2.4 AIMS OF THE WRONGFUL TRADING RULE AND WHETHER OR NOT THEY ARE A JUSTIFIABLE BASIS FOR IMPOSITION OF PERSONAL LIABILITY ON DIRECTORS OF COMPANIES

2.4.1 Creditor protection

At the core of the justifications for the willingness to have the corporate veils lifted is the desire to protect the interest of creditors and other persons who may fall victim to the abuse of the corporate veil by the persons behind it.[125] As it has been observed by Schulte,[126] wrongful trading was introduced in order to minimize the abuse of the limited liability protections by company officers against creditors of companies.

---

[124] It must be noted that before imposing personal liability for reckless trading against a director or officer of a company in South Africa, the court is required to have regard, among other factors, to the scope of the operations of the company, the role, powers and functions of the directors of the company, the amount of the debts, the extent of the company's financial difficulties of recovery from the said financial difficulties, if any; *Fourie vs. Newton* (2011) 2 All SA 265 (SCA).

[125] Lombard S, "Claims Against Negligent of Fraudulent Directors: Proposed Amendments to South African Legislation" (2007) 16 *INT'L Insolvency REV 75* has argued that the statutory civil liability rules that are enacted in different jurisdictions against directors of companies should they make themselves guilty of managing the business of their companies in a reckless, wrongful or fraudulent manner or if they engage in insolvent trading, can play a very vital role in protecting the interests of corporate creditors provided they are properly formulated.

[126] Schulte, R "Wrongful Trading: An Impotent Remedy?" (1996) *Journal of Financial Crime*, Vol 4 Issue: 1, 40.

© University of Pretoria

Creditor protection is therefore the primary aim for which the wrongful trading rule was invented.

In line with this view, Keay[127] has noted that when insolvency occurs, creditors will not receive the full amount of their claims and that in many cases, they will be fortunate to receive a portion of them. Quoting the report of the Hammer Committee, Keay has therefore contended that an examination of claims against past activities of directors of companies once the said companies become insolvent is a due inquiry which may yield a greater fund from which the claims of creditors may be satisfied.[128]

This observation is also shared by Hirt,[129] who argues that the purpose of the wrongful trading rule is to reverse the structural bias which exists under limited liability in favour the controllers (shareholder-directors) by internalizing, rather than externalize to unsuspecting creditors, the risk of loss in directors' decision-making process when the company approaches insolvency.

As a global attempt to achieve a creditor protection mechanism, UNCITRAL, in its Legislative Guide on insolvency law[130] is categorically clear on the need for creditor protection and, in fact, puts creditor protection as the first basis for the existence of the directors' obligations to the company during a period when the company approaches insolvency.[131] Some courts which are more pedantic, have actually required that the duty to safeguard the interests of creditors must start while the company is solvent. In a South African case of *S vs. Hepker*,[132] the court said that even directors of solvent

127 Keay, A *Insolvency: Personal and corporate law practice* (1998) 105.

128 Keay, A *McPherson: The law of company liquidation* (1999) 626.

129 Hirt HC "The wrongful trading remedy in UK law classification, Application and practical significance" (2004) 1 *ECFR* 71, 115.

130 United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April2013)

131 Ibid, 1.

132 (1973) 1 SA 472 (W).

© University of Pretoria

corporations should always consider creditors' interests in the running of the affairs of the corporations. In the words of the court:

> The concept of creditors having recourse only against a company as such, leaving shareholders immune beyond their shareholdings, was a legal invention of surpassing significance for the industrial expansion of the world. But it has placed great responsibility upon directors. Because of its limited liability, directors have a duty to manage the company strictly on the basis of fairness to all those who deal with it and who have no means of knowing its internal affairs. The courts will not be tolerant to deviation from this indispensable commercial guideline.[133]

Similarly, Templeman LJ in an English case of *Winkorth vs. Edward Baron Development Co Ltd*[134] said that the duty to manage the affairs of the company fairly to all those who deal with it requires, in respect of creditors of the company, that the directors must consider the interests of creditors even when a company is fully solvent. The learned judge said:

> …a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but a company owes a duty to its creditors to keep its property inviolate and available for repayment of its debts…A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of creditors."[135]

The proposition to extend the creditor-regarding duties of directors to the time when a company is fully solvent has, however, been opposed by other commentators. Grifffin,[136] for instance, has criticized the suggestion by Templeman LJ in the *Winkorth* decision above and has labelled it "misplaced and unnecessary." Griffin's view seems to agree with the view taken by Berle,[137] who argues that corporations exist for profit

133 Ibid, at page 484.

134 (1987)1 All ER 114.

135 Ibid, at page 118.

136 Griffin S, *Personal liability and disqualification of Company directors* (1999) Hart Publishing Co., 11.

137 Berle A, "For Whom Corporate Managers Are Trustees: A Note" (1932) 45 *Harv. L. Rev.* 1365.

© University of Pretoria

to shareholders and that interests of creditors should only arise at a certain point in time and not throughout the entire life of the corporation. According to Berle:

> You cannot abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such a time as you are prepared to offer a clear and reasonably enforceable scheme to someone else.[138]

2.4.1.1 Are creditors not already sufficiently protected under law?

The very notion of creditor protection through the invention of mechanisms such as the wrongful trading rule has been opposed by another school of thought. According to this school of thought, creditors are already protected elsewhere under corporate law in their dealings with corporations and therefore they do not need extra protection. A statement by Worthington[139] affords a good exposition of this theory. According to Worthington:

> "[N]o analysis of the director–creditor relationship provides any sound reasons for imposing fiduciary duties on directors to act in the best interests of creditors. Where such a duty to creditors has been proposed, no means of effectively dealing with the problems of standing to sue and ratification have been suggested. Creditors' interests are in fact already adequately protected by existing equitable and common law principles and statutory provisions."[140]

Numerous commentators who reject the extension of directors' duties to include the interest of creditors capitalize on the contractual nature of creditors' relationship with the company. Sealey, [141] for instance, argues that 'creditors deal with a company as a matter of bargain, not as a matter of trust, and bargain involves risk.' Sealey argues, further, that creditors are not as vulnerable as shareholders in that they are in a position to protect their own interests through contract,[142] for which reason it has been argued that they are not suitable beneficiaries of fiduciary duties by directors.[143] Concurring

---

138 Ibid, at page 1367.

139 Worthington, S "Directors' Duties, Creditors' Rights and Shareholder Intervention" (1991) 18 *Melbourne University Law Review* 121.

140 Ibid, at page 151.

141 Sealy, L "Directors' 'Wider' Responsibilities- Problems Conceptual, Practical and Procedural" (1987) *Monash University Law Review* 164.

142 Ibid.

143 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 27, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

© University of Pretoria

with the foregoing view, Rousseau[144] has contended that some of the contractual devices that creditors are at liberty to use to protect their own interests include interest rates charged and the negotiation of guarantees and loan covenants.

Lending weight to this view, Smith[145] has argued that fiduciary duties provide protection 'against opportunistic behaviour and the strength of that protection varies inversely with the potential for self-help on the part of the vulnerable party.' The view is also shared by Ziegel[146] who asserts that the onus rests on the creditors to bargain effectively and that directors should not serve as insurers against creditors' poor business judgment should they fail to do so.

In support of this school of thought, Lombard[147] refers to the sentiments of Adam Smith in the 1850s whose effect, Lombard argues, resounds to date, namely, that the measures embodied in company law principles, such as the fact that the name of companies whose members enjoy limited liability should end with the abbreviation "Ltd"; the compulsory registration of companies' memorandum and articles of association; the issuing of prospectus to potential investors, among others, are measures which form part of a very important doctrine of disclosure in company law, a doctrine which is based on the philosophy that those who have dealings with the company are adequately protected by being provided with information which enables them to safeguard their own interests.

Some courts have also rallied behind this school of thought. In *Nicholson vs Permakraft (NZ) Ltd*[148] the court remarked that as a result of a company being a separate legal entity, those minded to commence trading with the company must normally take the

---

144 Rousseau, S "The Duties of Directors of Financially Distresses Corporations: A Quebec Perspective on the Peoples Case" (2004) 39 *Canadian Business Law Journal* 368 at page 386.

145 Smith DG "The Critical Resource Theory of Fiduciary Duty" (2002) 5 *Vanderbilt Law Review*, 1339.

146 Ziegel JS "Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo – Canadian Perspective" (1993) 43 *University of Toronto Law Journal* 511.

147 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 27, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

148 (1985) 1 NZLR 242, Per Cooke J, at 250.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

company as it is and, short of fraud, they must be guardians of their own interests. Lord Templeman in *J H Rayner (Mincing lane) Ltd vs Department of Trade and Industry*[149] echoed this view with a salutary reminder that:

> Since Salomon's case, traders and creditors have known that they do business with a corporation at their peril if they do not require guarantees from members of the corporation or adequate security.[150]

By reason of the foregoing, it has been contended that creditors ought to take the necessary steps to ensure that in the event of corporate failure, their position is secure so as not to require the extra protection.[151] According to this school of thought, creditors of a company are only owed a duty by the directors from the moment a company becomes insolvent for the reason that from that point in time, the creditors become eventual stakeholders of the company. Street CJ in *Kinsela vs Russell Kinsela Pty Ltd*[152] highlighted this position in the words that:

> [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.[153]

This school of thought has, however, been criticized heavily for being merely theoretical than practical. To begin with, Butcher[154] has argued that much as in theory creditors seem to be adequately protected as suggested above, or that there are sufficient mechanisms to protect them, in practice things work out differently. The learned commentator argues that in many cases, companies will only conduct business on a take

---

149 (1989) 3 WLR 969.

150 Ibid, at page 986.

151 Ford, H Austin, R and Ramsey, I *Ford's Principles of Corporations Law* (9th ed) (1999) Reed International Books Australia Pty Ltd, at paras 20.020 and 20.280.

152 (1986) 4 NSWLR 722.

153 At page 730.

154 Butcher, BS *Directors' duties: A new millennium, a new approach?* (2000) The Hague; Boston: Kluwer Law International, 164.

© University of Pretoria

it or leave it basis thereby robing a potential creditor of an opportunity to bargain for protection, while in other cases, the commercial exigencies of getting the business done often do not allow for the requisite attention to detail, and all too often, although such attention to detail is commercially critical, it is sometimes simply overlooked.[155]

In concurring with this view, Morgan and Underwood[156] have contended that the inequalities in bargaining power inherent in many transactions do not create an environment where creditors can freely contract on terms that safeguard their interests, and, further, that competition for a market share among potential creditors compels them, in many instances, to forgo adequate protective measures in a bid to secure a contract.

The criticism against this school of thought centres on the fact that the contention that creditors can adequately protect themselves by charging interest on the sums owed, as it has been argued by Rousseau above, is flawed for the following five reasons:

- First, this contention fails to consider the plight of involuntary creditors such as tort victims.[157]

- Second, the rate of interest that may be agreed upon may be taken to have been arrived at as regards the risk as perceived at the date of making the contract and it may not take into account the unforeseen risk that may arise after conclusion of the contract.[158]

---

155 Ibid.

156 Morgan, B and Underwood, H "Directors' Liability to Creditors on a Corporation's Insolvency in Light of the Dylex and Peoples Department Stores *Litigation*" (2004) 39 *Canadian Business Law Journal* 336 at 339. See also Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 28, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

157 Landers J M "Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy" (1976) *University of Chicago Law Review*, 527, 529.

158 Botha, D "Directors' Fiduciary Duties to Bondholders? Some Relationship Between Corporate Financial Management and Fiduciary Law" (1993) *SA Merc LJ* 287.

© University of Pretoria

- Third, as Lombard[159] argues, this contention presumes that creditors always possess sufficient information to enable them to properly assess the risk that they bargain for, when in practice this is not the case since, as Ziegel[160] observed, information on a company's financial position is usually deficient and may change very quickly.

  It has been contended that even if creditors were to have all necessary information as well as the freedom to negotiate for the very best protective contractual measures to safeguard their interests when dealing with corporations, the cost involved in such an exercise might exceed the benefits they may derive from the said agreements thereby rendering the whole exercise financially imprudent,[161] particularly where small-scale trade creditors are concerned.[162]

- Fourth, the advent of insolvency will always make the interest compensation negotiated by the creditors less likely to be paid in full or at all as it is usually in the interest of shareholders of corporations at that time to engage in and continue with risky transactions in a desperate attempt to avoid insolvent liquidation and, should the transactions fail, the shareholders do not stand to lose more than what they would have lost in insolvent liquidation anyway, while creditors are the ones who fund the increase in risk without any additional benefits accruing to them should the ventures prove to be successful.[163]

---

159 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 28, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

160 Ziegel, JS "Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo – Canadian Perspective" (1993) 43 *University of Toronto Law Journal* 530.

161 Keay, A *McPherson: The law of company liquidation* (1999) 676.

162 Iacobucci, E 'Directors Duties in Insolvency: Clarifying What Is at Stake' (2004) 39 *Canadian Business Law Journal* 398.

163 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 30, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018) See also Keay, A "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 *Modern Law Review* 665, who contends that there is empirical evidence to support the fact that managers of corporations tend to engage in excessive risk-taking once a company is in financial distress.

© University of Pretoria

- Fifth, costs involved in the preparation of documents containing guarantees and covenants are high and there are also difficulties in detecting breaches as well as problems relating to the time factor for enforcement of rights under the said agreements.[164] Prentice[165] has subscribed to this view as follows:

> Because of normal human limitations (foresight, knowledge etc) the capacity to draft contacts to deal with future contingent states is inherently circumscribed and this greatly limits the utility of contracts to deal with any economic activity involving an element of futurity and uncertainty. Also, even if the future can be seen, the costs of negotiating a contract to deal with all contingencies that might arise would render the exercise prohibitively expensive and inefficient as the costs of contracting would exceed the benefits to be derived by the parties for having dealt with all known risks.[166]

- Lending weight to the foregoing, Ramsey[167] has argued that even the most sophisticated of creditors cannot foresee all contingencies in the commercial circles as to be able to contract for protection against themselves. According to the learned commentator, significant corporate restructurings, such as leveraged buyouts, have sometimes seen transfers of wealth from sophisticated creditors (bond holders) to shareholders.[168]

---

164 Sappideen, R "Fiduciary Obligations to Corporate Creditors" (1991) *Journal of Business Law* 365. See also Ramsey, I *Company Directors' Liability for Insolvent Trading* (200) CCH Australia Limited, 10; Landers, J M "Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy" (1976) University of Chicago Law Review, 527, 529.

165 Prentice, D "The Theory of the Firm: Minority Shareholder Oppression: Sections 459 – 461 of the Companies Act 1985" (1988) 8 *Oxford Journal of Legal Studies* 55 at 57 as quoted by Morgan, B and Underwood, H "Directors' Liability to Creditors on a Corporation's Insolvency in Light of the Dylex and Peoples Department Stores *Litigation*" (2004) 39 *Canadian Business Law Journal* 336.

166 Ibid, at page 339.

167 Ramsey I, *Company Directors' Liability for Insolvent Trading* (2000) Melbourne: Centre for Corporate Law and Securities Regulation and CCH Australia Limited, 10.

168 This has mainly occurred in the United States of America: Bratton, WW "Corporate Debt Relationships, Legal Theory in a Time of Restructuring" (1989) *Duke Law Journal* 92. Ramsey I, *Company Directors' Liability for Insolvent Trading* (2000) Melbourne: Centre for Corporate Law and Securities Regulation and CCH Australia Limited, 10, describes a leveraged buyout as an occurrence where existing shareholders of a company transfer control of the company to an outsider and a high level of debt is used to fund the acquisition. Because this debt will be serviced by the acquired company, this increases the risk of existing creditors of the company not being paid.

© University of Pretoria

- Finally, Sarra[169] has equally criticized the view that creditors should be able to protect themselves on the basis that the view does not consider the plight of other types of creditors. According to Sarra:

> Creditors are viewed as freely bargaining their contracts and thus assuming the risk of insolvency; hence directors should owe no duty to consider the interests of creditors. Yet the number and range of creditors of corporations varies. It is true that senior secured lenders are frequently in a position to bargain a premium in their debt arrangements that accounts for the risk of financial distress…yet even where such creditors have the bargaining power to impose self-help remedies when the corporation breaches the contract or to temper the risk of harm from firm failure, such creditors may not be able to bargain protection for directorial self-dealing, shirking, or conduct that is in breach of the directors' duties to the corporation…In contrast to the secured and senior creditors, there are thousands of creditors who have neither the bargaining power nor the information or resources to negotiate protections against risk of firm failure. Thus, while they become residual claimants, they have not been able to bargain any risk premium.[170]

The problem of inability on the part of traders to receive full payment from companies is, however, not a new phenomenon, except that unlike recently, there was no desire in the past to alter the law in order to afford extra protection to creditors. In 1925, the Greene Committee appointed in the United Kingdom under the Chairmanship of Wilfred Greene KC to investigate the position of private companies in relation to their creditors observed the following while recommending that no alteration of the law was desirable to meet the special case:[171]

---

169 Sarra, J "Wise people, Fiduciary obligation and reviewable transactions, Director's liability to creditors" (2004) *Annual Review of Insolvency Law,* 13.

170 Ibid. See also Brudney V, "Corporate Bondholders and Debtor Opportunism: In Bad Times and Good" (1992) 105 Havard Law Review 1821, dispersed creditors face a collective action problem and may therefore lack the appropriate incentives to undertake joint action to prevent opportunistic behaviour by the company where there is a threat of non-payment to the creditors.

171 Report of the Company Law Amendment Committee, *HMSO, London* Cmnd 2657, at para 86, accessed online on 5th June 2018 at https://www.worldcat.org/search?q=au%3AGreat+Britain.+Board+of+Trade.+Company+Law+Amendment+Committee.&qt=hot_author.

© University of Pretoria

> In many cases, traders have been far too ready to give credit to private companies of which they know nothing, without making any or sufficient enquiries as to the financial standing of the company or the persons who control it, and to this extent it may fairly be said that that trouble lies at their own door. This is particularly the case where manufacturers in periods of trade depression have been eager at any risk to find a sale for their goods.[172]

It is therefore clear that over 90 years later, the position of traders has remained the same. This however does not mean that traders have not learned lessons from the past. It rather entails the intricacies of commercial trading where creditors cannot guard against every eventuality in their trade.

Mindful of the plight of creditors as above, it is submitted that the conclusion drawn by Iacobucci[173] that '*just as fiduciary duties to shareholders are a response to contractual infirmities between shareholders and directors…similar contractual infirmities may also suggest shifting duties to creditors in insolvency*'[174] is the right mentality and that, based on this, there is justification for lifting veils of corporations, through the wrongful trading mechanism, among other mechanisms, and holding persons involved in the management of the said corporations liable for their actions which negatively affect creditors.[175]

---

172 Ibid, at para 56. See Report of the Review Committee on Insolvency Law and Practice, HMSO, London, Cmnd 8558, 1982 at para 90.

173 Iacobucci, E "Directors Duties in Insolvency: Clarifying What Is at Stake" (2004) 39 *Canadian Business Law Journal* 398.

174 Ibid, at page 409.

175 It must be noted that in Australia, the Law Reform Commission, *General Insolvency Inquiry* [Report No 45, 1998] ['Harmer Report'], a summary of which was accessed online on 17th July 2018 at https://www.alrc.gov.au/wp-content/uploads/2019/08/alrc45_Summary.pdf justified imposing personal liability for directors for insolvent trading, an equivalent of the Malawian and the English wrongful trading provision, as a way of protecting creditors, noting, at 122-123 [277] that:

> The concept of limited liability as a privilege available to the commercial immunity was introduced into English law by the Limited Liability Act 1855 [UK]. The limited liability company was seen then, and is seen now, as a devise for encouraging entrepreneurial activity and promoting economic growth. However, despite these desirable and widely accepted goals, the corporate form was abused. In particular, its use by persons who took advantage of being able to conduct business through a company with a minimum paid up capital was in marked contrast to the original conception of a company as a means of attracting substantial capital to undertake significant projects. There followed attempts to curb the abuses without derogating from the advantages of limited liability. In strict legal theory, the measures taken to curb abuses involve the invasion of the principle of separate entity of the company, although they are sometimes loosely characterized disturbing the principle of limited liability. Initially, the development of the law of the limited liability company centered upon the protection of

© University of Pretoria

2.4.1.2 Why a sudden global change of attitude in favour of protection of creditor interest?

Of late, there seems to be a sudden global change of attitude in favour of protection of creditor interest in the management of the business of companies whereby mechanisms, such as the wrongful trading rule, are devised in order to hold entrepreneurs personally liable for losses to creditors when traditionally the said losses have been borne by the company itself by virtue of the limited liability principle.[176] The important question that arises out of this is "why is creditor interest suddenly very important as to be used as a basis for upsetting well settled principles of corporate law such as the separate legal personality rule in *Salomon*?

According to Butcher,[177] the increase in corporate insolvencies, coupled with the recent economic recessions have recently created a public reaction necessitating a look into the conduct of the persons behind the management of companies and this has motivated the courts to adopt a harder attitude towards directors of failing companies.[178] Because of this situation, Farrar[179] has observed, the modern trend is to incorporate regard for creditor interests in the directors' fiduciary duties to the company and to provide sanctions for failure by the directors to fulfil the said duties.[180]

---

investors (shareholders and debenture holders). It was not until some 70 years after the introduction of the concept of limited liability that legislators turned to consider the protection of creditors.

176 Except for situations where corporate veils have been successfully lifted in order to hold entrepreneurs behind the said veils liable to the creditors' claims.

177 Butcher, BS *Directors' duties: A new millennium, a new approach?* (2000) The Hague; Boston: Kluwer Law International, 169.

178 As it has been observed by Terdpaopong, K and Farooque, O " Financial distress, restructuring and turnaround: evidence from Thai SMEs" 2012 (2) *RFAS* 119, 120, "The failure of a business has severe economic consequences and substantial costs, both financial, and psychological to numerous parties involved. The economic costs of business failures [is] significant in terms of both direct and indirect effects that include among others the expenses of either liquidating or attempting to restructure the internal financial domain of the business, accounting and legal fees and other professional service costs that resulted due to the crisis."

179 Farrar, JH "The Responsibility of Directors and Shareholders for a Company's debts" (1989) 4 *Canta Law Review* 12 at 31.

180 See also van der Linde, K "The Personal Liability of Directors for Corporate Fault – An Exploration" (2008) 20 *SA Merc LJ* 439, who argues that the increased focus on good corporate governance has led to a renewed interest in the duties of company directors. According to the learned commentator, this

© University of Pretoria

The rationale for the change of attitude to start giving priority to the interests of creditors rather than the interests of shareholders was well explained in Australia by the House of Representatives Standing Committee in Legal and Constitutional Affairs in its report titled C*orporate Practices and the Rights of Shareholders* (The 'Lavarch Report') in which the committee observed that:

> Increasingly companies have resorted to debt rather than equity for meeting their capital requirements. This has affected the traditional relationships between the directors and the shareholders by introducing new factors into equation. It needs to be noted that the interests of shareholders can be effected [*sic*] as creditors have priority to shareholders in the winding up of a company.[181]

Based on the foregoing, Butcher[182] has argued that in the context of insolvency, with the consequent loss of the company's capital, the shareholders have no financial interest in the company and in those circumstances, the directors must have regard to the interests of the company's creditors.

Dabner[183] has equally added weight to this argument by contending that it is only in the context of insolvency that the rights of shareholders give way to those of creditors because at that point, it is the creditors' investment that is at stake. Finn,[184] has also concurred, arguing that for the reason that when a company is solvent, although it may

---

should be true considering that *The King Report on Corporate Governance*, *1994* ('King I') (accessed online on 12th June 2017 at https://www.mervynking.co.za/pages/publications.htm) and *King Report on Corporate Governance for South Africa, 2002* ('King 2') (a summary of which report was accessed online at http://www.mervynking.co.za/downloads/CD_King2.pdf on 14th November 2018) have both highlighted the role and responsibilities of directors. It must be noted that the subsequent King Reports have equally highlighted the roles and responsibilities of company directors, rendering the observation by Van der Linde herein accurate.

181 House of Representatives Standing Committee on Legal and Constitutional Affairs, Corporate Practices and the Rights of Shareholders AGPS, *Canberra*, 1991 at para 5.3.17, accessed on 17th May 2017 at https://www.aph.gov.au/parliamentary_business/committees/house_of_representatives_committees?url=reports/1991/1991_pp293a.pdf. See also Grantham "The Judicial Extension of Directors' Duties to Creditors" (1991) *JBL* 1.

182 Butcher BS "Directors' duties: A new millennium, a new approach?" (2000) *The Hague; Boston: Kluwer Law International*, 172.

183 Dabner, J "Directors' Duties – The Schizoid Company" (1988) 6 *CSLJ* 105 at 114.

184 Finn, PD *Fiduciary Obligations* (1977) The Law Book Company Ltd, Sydney, 61.

© University of Pretoria

be in liquidation, the real interest in how the liquidation is effected lies with the shareholders since the creditors will be paid in any event, then during insolvency, the focus must similarly be on the persons whose real interests will be affected by the state of insolvency, namely, the creditors.[185]

2.4.2 Penalizing directors for opportunistic behaviour towards creditors

The second aim of the wrongful trading rule is to investigate the causes of insolvent liquidation of companies and to provide sanctions to the directors who can be shown to have failed to fulfil their obligations to the company from the moment the company began to navigate the vicinity of insolvency up to the time when insolvent liquidation of the company became unavoidable.

While it is admitted that the role of insolvency law is predominantly debt-collection[186] and the distribution of the insolvent estate among creditors, it has been argued that effective insolvency laws should also permit an examination of the circumstances giving rise to the said insolvency and, in particular, the conduct of directors of the company in question in the period preceding the inception of the insolvency process.[187]

---

[185] Consider, however, the view taken by Mokal, R "An agency cost analysis of the wrongful trading provisions: Redistribution, perverse incentives and the creditors' bargain" (2000) 59 *Cambridge Law Journal* 335 at 343, who argues, in respect to the wrongful trading rule in the UK which is similar to the rule in Malawi, that the rule fails to protect creditors as the duty to minimize the potential loss to the said creditors under the rule arises once it is clear that the company is beyond redemption. This view is shared by Lombard S, "Claims Against Negligent of Fraudulent Directors: Proposes Amendments to South African Legislation" (2007) 16 *INT'L Insolvency REV* 75, 91, who argues that the English wrongful trading rule takes any conduct by directors prior to the point when the company is beyond redemption to be irrelevant. According to Lombard, the directors may very well have caused the company to reach the point of no redemption and in that situation, creditors will not have redress for the conduct of the directors that led to the demise of the company. The view is further shared by Arsalidou, D "The Impact of Section 214(4) of the Insolvency Act 1986 on Directors' Duties" (2000) 22 *The Company Lawyer* 19, who argues that the wrongful trading rule only catches a 'limited span of negligent directorial conduct' and does not provide directors with an incentive to act with care when the company is solvent, but only when it has become clear to them that the company is going to fail.

[186] Jackson, T *The Logic and Limits of Bankruptcy law* (1986) Havard University Press, 3.

[187] United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April2013) 4. This document will hereinafter be referred to as the "UNCITRAL Legislative Guide."

© University of Pretoria

Based on the foregoing, the question that arises is whether, apart from offering last chance protection to creditors during insolvent liquidation by maximizing the assets of the company available for distribution, the wrongful trading mechanism also penalizes directors for their opportunistic behaviour towards creditors in the management of the affairs of companies during a period immediately preceding the onset of the said insolvent liquidation.

While the wrongful trading provision in Malawi does not directly provide that the liability imposed by the provision is a penalty on directors for causing or failure to prevent insolvent liquidation of companies, there are suggestions that this may be one of the rationales behind the provision with the aim of providing deterrence from such conduct to directors of other companies as well as future directors. This view seems to be well supported:

To begin with, Griffin[188] has argued this point right from the very notion of lifting the corporate veil, arguing that where a statute seeks to lift a corporate veil, its effect will not normally be to deny the existence of a corporate entity, but to penalize company directors for some form of corporate malpractice in their activities with respect to insolvent companies.

Secondly, the UNCITRAL Legislative Guide on Insolvency law[189] is categorically clear that 'civil liability imposed on a director in the vicinity of insolvency is typically based on responsibility for causing insolvency or failing to take appropriate action to monitor the financial situation of the company or indeed failure to avoid or ameliorate financial difficulty of the company and to minimize potential losses to creditors by avoiding insolvency.'[190]

---

188 Griffin, S *Personal Liability and disqualification of Company directors* (1999) Hart Publishing Co.,15.

189 United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April 2013).

190 Ibid, pages 9-10.

© University of Pretoria

Thirdly, while accepting that one of the main reasons why insolvency laws exist is to maximize the pool of assets available to all company creditors, Mokal[191] has referred, with approval, to the sentiments of Finch[192] and Goode[193] who argue that other visions of insolvency law pertain to attempting to rescue the firm and also to penalize the management of the firm for acts or omissions harmful to the company and its creditors.

Fourthly, it would appear that the requirement to prove a causal link between the conduct of the directors and the loss suffered by the company undergoing insolvent liquidation also suggests the desire to hold directors liable for causing or failure to prevent the said insolvent liquidation. In *Re Continental Assurance Co of London Plc*[194] the court held that it is not enough merely to say that if the company had not continued trading, a particular loss would not have been suffered by the company.[195] The court rather said that in order to impose liability for wrongful trading on directors, there must be sufficient connection between the wrongfulness of the directors' conduct and the company's losses.

Park J in that case remarked categorically that there must be more than a 'mere "but for" nexus…to connect the wrongfulness of the director's conduct with the company's losses.'[196] In *Liquidator of Marini Ltd vs. Dickenson*[197] as well as in *Brooks & Willets vs. Armstrong and Walker,*[198] wrongful trading claims failed because the claimants failed to prove an increase in the net deficiency (increase in the total debts) of the company's assets during the relevant periods of wrongful trading.[199]

---

191 Mokal, R "An agency cost analysis of the wrongful trading provisions: Redistribution, perverse incentives and the creditors' bargain" (2000) 59 *Cambridge Law Journal* 335 at 336.

192 Finch, V "The measures of Insolvency law" (1997) 17 *O.J.L.S.* 227.

193 Goode, R *Principles of Corporate Insolvency Law* (1997) 25-29.

194 (2007) 2 BCLC 287.

195 Ibid, at page 733.

196 Ibid.

197 (2004) BCC 172.

198 (2016) EWHC 2893 (Ch).

199 Similar points were made in *Morphitis v. Bernasconi* (2003) Ch 552 and *Morris v. Bank of India* (2005) BCC 739.

© University of Pretoria

The need to prove a causal link between the conduct of the director and the loss suffered by the company is much clearer in Australia as it emanates from statute,[200] just as it can also be seen through case law in South Africa. Although the insolvent trading rule in Australia and the reckless trading rule in South Africa[201] are framed differently from the wrongful trading rule in Malawi, the Australian and South African positions are still comparable to the wrongful trading rule in Malawi by virtue of them being rules that equally impose personal liability on directors of companies for conduct that leads to losses to the company and its creditors.

In Australia, for a claim of insolvent trading against a director to succeed under the Corporations Act, it must be shown that the director allowed or failed to prevent the company from incurring a debt at a time when the director knew or ought to have known that the company was insolvent or that it would become insolvent after incurring the debt or debts in question and the person to whom the debt is owed must be shown to have suffered loss or damage in relation to the debt because of the company's insolvency.[202]

Further, under section 588M (3) of the Australian Corporations Act,[203] a creditor from whom the company incurred the debt in respect of which a director contravened the insolvent trading provisions may recover from the director an amount equal to the amount of loss or damage suffered by the creditor because of the company's insolvency.[204]

200 Corporations Act No. 50 of 2001.

201 Note that "Reckless trading" rule in reference to the South African rule under Section 424 of the repealed 1973 companies Act is used for reference to the said provision only. It is not meant to define or summarize the provision.

202 Section 588 (J) (1) (c) of the Act.

203 Act no 50 0f 2001

204 Section 588G (2) and (3) of the Corporations Act 2001.

© University of Pretoria

Commenting on the two Australian provisions above, Austin and Ramsey[205] have contended that the provisions require that there must be a causal link between the directors' conduct and the loss suffered in order for an insolvent trading claim to succeed.

In South Africa, the general rule in relation to liability of a director for, *inter alia*, reckless conduct in running the affairs of a company leading to the insolvent liquidation of the company[206] was enunciated by the Supreme Court in *Philotex (Pty) Ltd vs. Snyman*[207] in which the court said that there is no requirement to prove a causal link between the relevant conduct and the debts or liabilities in respect of which a declaration of personal liability is sought.[208]

However, in *Saincic & others vs. Industro-Clean (Pty) Ltd & Another,*[209] which was decided much later than the *Philotex* case, the Supreme Court said that the absence of the said causal link is relevant for the court to determine whether or not it should make a declaration for personal liability against the defendant. The court said:

> "It is true that it is not necessary to prove a causal link between the relevant conduct and the debts or liabilities for which there is a declaration of personal liability in terms of section 424. But the absence of such a proven link is a factor to be taken into consideration by the court in

205 Austin, P and Ramsey, I *Ford's Principles of Corporations law* (2008) 1119.

206 Section 424 of the 1973 companies Act. Note that the 1973 companies Act was repealed by the 2008 companies Act in South Africa. However, chapter 14 of the said Act was saved and it is still applicable in respect of winding up of insolvent companies.

207 (1998) 2 SA 138 SCA.

208 An important question that is worth mentioning with respect to the reckless trading rule in South Africa was whether the mere fact that the conduct of the director put the interests of creditors in jeopardy is enough to invite liability against the said directors for reckless trading. This question is pertinent because if answered in the affirmative, it has the effect of discouraging legitimate risk taking by directors, a fact which may stifle entrepreneurship as business ideally involves taking of risks. In *Nel and others NNO vs. McArthur and others* 2003 (4) SA 142 (T) at 156, the court took the opinion that provided the conduct of the director in question carries with it the risk that creditors will not be paid, it can be regarded as reckless trading. A few years later, however, the Supreme Court of South Africa changed the law in *Heneways Freight Services (Pty) Ltd vs. Grogor* 2007 (2) SA 561 (SCA) by holding that the mere fact that the debtor puts the creditors at risk does not mean that such a debtor acted recklessly. In the view of the court, when the company has become insolvent as to make liability for reckless trading likely against directors, the inquiry should be whether the directors genuinely believed that the company would be able to pay its debts.

209 (2009) 1 SA 538 (SCA). See also Sharrock, R *et al Hockly's Insolvency law* (2012) 267.

© University of Pretoria

> the exercise of its discretion and in order to decide whether such a declaration is, in all the circumstances, just and equitable.[210]

Interesting remarks suggesting disapproval of this general rule were, however, made by Harms JA in the said *Saincic* decision. The learned Justice of Appeal seemed to tacitly approve his earlier dictum in *L & P Plant Hire BK v. Bosch*[211] in relation to section 64 of the Close Corporations Act,[212] an equivalent of section 424 of the Companies Act,[213] to the effect that in the case of a creditor's claim under the said Close Corporations Act, section 64 is to be applied restrictively so as to apply only where the result of the relevant conduct is that it has a negative impact on the creditor's claim against the corporation.

Harms JA added a caveat, however, that to the extent that his dictum in *L & P Plant hire* decision seemed to conflict with earlier cases, such as the *Philotex* case above, the dictum had to be seen in the context of its facts. The factual context of *L& P Plant hire* was explained by the Supreme Court of Appeal in the case of *Fourie vs. First Rand Bank Ltd*[214] when the court said:

> "The context of L & P Plant Hire was that there was no evidence that the close corporation concerned was unable to pay its debts. Read in that context, the judgment is rightly understood…as saying no more than this: if, despite the reckless conduct of the company's business, it is nevertheless able to pay its debts to a particular creditor, that creditor has no cause of action under s 64 – or s 424 – against those responsible for the reckless conduct"[215]

---

210 See also Phungula, S "Lessons to be learned from reckless and fraudulent trading by a company, Section 424 (1) of the Companies Act 61 of 1973 and sections 22 and 77(3) of the Companies Act 71 of 2008." *SA Merc LJ*, Vol 28, No. 2, 2016, in which a contention is being made that the *Caincic* case has changed the law on the requirement of causal link which was thought to be settled by the *Philotex* case.

211 (2002) 2 SA 662 SCA Paras 39-40.

212 Act 69 of 1984.

213 Act 71 of 2008.

214 2013 1 (SA) 204 (SCA).

215 Ibid, at para 28. The court further added that 'S. 424 was not intended to create a joint and several liability between the company and those responsible for reckless conduct of its business, but rather to protect creditors against the prejudice they may suffer as a result of the business of the company being carried on in that way. Logic dictates that unless the company is unable to pay, no such prejudice would follow.' See also Stevens and De Beer "The Duty of Care and Skill, And Reckless Trading: Remedies in Flux" 2016, *SA Merc LJ* 250.

© University of Pretoria

Delport *et al*[216] contend that the dictum of Harms JA in the *L & P Plant Hire* decision should not be construed so as to indicate that it is a general requirement that the plaintiff must establish a causal link between the conduct complained of and the debts in respect of which personal liability is sought.

However, considering that the *Saincic* decision is to the effect that in the absence of a causal link the court will find it unjust and inequitable to make a declaration for personal liability against a Defendant, and considering also that the *Fourie vs. Newton* decision is to the effect that if the company is able to pay the debts then there is no cause of action, the combined effect of these two decisions is that if the company in South Africa is unable to pay the debt, but there is no causal link between the misconduct and the debt, the court will find it unjust and inequitable to make an order for personal liability.

Apart from the foregoing, the sentiments of Cameron JA in *Ebrahim vs. Airport Cold Storage*[217] also suggests that personal liability of persons behind the management of corporations when the corporations plunge into insolvent liquidation is designed to make the said persons responsible for causing or failure to prevent the said liquidation. His words, in respect of section 424 of the Companies Act 1973, were that 'the provision in effect exacts a quid pro quo: for the benefit of immunity from liability for its debts, those running the corporation may not use its formal identity to incur obligations recklessly, grossly negligently or fraudulently. If they do, they risk being made personally liable.'[218]

When considered in light of the fact that this provision only applies when a company enters formal insolvency proceedings,[219] it is submitted that the sentiments of Cameron

216 Delport *et al Henochsberg on the Companies Act, 2008,* Vol 2, Issue 14, Appx 1, P. 292.

217 (2008) 6 SA 585 (SCA).

218 With respect to the reckless trading rule in South Africa, it must be noted that while the rule does not specifically refer to directors, it is often used against directors; Van der Linde K, "The Personal Liability of Directors for Corporate Fault – An Exploration" (2008) 20 *SA Merc LJ* 439, 443. The rule is, however, applicable to any officer of the company provided they were knowingly a party to the carrying of the business of the company recklessly. In *Strut Ahead Natal (Pty) Ltd vs. Burns* 2007 (4) SA 600 (D), a non-director was sued for reckless trading, although he escaped liability for lack of gross negligence in his conduct.

219 Delport *et al Henochsberg on the Companies Act, 2008,* Vol 2, Issue 14, Appx 1, P. 291.

© University of Pretoria

JA are to be taken to mean that the personal liability sought to be imposed by the provision on the persons managing the affairs of a corporation is a price they must pay for causing or failure to prevent the said insolvency.

It will be seen from the foregoing that the statutory position in Australia and the case law in South Africa are similar in the sense that they both require the existence of a causal link between the conduct and the debt for personal liability to be imposed under the relevant provisions.

English common law is to a similar effect, a factor which lends weight to the contention that the need for a causal link between the conduct and personal liability under wrongful trading in Malawi seems to be, when regard can be had to the trend in comparable jurisdictions as above, predicated on the desire to penalize directors for causing or failing to prevent insolvent liquidation of their companies.

2.5 RELEVANCE OF ECONOMIC THEORY TO DIRECTORS' LIABILITY

Rules that create legal liability on persons for their conduct, such as the wrongful trading rule, the subject matter of this study, are recognized as having some economic theory underpinnings. In his article titled *Economic Theories of Legal Liability*,[220] Robert D. Cooter has argued that the use of a negligence standard to create and enforce efficient standards of behavior is one of the economic theories of legal liability.[221]

The wrongful trading rule, which, it is submitted, is a statutory restatement of the common law negligence principle, creates and enforces efficient standards of behavior in directors of financially distressed companies by requiring them to, for instance, immediately embark on courses of action that may either rescue the company or, in the event that a rescue is unachievable, courses of action that may minimize potential losses to the company's creditors as a whole when the company plunges into insolvent liquidation.

---

220 Cooter, RD, *The Journal of Economic Perspectives,* Vol 5, No 3 (Summer, 1991) pp. 11 – 30.

221 Ibid, at p 11.

© University of Pretoria

Although this study will not dwell much on economic theory implicit in the wrongful trading rule, chapter 4 of this study will elucidate the efficient standards of behavior that arise in respect of directors whose companies become financially distressed and which standards of behavior, if not complied with, invite liability for wrongful trading when the company finally plunges into insolvent liquidation.

Apart from the foregoing, the relevance of the economic theory implicit in the wrongful trading rule as a restatement of the common law negligence principle is that the fear of potential liability for wrongful trading on the part of directors compels them to act prudently even when their companies are fully solvent. This fear, it is submitted, compels the directors to ensure that they comply with efficient standards of behavior required for serving as directors of companies and this, in turn, has the potential of maximizing shareholders' wealth. As it has been observed by Anderson H, in her article *Creditors' rights of recovery: Economic Theory, Corporate Jurisprudence and the role of fairness*,[222] "the contribution of economic theory to positive corporate law is largely limited to the objective of shareholder wealth maximization".

Although not a focus area of this thesis, economic theory is worth mentioning in this context, also in view of the observation by Cooter, who stated:[223]

> Economics intermingled with law at its inception. Adam Smith wrote not only *The Wealth of Nations*, but also *Lectures on Jurisprudence* (1766 [1978]). The elaboration of price theory by mathematical economics in this century, however, took the legal framework for granted. Liability law [such as the wrongful trading rule] is an important mechanism for allocating resources, which should interest economists for its own sake. In addition, *liability law* [own emphasis] is a repository of practical knowledge about incentives whose study is yielding fresh insights into power, externalities, markets, organizations, and other phenomena.[224]

---

222 (2007) *Melbourne University Law Review*, Vol 30, p. 6.

223 Cooter, RD, *The Journal of Economic Perspectives,* Vol 5, No 3 (Summer, 1991) pp. 11 – 30.

224 Ibid, at p 28.

© University of Pretoria

2.6 CHAPTER CONCLUSION

In this chapter, which was aimed at giving an exposition of the conceptual justifications of the wrongful trading rule as a way of emphasizing the importance of the rule under Malawian law, it has been established that the wrongful trading rule originated from the United Kingdom in the mid-1980s and was copied into section 187 of the Insolvency Act of 2016 in Malawi.

Further, it has been established that the rule was invented in the United Kingdom as a result of the desire to have a statutory rule which created personal liability against directors of companies for their recklessness or indifference in the management of the affairs of companies when the said companies were faced with insolvency and creditors eventually suffered losses during insolvent liquidation of the companies.

It has also been established that the wrongful trading rule came about because the fraudulent trading rule, which was already in existence at that time in the United Kingdom, was deemed to be incapable of curbing recklessness or indifference on the part of directors of companies when running the affairs of financially distressed companies for a number of reasons. First, the need to prove fraud to the criminal standard under the fraudulent trading rule meant that fraudulent trading was difficult to establish against directors.

Second, the fraudulent trading rule was incapable of catching directors who acted honestly but whose actions were a reckless disregard to the interest of creditors like in the *Re Patrick Lyon Ltd* decision where the fraudulent trading rule could not be used to catch a director-owner who traded insolvently at the expense of the creditors of his company with the aim of validating a floating charge in his favour. It has therefore been established that the wrongful trading rule came about as a result of frustration at the failures of the fraudulent trading rule to curb director indifference to the plight of creditors in the running of the affairs of companies.

Further, it has been established in this chapter that in the quest to create the wrongful trading rule, the Cork Committee in the United Kingdom highlighted the need to have a rule that would require directors to satisfy themselves regarding the company's ability

© University of Pretoria

to discharge its financial obligations as a condition for continuing to trade. Where it was clear that the company could not discharge its liabilities, the rule had to place an active responsibility on the part of the directors not to allow the company to continue trading but rather compel the directors to place the company in a form of an insolvency process.[225]

Targeting directors of the company, however, entailed that the contemplated rule had to transcend the principle of separate legal personality. As it is clear under the separate legal personality principle, when a company incurs a debt, the company alone is responsible for the repayment of the debt and the directors and shareholders cannot, under the separate legal personality principle, be responsible for the repayment of the said debt.[226]

As it has been established in this chapter, the separate legal personality principle meant that directors were protected from claims by creditors of companies and this gave the directors the incentive to exploit this protection and make decisions that were harmful to creditor interest especially where companies were approaching insolvency, knowing that they would not be liable. This principle stemmed from the House of Lords decision in *Salomon*.[227]

It has been established in this chapter that the effect created by the separate legal personality principle on creditor interest was unpleasant and, unsurprisingly, rules began to emerge on how to alleviate the impact of the principle. Under common law, rules were devised requiring piercing of corporate veils and placing liability on the members of companies for debts incurred by the company.[228] On the other hand, the legislature also began devising rules that could alleviate the impact of the principle. To this end, it has been established in this chapter that the wrongful trading rule is one of such rules that were devised by the legislature in order to alleviate the detriment to

225 See generally para 2.2 above.

226 See para 2.3.1 above.

227 See para 2.3.2 above.

228 See para 2.3.4 above.

© University of Pretoria

creditor interest which was being perpetrated by directors of companies under the cover of the separate legal personality principle.[229]

On the question of whether it is justifiable for the wrongful trading rule to transcend the well settled principle of limited liability that is implied by the separate legal personality principle, it has been established that the justification lies in the fact that the limited liability principle had been used so many times by directors to achieve ends which were detrimental to creditor interest in the running of the affairs of companies and hence the need to devise a rule that removed the protection that was afforded by the principle, imposing personal liability on the directors for such conduct, became necessary and justifiable.[230]

On the question of whether the wrongful trading rule over-protects creditors who have the opportunity to protect themselves in their dealings with companies by means of demanding interest in their agreements and also by ensuring that their agreements are backed by guarantees, it has been established that while these protections exist in theory, in practice things work out differently for the reason that companies deal with creditors on take-it or leave-it basis and hence the creditors, keen to secure business, may not usually have the power to safeguard their positions by demanding interest or guarantees.

Further, it has been established that the cost of negotiating contracts which take care of all the contingent interests and all possible guarantees may sometimes surpass the cost of the business being contracted on particularly for small scale traders, rendering the protective contracts unachievable. It has also been established that the notion of creditors being able to protect themselves in their dealings with companies does not consider the plight of involuntary creditors, such as tort victims.[231]

---

229 See para 2.3.5 above.

230 See para 2.3.6 above.

231 See generally para 2.4.1 above.

© University of Pretoria

On the question of why there seems to be a sudden change of attitude in favour of protecting creditor interests at the expense of well settled corporate law principles such as the limited liability principle, it has been established that the increase in corporate insolvencies, coupled with the recent economic recessions have created a public reaction necessitating extra protection of creditor interest by looking into the conduct of the persons responsible for the management of the affairs of companies during the period leading to insolvency of the companies. Where the said conduct is found to have led to or contributed to the collapse of the company and thereby causing losses to creditors, the directors responsible for the said conduct are penalized by the imposition of personal liability against them through the wrongful trading rule.[232]

On the relevance of the economic theory to directors' liability for their conduct in the running of the affairs of solvent or financially distressed companies, it has been established that implicit in the wrongful trading rule is an economic theory which creates and enforces efficient standards of behavior in directors of both solvent and financially distressed companies and that this in turn promotes shareholder wealth maximization.

232 See para 2.4.1.2 above.

© University of Pretoria

CHAPTER 3

MEANING OF "DIRECTOR" FOR PURPOSES OF THE WRONGFUL TRADING RULE IN MALAWI

SUMMARY

3.1 Introduction……………………………………………………………83

3.2 Meaning of the term "director" in Malawi……………………………...84

3.3 Who can be a director in Malawi?...86

3.4 Types of directors in Malawi and their liability for wrongful trading…....88

3.5 Other persons who may be adjudged to have been directors of companies for purposes of wrongful trading in Malawi……………..110

3.6 Chapter conclusion……………………………………..…………116

3.1 INTRODUCTION

It having been made clear in the preceding chapter that conceptual justifications exist in favour of the having the wrongful trading rule under Malawian insolvency law, this chapter is dedicated to answering the second sub-question of the main research question of this study, namely, "what is the meaning of the term "director" for purposes of the wrongful trading rule in Malawi?" This question will be found to be important in this study as it reveals all different types of persons, both natural and artificial, who may be liable for wrongful trading in Malawi.

In answering this important question, this chapter begins by providing the meaning of "director" under the Companies Act of 2013 in Malawi, which meaning is then compared with the meanings of the same term in the comparable jurisdictions, namely,

© University of Pretoria

the United Kingdom, South Africa and Australia. The chapter then discusses the eligibility for appointment as director under the Companies Act of 2013 in Malawi.

From that discussion, the chapter goes on to discuss the types of directors under corporate law generally and the liability of each type of a director for wrongful trading. In this vein, the chapter first discusses *de jure* directors and all the sub-types of directors under *de jure* directorship and their liability for wrongful trading. These include temporary directors, nominee directors, puppet directors, *ex-officio* directors as well as alternate directors.

The chapter then discusses *de facto* directors. Considering that a serious issue that arises in respect of acts done by *de facto* directors is one of validity of their acts, the chapter first discusses the law regarding the validity of acts performed by *de facto* directors before discussing the liability of *de facto* directors for wrongful trading.

The chapter winds up by discussing shadow directors. This is done with particular highlight on the distinction between shadow directors and *de facto* directors. The chapter then discusses the liability of shadow directors generally for wrongful trading before narrowing down to discuss other interesting types of shadow directors who will also be liable for wrongful trading in relation to the insolvent company.

These include the shareholders of the insolvent company; independent companies; bankers of the insolvent company; professional advisors of the insolvent company such as accountants, auditors and insolvency practitioners; persons occupying positions lower than that of a director in the company (such as managers) and, finally, the chapter discusses how any other person, whether or not they were at all material times engaged by the insolvent company, can be adjudged to have been a " director" of the insolvent company for purposes of the wrongful trading rule.

3.2 MEANING OF THE TERM DIRECTOR IN MALAWI AND IN THE COMPARABLE JURISDICTIONS

3.2.1 **Malawi**

© University of Pretoria

Section 158 of the Companies Act of 2013 in Malawi provides that the term director includes a person occupying the position of director of the company by whatever name called.[233] From this definition, it is clear that a person can become a director without necessarily being called a director and without necessarily being appointed to be a director. This seems to be the position in the comparable jurisdictions of this study as follows:

3.2.2 **United Kingdom**

In the United Kingdom, section 250 of the Companies Act[234] provides that the term director includes any person occupying the position of director by whatever name called. Paolini[235] has contended that the English definition is wider than simply including a person who has been validly appointed as a director and can also encompass *de facto* and shadow directors. Paolini further argues that the rationale for the broad and somehow uncircumscribed definition under English law dwells in the fact that directors are subject to a series of duties which could be easily circumvented if the concept of a director is specific.[236] An open definition, it is argued, allows a certain amount of discretion to be exercised by the courts on a case-by-case basis in establishing whether or not a person can be adjudged to be or to have been a director of a company at any particular time.[237]

3.2.3 **South Africa**

[233] Section 158(1) (a) of the Companies Act of 2013.

[234] Companies Act 2006.

[235] Paolini A, (Ed) (Article of Andrea Lista, p.76) "Research handbook on Directors' Duties" (2016) *Edward Elgar Publishing*, UK & USA, 286.

[236] Ibid.

[237] Paolini argues, ibid, that if the definition of a director only encompassed persons duly appointed as directors, the real persons effectively controlling companies could avoid being subject to directors' duties just by virtue of the fact that they were never duly appointed as directors of the company.

© University of Pretoria

In South Africa, a director is defined under Section 1 of the Companies Act[238] as a member of the board of a company as contemplated by Section 66 of the said Act, or an alternative director of a company and includes any person occupying the position of a director or alternate director by whatsoever name designated. Cassim[239] has argued that through this definition, the title or description of the position is not relevant in determining whether a person is a director and therefore that it is possible for someone to be a director even though he or she is referred to as a manager. According to Cassim, it is the substance of that person's activities rather than the title given to the person that will determine whether he or she is a director.[240]

3.2.4 **Australia**

In Australia, a director is defined as any person appointed to the position of director or the position of an alternate director who is acting in that capacity regardless of what they are called, and it also includes persons who were not validly appointed but who act as directors or whose instructions or wishes are adhered to by directors.[241]

3.3 WHO CAN BE A DIRECTOR IN MALAWI?

Under the Companies Act of 2013 in Malawi, except in the case of state-owned companies,[242] only a natural person is eligible for appointment as a director of a company.[243] Further, no person is eligible for appointment as a director in Malawi if he is below 18 years of age,[244] and, in case of public companies, if he is over 70 years of

---

238 Act 71 of 2008.

239 Cassim FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty), Ltd 236.

240 Ibid.

241 Section 9 of the Corporation Act 50 of 2001.

242 Section 164(2)(d) of the Companies Act.

243 Section 164 (1) of the Act.

244 Section 164(1)(a) of the Act.

© University of Pretoria

age.[245] A person may also not be eligible for appointment as a director in Malawi if that person:

(a) Is an undischarged bankrupt.[246]

(b) Is prohibited from being a director or promoter or being concerned or taking part in the management of a company.[247]

(c) Has been adjudged to be of an unsound mind.[248]

(d) By virtue of the constitution of a company, does not comply with any of the qualifications for directors.[249]

Interestingly, the Companies Act in Malawi further provides that a person who is disqualified from acting as a director but who acts as a director shall be deemed to be a director for the purposes of a provision in the Act that imposes a duty or an obligation on a director of a company.[250]

---

245 Section 164(1) (b) of the Act. Provided that where the said person was already a director of the company before attaining the age of 70 years, his office, as a director of a public company or of a subsidiary of a public company, shall become vacant at the conclusion of the annual meeting commencing next after the director attains the age of seventy years: Section 169 (4) of the Act.

Where the office of that director becomes vacant as provided for above, the provisions for automatic re-appointment of retiring directors in default of any appointment shall not apply with respect to the director referred to above: Section 169 (5) of the Act.

The foregoing notwithstanding, a person of or over the age of 70 years in Malawi may be appointed or re-appointed as a director of a company to hold office until the next annual meeting of the company or be authorized to continue to hold office as a director until the next annual meeting of the company: Section 169 (6) (a) of the Act. In case of an application for incorporation of a public company, a person over 70 years of age may be appointed as a director with the consent in writing of the proposed shareholders: Section 169 (6) (b) of the Act.

Nothing provided above can limit or affect the operation of a provision in the constitution of a company preventing any person from being appointed a director or requiring any director to vacate office at any age below 70 years.

246 Section 164(2)(c) of the Act. It must be noted that the Insolvency Act 2016 in Malawi provides for both corporate insolvency and bankruptcy of individuals.

247 Section 164(2)(c) [sic] of the Act.

248 Section 164(2) (d) of the Act. See also Parts V and VII of the Mental Treatment Act Cap 34:02 of the Laws of Malawi.

249 Section 164(2) (f) of the Companies Act. For example, where a director is required by the constitution to take up shares in the company and fails to do so within the prescribed time.

250 Section 164(3) of the Companies Act of 2013. Ideally This is meant to offer protection to innocent third parties who may be misled to transact with the said persons on the understanding that they are duly

© University of Pretoria

3.4 TYPES OF DIRECTORS IN MALAWI AND THEIR LIABILITY FOR WRONGFUL TRADING

Although several types of directors exist under the law, Keay[251] has argued that effectively there are three main kinds of directors, namely, *de jure* directors, *de facto* directors and shadow directors. In view of Keay's analysis, it is submitted that the rest of the types of the directors are only mere designations falling under these three main types.

3.4.1 *De Jure* Directors

These are directors who have been formally appointed, with their consent, and in accordance with the company's Articles of Association.[252] These appointments will usually appear in the company's records held by the Registrar of Companies.[253] Consent to the appointment is very vital for *de jure* directors such that no person can be appointed as a director under the Companies Act in Malawi unless that person has consented in writing to be a director and certified that he is not disqualified from being appointed or holding the position of a director of a company.[254]

Validity of the appointment process and consent by the appointees being the only determinants, it will be clear that once appointed, *de jure* directors could be known by various designations depending on the process by which they are appointed as well as the responsibility which they are given upon appointment. Some of the designations and how the directors may be liable for wrongful trading include the following:

---

appointed as directors. In *In the Matter of East Africa Sailing and Trading Co Ltd* in Malawi, Com. Court Petition No. 4 of 2012, the High Court held that the actions of directors who were irregularly appointed perpetrated unfairly prejudicial conduct against the petitioner and the Court compelled the said irregularly appointed directors to buy the petitioner's shares.

[251] Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 5.

[252] Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty), Ltd 238.

[253] Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 5.

[254] Section 165 of the Companies Act of 2013.

© University of Pretoria

3.4.1.1 Temporary directors and their liability for wrongful trading

These are directors who may be appointed to serve on a temporary basis when a vacancy exists in the board until such a time when the vacancy has been filled by a director who has been formally elected. Although not specifically provided for under the Companies Act in Malawi, it will be noted that the Act does not preclude the appointment of a temporary director where a vacancy occurs at a company's board provided that the constitution of the company allows the said appointment.

Unlike the position in Malawi, the position of a temporary director is recognized by statute in South Africa. Under the South African Companies Act of 2008, unless the memorandum of incorporation of a profit company provides otherwise, a board is empowered to appoint a person who satisfies the requirements for election as a director to fill any vacancy and serve as a director of a company on a temporary basis until the vacancy has been filled by election, and upon the temporary director being appointed, he assumes all the powers, functions and duties, and is subject to all of the liabilities of any other director of the company.[255]

Although appointed to fill a temporary position, a temporary director will still be required to satisfy the requirements for election as director for the reason that upon appointment, he or she will assume the same powers, functions and duties as are assumed by non-temporary directors and also that he or she will be subject to all the liabilities of directors in the same way as the other non-temporary directors.[256] For this reason, a temporary director can be liable for wrongful trading in the same way as the rest of the non-temporary directors, and the fact of him having been only a temporary director may not be used to escape liability for wrongful trading where the relevant conduct giving rise to the said liability occurred during his tenure as a temporary director.

---

[255] Section 68 (3) of the companies Act No. 71 of 2008.

[256] Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty), Ltd 238.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

3.4.1.2 Nominee Directors and their liability for wrongful trading

Usually, a nominee director is appointed by a shareholder who controls sufficient voting power in a company to represent his interest. Apart from representing a major shareholder, Cassim[257] contends that a nominee director may also be appointed to represent a class of shareholders, a significant creditor, or an employee-group. Nominee directors are useful in certain situations like where a major shareholder agrees to subscribe for shares in a company on condition that he or she should have a representation on the board of directors or where a major shareholder lacks the time or expertise to serve as a director personally and instead prefers to appoint a nominee to act on his or her behalf.[258]

A question that arises in respect of nominee directors is usually one of loyalty. Having been nominated by a stakeholder in the company, the question is usually whether a nominee director sitting on the board would not want to foster the interests of the nominator in instances where the said interests conflict with the interests of the company. The position of the law in this regard was given by Margo J in *Fisheries Development Corporation of SA Ltd vs. Jorgensen*[259] who said that:

> A director is in that capacity not the servant or agent of the shareholder who votes for or otherwise procures his appointment to the board…The director's duty is to observe the utmost good faith towards the company and in discharging that duty he is required to exercise an independent judgment and to take decisions according to the best interests of the company as his principal. He may in fact be representing the interests of the person who nominated him, and he may even be the servant or agent of that person, but, in carrying out his duties and functions as a director, he is in law obliged to serve the interests of the company to the exclusion of any nominator, employer or principal.[260]

---

[257] Ibid.

[258] Ibid.

[259] (1980) 4 SA 156.

[260] Ibid, at page 163. Note that this position is said to be premised on the concept of a company as a separate entity, in terms of which a company is viewed as a juristic person with its own rights and duties separate from its members. This concept stems from the decision in *Salomon vs. Salomon & Co.*, *supra*. See also decisions that followed the *Salomon* decision, e.g. *Walker vs. Winborne* (1975-76) 137 CLR 1

© University of Pretoria

The approach seems to be the same in other jurisdictions such as the United Kingdom, Canada and the United states of America. In the United Kingdom, the court in *Boulting vs. ACTT*[261] said the following in respect of the appointment of a nominee director by a large shareholder:

> There is nothing wrong in it. It is done every day. Nothing wrong, that is, so long as the director is left free to exercise his best judgment in the interests of the company that he serves. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful.[262]

This position aligns with the dictum of Lord Denning made a few years before the *Boulting* judgement in *Scottish Co-operative Wholesale Soc. Ltd. vs. Meyer*.[263] The case involved the application of the remedies for alleged shareholder oppression under the 1948 English Companies Act in relation to directors of a textile corporation who were nominated by members of a co-operative society shareholder. In finding against the said nominee directors, Lord Denning had this to say:

> What, then, is the position of the nominee directors here? Under the articles of association of the textile company the co-operative society was entitled to nominate three out of the five directors, and it did so. It nominated three of its own directors and they held office, as the articles said, "as nominees of the co-operative society." These three were, therefore, at one and the same time directors of the co-operative society – being three out of 12 of that company – and also directors of the textile company – three out of five there. So long as the interests of all were in harmony, there was no difficulty. The nominee directors could do their duty by both companies without embarrassment. But, so soon as the interests of the two companies were in conflict, the nominee directors were placed at an impossible position…It is plain that, in the circumstances, these three gentlemen could not do their duty by both companies, and they did not do so. They put their duty to the co-operative society above their duty to the textile company in the sense, at least, that they did nothing to defend the interests of the textile company against the conduct of the co-operative society. They probably thought that "as nominees" of the co-operative society their first duty was to the co-operative society. In this they were wrong. By subordinating the interests of the textile company to those of the co-operative society, they conducted the affairs of the textile company in a manner oppressive to the other shareholders.[264]

---

261 (1963) 2 QB 606.

262 Ibid, at page 626.

263 (1959) A.C 324.

264 Ibid, at page 366-67.

© University of Pretoria

Millard[265] has argued that the foregoing position supports the legal position that despite a director being placed on a board specifically to represent and speak for a particular shareholder or other constituency, the director owes his first duty to the corporation as a whole and no particular interest is to take precedence over this duty. Boxell[266] has, however, warned that the requirement not to subordinate the interests of the company on whose board the nominee director serves over those of his appointor to that board should not be interpreted to require the nominee to shut his eyes to the concerns and interests of his said appointor, or that he should not, in special circumstances, have regard to such interests.

In Canada, the court in *PWA Corporation vs. Gemini Automated Distribution systems Inc*[267] acknowledged the fact that a director might find it difficult to separate the interests of the company from those of the shareholder who appointed him. However, the court said that even in the midst of that difficulty, the appointed director must still act in the best interest of the company and that he must endeavour to separate potentially conflicting loyalties.[268]

In the United States of America, the court in *First American Corporation vs. Al-Nahyan*[269] made a similar point. In that case, directors of a wholly owned subsidiary concluded a transaction that was detrimental to the subsidiary, but favourable to the holding company. For that reason, the said directors were accused of having breached their fiduciary duties and in their defence, the directors contended that the only fiduciary duty they owed was owed to the ultimate holding company. The court rejected this contention and held that the directors owed their fiduciary duties to the

---

265 Millard JA, QC "The Responsible Director" (1989) *The Carswell Company Ltd.*, Canada, 7.

266 Boxell, T (Consultant Editor) *A Practitioner's guide to Directors' Duties and Responsibilities*, 4th Ed, (2010), Thomson Reuters (Legal) Limited, 85.

267 (1993) 8 BLR (2d) 221.

268 Ibid.

269 17 F. Supp. 2d 10 (D.D.C. 1998).

© University of Pretoria

corporation on whose board they were sitting, in this case the subsidiary and not the holding company.

On the question of whether a nominee director may be liable for wrongful trading, the answer seems to be in the affirmative. This seems to derive from the fact that upon being nominated, the nominee director enjoys all the benefits that come with his directorship and, as it has been discussed above with respect to the question of loyalty, the nominee director is required to exercise his decisions in the best interests of the company on whose board he sits and not in the interest of the person that nominated him.

In this regard, the nominee director may be liable for wrongful trading if the conduct giving rise to this liability occurred during the period when his nomination was effective and he may not escape liability for wrongful trading solely on the basis that he was only a nominee director, particularly considering that the law requires that he should not be loyal to his nominator in making his decisions.

3.4.1.3 Puppet directors and their liability for wrongful trading

Heimstra J in *S vs. Shaban*[270] defined a puppet director as a person "placed in boards to pretend to have taken part in resolutions of which he knows nothing." The court went on to express disapproval of the practice of planting puppet directors in boards, observing that:

> [O]ur law does not know the complete puppet who pretends to take part in the management of a company whilst having no idea what it is to which he puts his signature. It is utterly foreign to the basic concepts of our law and the courts will punish it as fraud.[271]

[270] (1965) (4) SA 646 (W). See also Havenga, M "Breach of directors' fiduciary duties; Liability on what basis?" (1996) *SA Merc LJ* 366.

[271] Ibid, at page 652.

© University of Pretoria

Cassim,[272] on the other hand, has defined a puppet director as a person who has been placed on the board of directors with the intention that he or she should blindly follow the instructions of his or her controller. In *S vs. De Jager*,[273] previous directors of a company had resigned and appointed puppet directors to the board. The said previous directors still controlled the company and occupied the position of directors and as such they could still be described as directors of the company. The court held that the appointment of the puppet directors was a sham and that it could be disregarded. Note that the court in this case also referred to puppets as "stooges" and "dummies."[274]

3.4.1.3.1 Liability of puppet directors for their acts

An important question that arises with regard to puppet directors is whether it is possible to institute an action against them for breach of fiduciary duties considering the fact that these are directors who do not exercise a mind of their own in the decision-making process in the affairs of the company as they are virtually controlled and manipulated by their masters.

Cassim[275] has argued that a puppet director is not absolved from liability for breach of duties by pushing the blame to the person who appointed him or her for having been the true maker of his decisions. Similarly, Lombard[276] argues that since they are appointed to the office of the director and they are in fact *de jure* directors, there is no reason why puppet directors should not incur liability for a breach of their fiduciary duties.

---

[272] Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty), Ltd 238.

[273] (1965) (2) SA 616.

[274] Similar terms were also used by the court in *R vs. Shaban* (1965) (4) SA 646 (W).

[275] Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty), Ltd 238.

[276] Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 169, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

© University of Pretoria

The foregoing views seem to be in line with the position taken by the court over half a century ago in *Selang or United Rubber Estates Ltd vs. Cradock and others,*[277] where the following was said with regard to the courts' decision to hold puppet directors liable for breach of fiduciary duties:

> They exercised no discretion or volition of their own and they behaved in utter disregard of their duties as directors to the general body of stockholders or creditors or anyone but C. They put themselves in his hands, not as their agent or adviser but as their controller. They were puppets which had no movement apart from the strings and those strings were manipulated by C… They doubtless hoped for the best but risked the worst; and that worst has befallen them.[278]

For the foregoing reasons, puppet directors may be liable for wrongful trading. On the question of whether the manipulators of the puppet directors may equally be liable for wrongful trading, it has been argued that a 'puppet master' will similarly not be able to escape liability by contending that he or she was not formally appointed to the office of the director as the fact of him having been the true maker of the puppet's decisions will make him a shadow director and therefore qualify him for liability for breach of directors' duties in that regard,[279] including liability for wrongful trading.

3.4.1.4 *Ex-Officio* Directors and their liability for wrongful trading

According to Cassim,[280] an *ex-officio* director is a person who is a director of a company as a consequence of holding some other office, title, description, or any other similar status. An *ex officio* director will have all the powers that are assumed by a director of the board in the company and will exercise all the functions of any other director of the company that are allowed by the constitution of the company. A person will not be eligible to serve as an *ex-officio* director of a company despite holding a status which

---

277 [1968] 2 Lloyds Rep 289.

278 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 169, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

279 See *S vs. Hepker* (1973) (1) SA 472 (W) 484. For the complete discussion of the concept of a shadow director, see the general discussion on shadow directors below.

280 Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty) Ltd, 237.

© University of Pretoria

qualifies him to serve as such if he is ineligible or disqualified to be a director under the law. Upon qualifying as an *ex-officio* director, a person becomes subject to the duties and liabilities that attach to the position of the director of the company and therefore he may be liable for wrongful trading.

3.4.1.5 Alternate director and their liability for wrongful trading

The Companies Act in Malawi provides that the term director includes an alternate director.[281] An alternate director is elected to serve as a member of the board of a company in substitution for another director who was equally duly elected as a director of the board. This usually happens in cases where the initial director is, for whatever reason, unable to attend a board meeting or meetings. This is done to ensure that the initial directors' influence is still maintained at the board.

An alternate director will cease to hold office whenever the initial director ceases to be a director or gives notice to the Company Secretary that the alternate director no longer represents him.[282] An alternate director will possess all the powers and perform all the functions which the initial director had and will be subject to the same liabilities that attach to any other director of the board. For this reason, an alternate director may be liable for wrongful trading if it can be shown that he breached the directorial obligations that give rise to liability for wrongful trading during the time when his appointment as an alternate director was effective.

Presumably, the director who has been substituted by the alternate director may not be liable for breach of directorial duties, including wrongful trading, if the conduct giving rise to the said liability was done by the alternative director.

3.4.2 *De facto* Directors

It has been argued that it is very unlikely or impossible to have a legislative provision that defines the term *de facto* director although the term has been used for a long time in

281 Section 158(1) (b) of the Companies Act of 2013.

282 Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty) Ltd, 237.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

legal parlance.[283] Even under common law, there seems to be a divergence of opinions as to the definition of *de facto* director.[284] While one opinion, as expressed by the court in *R v Mall*[285] defines a *de facto* director as a director who is actually appointed but in whose appointment a defect exists, another opinion propagates a wider definition and includes, as *de facto* directors, those who act as directors without having been appointed to the office.[286]

Millet LJ in *Re Hydrodam (Corby) Ltd*[287] defined a *de facto* director as:

> A person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a de facto director of a company it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of the company's affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level.[288]

According to Brown,[289] where a person only becomes legally entitled to fill the office of a director provided certain formal requirements are complied with, it follows that

---

283 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 6.

284 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 169, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

285 (1950) (4) SA 607 at 624.

286 Paolini A, (Ed) (Article of Andrea Lista, p.73) "Research handbook on Directors' Duties" (2016) *Edward Elgar Publishing*, UK & USA, 286. See also Meskin, PM, Kunst, JA, Galgut, B, Deport, P, Vorster, Q, and Burdette, D. *Henochsberg on the Companies Act 71 of 2008* (Lexis Nexis 2011, Loseleaf edition) where the term "pretend directors" is used to describe these directors and where it is suggested that these are not to be regarded as directors under the South African Companies Act, and further that the term should be reserved for directors who were actually appointed, but in whose appointment there is some irregularity.

287 (1942) 2 BCLC 180.

288 Ibid, at page 183.

289 Brown, SR "Company directors: A concise treatise on the duties, powers, rights and liabilities of company directors in Australia" (1965) *London, Sweet & Maxwell*, 2nd ed. 129.

© University of Pretoria

non-compliance with such requirements will result in that person not being a director *de jure,* even though he may be a director *de facto.*

Lombard[290] has argued that for the purposes of identifying the parties that may incur liability for breach of fiduciary duties, the definition of *de facto* directors should not only refer to those in whose appointment a defect exists, but rather that it should include those directors who acted without any form of appointment at all. This view supports by the view taken earlier in *Cyberscene Ltd vs. i-Kiosk Internet and Information (Pty) Ltd*[291] where the court said that:

> [A] director who was not formally appointed either because of some defect in his appointment or because there was no formal appointment at all, stands in the fiduciary relationship from the time he commences to act as a director; for the relationship arises, not as legal consequence of his holding the office as if it was an incident of the office itself, but from the nature of his position in relation to the company and the company's position to him.[292]

In *Re Kaytech International Plc*,[293] a *de facto* director was defined as a person who assumes the function and status of a director and who is held out by the company as a director or who claims to be the director and acts as one without having been appointed to that position according to law. In *Secretary of State for Trade and Industry vs. Becker,*[294] the court pointed out that in order for a person to be called a *de facto* director, it must be established that the person undertook functions in relation to the company which could properly have been discharged only by a director.

---

290 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 164, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

291 2000 (3) SA 806.

292 Ibid, 820.

293 (1992) 2 BCLC, 351.

294 (2003) 1 BCLC 555.

© University of Pretoria

Cassim[295] has argued that apart from the foregoing, the alleged *de facto* director must have participated in directing the affairs of the company on an equal footing with the other directors and not in a subordinate role. Further, Cassim adds that the person must be shown to have exercised real influence in the corporate decision-making process for him to be called a *de facto* director, and that there is no single test to determine whether a person is a *de facto* director and, as such, all circumstances will have to be taken into account.[296]

Keay[297] isolates some of the factors to be taken into consideration in determining if a person is a *de facto* director as being:

(a) Whether there was a holding out of the person as a director by the company.

(b) Whether the person had used the title.

(c) Whether the person had proper or management's information on which to base decisions.[298]

(d) Whether the person had to make major decisions.

While the court in *Secretary of State for Trade and Industry vs. Tjolle*[299] emphasized the point that it must be shown that the person alleged to be a *de facto* director made major decisions for the company, the court in that case also emphasized the point that no single factor is decisive on its own as to whether a person is a *de facto* director and that even where a person uses the title "director" the circumstances may be such that the court will be unable to find that the said person was a *de facto* director.

---

295 Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty) Ltd, 239.

296 Ibid.

297 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 6.

298 *Secretary of State for Trade and Industry vs. Kaczer* (1992) 2 BCLC 351.

299 (1998) 1 BCLC 333.

© University of Pretoria

In the Australian case of *Deputy Commissioner of Taxation vs. Solomon*,[300] two persons who had resigned as directors of the company were held by the court to be *de facto* directors because it was shown that they were involved in the main activities of the company; performed top-level management functions; acted for the company in important matters and were, over and above the foregoing, perceived by outsiders as directors.

In making its finding, the court also took consideration of the facts that one of them had daily contact with the properly appointed directors of the company; had the right to approve an asset sale and was actively involved in the preparation of projections of cash flow, while the other person was involved in negotiations with directors and third parties in relation to possible capital injections into the company; sought professional advice for the company and also that he was actively involved in the preparation of cash flow projections.

In view of the foregoing, Keay has argued that the law is concerned with the substantive nature of what the person does in the life of the company and not what he or she is called.[301] This view point supports the finding of the court in *Secretary of State for Trade and Industry vs. Tjolle* above, where the court refused to make a finding that a person was a *de facto* director despite the fact that titles such as "deputy managing director" and "chief executive" were used interchangeably to describe her.[302]

However, in *Secretary of State for Trade and Industry vs. Jones,*[303] the court said that the use of the word "director" in relation to a person is significant in supporting a finding that the person is a *de facto* director of a company. Although this is the position, it must be noted that a person does not have to believe that he or she is a director before being regarded as a *de facto* director.[304]

---

300 (2003) 199 ALR 325.

301 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 6.

302 (1998) 1 BCLC 333.

303 (1999) BCC 366 at 349.

304 *Re Kaytech International Plc* (1992) 2 BCLC, 351.

© University of Pretoria

It has been argued that going above and beyond the official titles and definitions, the pivotal question in determining whether or not a person is a *de facto* director revolves around the participation of the individual concerned in the governing corporate structure and the notional boardroom of the company.[305]

3.4.2.1 Validity of acts of *de facto* directors

An important question that arises with regard to acts done by *de facto* directors is whether their acts are valid, considering that these are persons who were never legally appointed as directors, or that they are directors in whose appointment a defect exists. In Malawi, the position is very clear that the acts of a director will be valid even though the director's appointment was defective,[306] or indeed even if the director is not qualified for appointment as a director.[307]

On the contrary, Brown[308] has argued that in the absence of any special legal rules relating to the position, a *de facto* director who acts for a company of which he is allegedly a director does not enter into acts which are valid as against the company. The view taken by Brown has, however, not received much support from legal scholars and the courts. The starting point in answering the above question, it would appear, is to inquire if *de facto* directors are, at law, capable of binding the company through their transactions.

Through the Internal Management rule, it would appear that *de facto* directors can bind their companies. The rule, developed by the court in the case of *Royal British Bank vs. Tarquand*[309] is to the effect that persons dealing with a company and in good faith may

---

305 Hannigan B, *Company Law* (2009) Oxford University Press, 141.

306 Section 173 (a) of the Companies Act 2013.

307 Section 173 (b) of the Act.

308 Brown, SR "Company directors: A concise treatise on the duties, powers, rights and liabilities of company directors in Australia" (1965) *London, Sweet & Maxwell*, 2nd ed. 129.

309 (1856) 6 El. & Bl. 327. Note however that in *Moris vs. Kanssen & Others* (1946) 1 All E.R. 586, the court warned that the internal management rule is subject to the maxim *Omnia praesumuntur rite esse acta*: the company would not be bound to an act which is *ultra vires* its constitution, and in

© University of Pretoria

assume that acts within the constitution and powers of the company have been properly and duly performed, and are not bound to inquire whether acts of internal management have been regular. The rule was well explained by the court in the case of *Mahony vs. East Holyford Mining Co.*[310] as follows:

> When there are persons conducting the affairs of a company in a manner which appears to be perfectly consonant with the articles of association, then those dealing with them, externally, are not to be affected by any irregularities which may take place in the internal management of the company. They are entitled to presume that that of which only they can have knowledge, namely the external acts, are rightly done, when those external acts purport to be performed in the mode in which they ought to be performed. For instance, when a cheque is signed by three directors, they are entitled to presume that those directors are the persons properly appointed for the purpose of performing that function, and have properly performed the function for which they have been appointed. Of course, the case is open to any observation arising from gross negligence or fraud."[311]

By virtue of this rule, it would be seen that persons dealing with *de facto* directors of a company can rely on the rule and successfully have the company bound by the acts performed by its *de facto* directors. The Companies Act in Malawi lends weight to this position by providing that a company, or a guarantor of an obligation of a company, shall not assert against a person dealing with a company or with a person who has acquired property, rights, or interests from the company:

(a) That the Companies Act, in so far as it provides for matters of company meetings and internal procedure, or the constitution of the company has not been complied with.[312]

---

addition, the court also added that the rule can only be invoked by persons who are entitled to assume just because they cannot know, and not those who would have known if they made proper enquiries.

Note that the internal management rule in Malawi is aided by section 41 of the companies Act of 2013 which is to the effect that a person shall not be affected by or deemed to have notice or knowledge of, the contents of, the constitution of, or any other knowledge relating to a company merely because the constitution or document is registered in a register kept with the Registrar of companies (section 41 (a) of the Act) or merely because the constitution or document is available for inspection at an office of the company (Section 41 (b) of the Act.

[310] (1875) L.R. 7 H.L. 869.

[311] Ibid, Per Lord Hatherley at p. 874.

[312] Section 40 (1) as read with section (40) (1)(a) of the Act.

© University of Pretoria

(b) That the person named as a director of the company in the most recent notice received by the Registrar of companies has not been duly appointed.[313]

(c) That the person, although duly appointed, does not have authority to exercise a power which a director of a company carrying on business of the kind carried on by the company customarily has authority to exercise.[314]

(d) That a person held out by the company as a director has not been duly appointed,[315] or does not have authority to exercise a power which a director of the company carrying on business of the kind carried on by the company customarily has authority to exercise.[316]

The foregoing seems to auger well with the position taken by the court in *Channel Collieries Trust Ltd vs. Dover, etc., Railway Co.*[317] that acts done by *de facto* directors need to be given legal effect, observing that:

> Common sense really requires that there shall be some provision giving legal effect to acts in respect of which there is a technical informality because some slip has been made, where the acts have been done in good faith and where the slip has occurred because the parties have not had present to their minds the legal difficulties in the way of doing what they honestly thought they were entitled to do. In most of the cases that arise, I think that the directors or persons acting as directors know the facts of the case, and of course are presumed to know the articles of the company, but it is not present to their minds that they are not carrying out the matter in a properly formal way.[318]

[313] Section 40(1) (b)(ii) of the Act.

[314] Section 40(1)(b)(iii) of the Act.

[315] Section 40 (1) (c) (i) of the Act

[316] Section 40 (1) (c) (ii) of the Act. Note however that under Section 40 (d) of the Act, a person held out by the company as a director of the company with authority to exercise a power which a director of the company carrying on business of the kind carried on by the company does not customarily have authority to exercise, does not have authority to exercise that power.

[317] (1914) 2 Ch 504

[318] Ibid, per Swinfen Eady LJ at 515.

© University of Pretoria

3.4.2.2 Liability of *de facto* directors for wrongful trading

Given that there seems to be a solid basis both under statutory law in Malawi as well as common law that acts of *de facto* directors are valid as against the company for which the acts are undertaken, an important follow up question that arises is whether *de facto* directors do equally owe duties to the company and to creditors and that they are subject to the same obligations towards the company breach of which invites liability for, among others, wrongful trading.

Although not answering the question in respect of liability for wrongful trading, but to which angle the answer may be extrapolated, Lombard[319] who relies on the principle of "no power without responsibility" argues that a person who occupies a position of trust must be held responsible to the duty that attaches to that trust. Similarly, Havenga[320] concurs with this position by contending that a *de facto* director who has placed himself in a fiduciary position should bear the consequences and responsibilities that come with that position.

Based on the foregoing, there seems to be no reason as to why a *de facto* director, who exercised the functions that are ordinarily exercised by a *de jure* director of the company and who was held out and understood to be a decision maker with his instructions being followed should not be held liable for breach of the obligations that ordinarily attach to the person he was held out to be. In this vein, a *de facto* director may be liable for wrongful trading.

319 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 169, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

320 Havenga. M "Fiduciary duties of company directors with specific regard to corporate opportunities" (1998) *University of Free State,* South Africa, 309.

© University of Pretoria

3.4.3 Shadow Directors

The definition of a shadow director presupposes that there is a board of directors which acts in accordance with instructions from someone else.[321] Cassim,[322] for instance, defines a shadow director as a person in accordance with whose directions or instructions the directors of the company are accustomed to act. Cassim adds that as the name suggests, a shadow director "lurks in the shadows" sheltering behind others who he or she claims are the only directors of the company to the exclusion of himself.[323] On the question of the origin of the concept of shadow directors, de Lacy[324] explains that the concept of a shadow director emerged to prevent intermediaries being used to act as directors in boards as a façade for the real exercise of power within the company.

It must be noted that while the Companies Act in Malawi does not specifically mention the term "shadow director," the wording of the Act indicates clearly that shadow directors are subtly recognized. Section 158 (2) of the Act provides that the term "director" includes the following:

(a) A person in accordance with those directions or instructions a director may be required or is accustomed to act.[325]

(b) A person in accordance with whose directions or instructions the board of the company may be required or is accustomed to act.[326]

---

321 *Re Lo-Line Electric Motors Ltd* (1988) Ch 477 at 489. See also Havenga, M "Fiduciary duties of company directors with specific regard to corporate opportunities" (1998) *University of Free State*, South Africa at page 57.

322 Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty) Ltd, 239.

323 Ibid. See also *Re Hydrodam (Corby) Ltd* (1944) 2 BCLC 180. In New Zealand, a person qualifies to be labelled as a shadow director if it is shown that they control even only one of the directors of the board: Jones, D "The Phantom Director: A Comic Character" (1997) *Paper for Joint Conference of Law Society for Accountants* [recommending a repeal of the shadow director provisions]

324 de Lacy "The concept of a company director: Time for a new expanded and unified statutory concept" (2006) Journal of Business Law 267 at 291.

325 Section 158(2)(a) of the Companies Act.

326 Section 158(2)(b) of the Companies Act. Cassim, *Supra*, at p 239 adds that if only a minority of the company's directors is accustomed to act in accordance with a person's instructions or directions, this will not be enough to make that person a shadow director.

© University of Pretoria

(c) A person who exercises or who is entitled to exercise or who controls or who is entitled to control the exercise of powers which, apart from the constitution of the company, would fall to be exercised by the board.[327]

(d) A person to whom a power or duty of the board has been directly delegated by the board with the person's consent or acquiescence or who exercises the power or duty with the consent or acquiescence of the board.[328]

It is however important to note that as far as the liability of directors is concerned, which includes liability for wrongful trading, the Companies Act in Malawi interestingly includes a shadow director. The Act provides that for purposes of, among others, duties and liabilities of directors, a director includes a person in accordance with whose directions or instructions a director, alternate director and a "shadow director" may be required or is accustomed to act.[329]

Apart from the statutory recognition, shadow directors have also been recognized under common law even if, in some instances, they have not been referred to as shadow directors.[330] In *Ultraframe (UK) Ltd vs. Fielding*,[331] the court clarified a number of factors concerning shadow directors as follows:

> Firstly, in relation to the question of who must be accustomed to act, this means that a governing majority of the board must be accustomed to act in accordance with the directions or instructions of the alleged shadow director. The purpose of the legislation is to catch a person who

[327] Section 158(2)(c) of the companies Act.

[328] Section 158(2)(d) of the companies Act. Note that the position is similar with the companies Act in the United Kingdom defines a shadow director as a person in accordance with whose directions or instructions the directors of the company are accustomed to act. This definition is similar to the definition of shadow director under section 251 of the insolvency Act 1986 as well as in section 22(5) of the Company Directors Disqualification Act 1986 in the United Kingdom.

[329] Section 158(3) of the Companies Act of 2013.

[330] *S v De Jagger* (1965) (2) SA 616; Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty) Ltd, 240.

[331] (2003) EWCA Civ 1805.

© University of Pretoria

> effectively controls the running of the company by controlling the board. Therefore, a person is unlikely to be within the definition of a shadow director if only one or two directors on a board of several directors follow his instruction.
>
> On the question of how must the directors react to the instructions, the directors must do something in conformity with such instructions. It is not sufficient for the alleged shadow director simply to give instructions to the directors; his instructions must be translated into action by the board.
>
> The directors must act on the alleged shadow directors' directions as a matter of regular practice; it must be a regular course of conduct of the directors over a period of time.

This is a departure from an earlier position expressed by the court in *Secretary of State for Trade and Industry v Becker*[332] where the court acknowledged that while it is necessary to establish that the directors acted on more than one occasion on instructions or directions of the person sought to be regarded as a shadow director, there is no need to prove that the directors either constantly took instructions during the life of the company or even for a significant period of time.

On the relevance of the nature of communication between the alleged shadow director and the board, the court in *Secretary of State for Trade and Industry v Deverell*[333] said that in determining whether a person should be regarded as a shadow director, there is need to look at the communication between the alleged shadow and the board and determine whether, objectively, the said communication can be regarded as directions or instructions. The court in that case emphasized that the outcome of the communication is an important element to focus on, and, further, that there is no need to establish the fact that the giver of the instructions expected them to be followed.[334]

It is important to note that while subservience by the board to the instructions of the alleged shadow director will be a relevant factor, it is not necessary to establish

[332] (2002) EWHC 2200.

[333] (2001) Ch. 340.

[334] Ibid.

© University of Pretoria

subservience to the alleged shadow director's instructions before he can be regarded as a shadow director.[335]

3.4.3.1 Difference between *de facto* directors and shadow directors

According to Keay,[336] it is important to distinguish between a *de facto* director and a shadow director for the reason that the two terms do not overlap. While a *de facto* director claims and purports to act for the company as a director and is held out as such by the company despite the lack of formal appointment to the position of director, a shadow director does not make a claim to act for the company as a director and, instead, he actually maintains that he is not a director of the company.[337]

Further, while it is necessary to prove that the person sought to be labelled as a *de facto* director undertook functions in relation to the company which could only properly be discharged by a director as was pointed out in *Re Hydrodam (Corby) Ltd*,[338] shadow directors tend to hide behind *de jure* directors and cannot be seen to carry out any function entrusted in the directors of the board while they "pull the strings" behind the scenes.[339]

For the foregoing reasons, while concealment of authority will not usually occur with respect to *de facto* directors, and while it is not necessary to prove concealment in respect of shadow directors, in practice, most shadow directors are likely to want to remain anonymous.[340] Cassim[341] gives two important reasons why shadow directors would want to remain anonymous as being the wish to avoid being subject to some of

---

335 Ibid.

336 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 8. See also *Re Hydrodam (Corby) Ltd* (1944) 2 BCLC 183.

337 Ibid.

338 (1944) 2 BCLC 183.

339 *Re PFTZM Ltd* (1995) BCC 280 at 290.

340 Cassim, FH (Managing Ed) *et al*, *The Law of Business Structures* (2012) Juta & Company (Pty) Ltd, 239

341 Ibid.

© University of Pretoria

the duties and obligations imposed on directors, such as liability for wrongful trading if the company plunges into insolvent liquidation, or indeed because these will be persons who are not eligible or have been disqualified from being validly appointed as directors.

3.4.3.2 Liability of shadow directors for wrongful trading

A further question that arises with respect to shadow directors is whether they should incur similar liability with the rest of the directors considering that shadow directors are never officially appointed and that they usually exert their influence in boards through puppet directors.

Lombard[342] has suggested that in light of the statutory recognition of the concept of shadow director, it is expected that the courts will be willing to hold puppet masters as shadow directors and therefore that those controlling puppets may be held liable for a breach of fiduciary duties on the basis of an implied mandate given by the company rather than the fact that they are regarded as directors of the company.

However, with respect to the liability for wrongful trading in Malawi, the liability of shadow directors is much clearer. Due to the desire, arguably, to ensure that no person who exercises the power of a director evades liability for wrongful trading with the aid of the Companies Act which does not specifically use the term "shadow director," the Insolvency Act in Malawi, which creates the liability for wrongful trading in section 187, specifically uses the term "shadow director," and provides that the term director, for the purposes of liability for wrongful trading, includes a shadow director.[343]

---

342 Lombard, S *Directors' Duties to Creditors*, LLD Thesis (2006) UP 168, available online at https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6 (accessed on 7th March 2018).

343 Section 187 (7) of the Insolvency Act of 2016.

© University of Pretoria

3.5 OTHER PERSONS WHO MAY BE ADJUDGED TO BE DIRECTORS OF COMPANIES FOR PURPOSES OF WRONGFUL TRADING

3.5.1 Shareholders and their liability for wrongful trading

The Companies Act of 2013 in Malawi provides for instances where a shareholder may be regarded as a director. This occurs where the constitution of the company provides a power on shareholders which is exercisable by the board and the shareholder exercises the said power or takes part in deciding whether to exercise that power. The said shareholder is deemed, in relation to the exercise of the power or any consideration concerning its exercise, to be a director for the purposes of, among others, performing duties and incurring liability as a director.[344]

Further, a shareholder is, under the said Act, also regarded as a director where the constitution of the company requires the said shareholder to make a decision or direction for the exercise of a power by a director or the board and the shareholder takes part in the making of the decision that the power should or should not be exercised,[345] or takes part in the making of any decision whether to give a direction in the making of any such decision as the case may be in relation to directors' duties.[346]

From the foregoing, it will be clear that where a shareholder is mandated by the constitution of the company to exercise a power which is otherwise exercisable by the board and he exercises it or takes part in deciding whether to exercise it and in doing either of these or both he breaches the relevant directorial obligations that invite liability for wrongful trading, the shareholder may be liable for wrongful trading.

Similarly, where breach of the directorial obligations that invite liability for wrongful trading has occurred in respect of a shareholder who is mandated by the constitution of the company to decide or to give a direction for the exercise of the power by a director

[344] Section 158(4) of the Act.

[345] Section 158(5)(a) of the Act.

[346] Section 158(5)(b) of the Act.

© University of Pretoria

or the board, the said shareholder, having taken part in making the decision that the power should or should not be exercised, or having given a direction in the making of any such decision, may also be liable for wrongful trading.

3.5.2 Independent companies and their liability for wrongful trading of other companies

It has been noted that while a company cannot itself be appointed a director of another company,[347] it can be held to be a shadow director of another company[348] as was the case in *Re A Company No. 005009 of 1987*.[349] In this regard, the company which is held to have been a shadow director of the other may be liable for wrongful trading of that other company. However, the court said, in *Re Hydrodam (Corby) Ltd*,[350] that where a company is deemed to be a shadow director, the directors of that company will not equally be regarded as having been shadow directors by reason of them being members of the boards of the company which is held to have been a shadow director.

Ramsey[351] has highlighted the consequences of a company being held to have been a director of another. According to the learned commentator, a company which has substantial assets and is held to be a shadow director of a company with fewer assets will see its assets being made available to pay the debts of the other company[352] during proceedings of the sort of the wrongful trading proceedings.

347 Except in the case of state-owned companies; Section 164(2)(d) of the Companies Act of 2013.

348 Ramsey I, (Ed) *Company Directors' Liability for Insolvent Trading* (2000) CCH Australia Limited, 2.

349 (1988) 4 BCC 424. See also *Standard Chartered Bank of Australia Limited vs Antico* (1995) 13 ACLC 1381; 18 ACSR 1.

350 (1994) BCC 161 at p. 164.

351 Ramsey I, (Ed) *Company Directors' Liability for Insolvent Trading* (2000) CCH Australia Limited, 2.

352 Ibid.

© University of Pretoria

3.5.3 Parent companies and their liability for wrongful trading of their subsidiaries

The mere fact that a company is a wholly owned subsidiary of another, a parent company, does not make the parent company a shadow director of the subsidiary as for it to be liable for wrongful trading of the subsidiary. The practicality of the relationship of a parent company and a subsidiary, and the possibility of the parent company being adjudged to have been a shadow director was well explained by Payne and Prentice[353] that:

> Although the separate legal personality is the starting point, there is something commercially unreal in finding that a wholly owned subsidiary is not subject to the stringent control of its parent. It is clear that in terms of strict company law principles, there are no legal objections to a subsidiary supporting the activities of its parent, or other members of the group in circumstances where the collapse of the group will prejudice the subsidiary's interests. If the directors of a subsidiary decide that the transaction is in the interests of the subsidiary, it is submitted that the parent would not be a shadow director. In this situation, the directors would have brought independent judgement to bear on the matter and the fact that what they decided coincided with the parent's desires will not make the latter a shadow director.[354]

However, conceivably, it is possible for a parent company to be held to be a shadow director of a subsidiary and therefore liable for wrongful trading of the subsidiary. This will depend on whether the parent company gave instructions which the subsidiary is accustomed to follow. In *Re Hydrodan (Corby) Ltd*,[355] H was a wholly owned subsidiary of E plc. H had two corporate directors. When it went into insolvent liquidation, the liquidator sought to make two of the directors of E plc liable for the wrongful trading of H claiming that they were shadow directors of H. Millet J held that if the liquidator could show that E plc had given instructions to the board of H and the directors of H were accustomed to act on such instructions, this would have rendered E

353 Payne J, and Prentice D, "Civil Liability of Directors for Company Debts Under English Law" an Article in Ramsey I, (Ed) *Company Directors' Liability for Insolvent Trading* (2000) CCH Australia Limited.

354 Ibid, at page 203. See also *Equiticorp Finance Ltd vs. Bank of New Zealand* (1993) 11 ACSR 642.

355 (1994) 2 BCLC 180.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

plc a shadow director of H and it would have invited liability for wrongful trading against E plc, but not merely because H was wholly owned by E plc.

Interestingly, the learned Judge said that even where the said instructions were given by the directors E plc and H was accustomed to act on the same, the said directors would not be held liable as shadow directors of H as they would have been acting as the appropriate organ of E plc, and in that case, it is E plc which would have been found to be the shadow director of H and therefore liable for wrongful trading of H. The learned judge put the foregoing in the following words:

> The liquidator submitted that where a body corporate is a director of a company, whether it be a *de jure*, de facto or shadow director, its own directors must ipso facto be shadow directors of the company. In my judgement that simply does not follow. Attendance of board meetings and voting, with others, may in limited circumstances expose a director to personal liability to the company of which he is a director or its creditors. But it does not, without more, constitute him a director of any company of which his company is a director.

3.5.4 Banks and their liability for wrongful trading of their customers

The relationship of a bank and a borrowing company which is financially distressed may sometimes result in the bank being held as a shadow director of the borrowing company and therefore become amenable to liability for wrongful trading. Referring to a bank as a secured lender of a financially distressed company, Ramsey[356] has said the following:

> "A secured lender of a failing company often has the option of exercising protective covenants that, among other things, allow for execution on the security. If such a lender directs specific action as a condition for not exercising the covenants, the lender risks classification as a shadow director and liability under insolvent trading provisions. The test seems to be whether a lender has crossed over the line from simply conditioning its future cooperation on specified debtor behaviour into supplanting the board's prerogatives."[357]

---

[356] Ramsey I, (Ed) *Company Directors' Liability for Insolvent Trading* (2000) CCH Australia Limited.

[357] Ibid, at page 31. Note that insolvent trading provisions referred to in the quotation above are the Australian equivalent of the wrongful trading provisions in Malawi. See, however, the view taken by Millet J "Shadow Directorship - A Real or Imagined Threat to Banks" (1991) 1 *Insolvency Practitioner*, 14, who had argued, much earlier than Ramsey, that a bank attaching conditions to continued support is not enough to make the bank a shadow director because the bank leaves the

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

Similarly, In *Standard Chartered Bank of Australia vs. Antico*[358] the court said the following:

> I accept that…it is not uncommon for lenders to impose conditions on loans, including conditions as to the application of funds and disclosure of borrower's affairs; and that it is even less uncommon for lenders to require security for a loan, and then to require the sale of the property over which the security is given. Certainly these factors on their own would not amount to assuming the position of a director, or taking part in the management of a borrower company.[359]

The foregoing seems to agree with the view previously taken In *Re PFTZM Ltd*,[360] where the court pointed out that banks will not be categorized as shadow directors when they merely lay down terms for continuing to provide credit for the business of a company for the reason that since the company is at liberty to decline the terms laid down, the said terms cannot be regarded as instructions.[361]

It is therefore clear that where a bank oversteps its mandate and instructs the board of a financially distressed borrowing company on what to do in order to continue accessing credit from it, and the borrowing company follows the instruction and eventually plunges into insolvent liquidation by virtue of the instructions followed, the bank may be found to have been a shadow director of the borrowing company and may be held liable for wrongful trading of the said borrowing company.[362]

---

decision to the customer on whether it will comply or not. It is submitted that the test given by Ramsey above is more plausible.

358 (1995) 131 ALR 1.

359 Ibid, at page 70, per Hodgson J.

360 (1995) BCC 280.

361 Ibid, at page 292. See also *Re A company (No. 005009 of 1987)*, (1998) 4 BCC 424; and O'Donovan J, "Banks as Shadow Directors" 25 *Victoria U. Wellington L Rev* 283, 285, who argues that banks cannot avoid liability as shadow directors by causing the borrower to engage a consultant chosen by the bank. The learned commentator observes that it is safe for the bank to be consulted about the selection of the consultant and even for the bank to recommend a number of consultants for appointment by the borrower, but the actual appointment should be made by the borrower of its own volition.

362 See also Syrota G, "Insolvent Trading: Hidden Risks for Accountants and Banks Participating in 'Work Outs" (1993) 23 *University of Western Australia Law Review*, 329.

© University of Pretoria

3.5.5 Persons occupying positions lower than that of a director and their liability for wrongful trading

It has been suggested that even a person who is not a director and who occupies a rank lower than that of a director may be found to have been a shadow director and therefore become liable for wrongful trading. This would occur, for instance, where a director delegates his decision-making power to that person and the director is accustomed to acting on the instructions of that person. In this regard, that person may qualify to be regarded as a shadow director in relation to the instructions given by him to the director,[363] and may, on that basis, become liable for wrongful trading.

3.5.6 Professional advisers and their liability for wrongful trading of their clients

The Companies Act in Malawi excludes from the definition of a director a person who acts only in a professional capacity when giving his advice to directors or the board in circumstances where the directors or the board may be required or accustomed to act.[364] The position is similar to that obtaining in South Africa,[365] the United Kingdom[366] and Australia.[367]

---

363 Mokal R, "Corporate Insolvency; Theory and Application" (2005) Oxford University Press, 266.

364 Section 158(6) of the Companies Act of 2013. Note that similarly, New Zealand and England have provisions declaring that persons providing professionals advice are not to be regarded as shadow directors with regard to the decisions made by the board subsequent to the said advice.

365 In South Africa, persons who act as advisors or business associates can face liability for reckless trading if they are pursuing their own business objectives rather than being associated with the company in a common pursuit; Van der Linde K, "The Personal Liability of Directors for Corporate Fault – An Exploration" (2008) 20 *SA Merc LJ* 439, 443. See also the decisions of the courts in *Cooper & Others NNO vs. SA Mutual Life Assurance Society & Others* 2001 (1) SA 967 (SCA); *Powerteck Industries Ltd vs Mayberry & Another* 1996 (2) SA 742 (W); *Klerk NO vs. SA Metal and Machinery Company (Pty) Ltd & Another* 1996 [2001] All SA 276 (E).

366 Section 251 (2) of the Companies Act of 1986 The position is the same in New Zealand; Ramsey I, (Ed) *Company Directors' Liability for Insolvent Trading* (2000) CCH Australia Limited, 32.

367 Section 9 of the Corporations Act 2001 in Australia makes it clear that the director definition does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors of the company or body. The courts have shown support for this position. in *Re Akron Roads Pty (in liq) [No 3]* (2016) VSC 657, the Supreme Court of Victoria considered a claim for insolvent trading which was instituted by a liquidator against a management consulting company on the basis that it had been deeply involved in the management and administration of Akron Roads. Applying *Buzzle Operations Pty Ltd (in liq) vs. Apple Computer Australia Pty Ltd* (2011) NSWCA 109, the court held that even deep involvement in the management and administration of Akron Roads was insufficient to establish that the management consulting company had been a shadow director of Akron Roads for the reason that the management consulting company had not overborne the directors of Akron Roads, nor

© University of Pretoria

Much as this is the position under statute, there are times when the said professional advisers act in such a way that they cross the line and move from advising to instructing. In such instances, the professional advisers can, under common law, be regarded as shadow directors and therefore become subjected to the directors' duties and liabilities in relation to the company to which their directions were given.[368]

In *Re Tasbian (No 3)*,[369] a chartered accountant who was engaged as an external consultant to conduct an intensive care assignment devised a work out plan himself, required company cheques to be countersigned by himself and initiated some major management decisions one of which was the transfer of the entire workforce of the company to a shelf company and the rehiring of the same workforce from the shelf company in order to secure tax savings. The court of Appeal found him to have been a *de facto* director and a shadow director of the company on the basis that although he was a professional advisor, he had crossed the line and he was deeply involved in the management of the company beyond the proper performance of his professional capacity. In circumstances such as the foregoing, the professional advisors may become liable for wrongful trading of their client-companies.

3.6 CHAPTER CONCLUSION

In this chapter, which was aimed at providing the meaning of the term "director" for purposes of the wrongful trading rule in Malawi, it has been established that the term director is defined broadly to encompass any person who occupies the position of a

---

had the directors of Akron Roads acted in accordance with the management consulting company's wishes or instructions. In the view of the court, there was need to show that the wishes and instructions of the management consulting company were habitually complied with by the appointed directors over a period of time, even though those instructions or wishes needed not cover every aspect of running the company.

368 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 7.

369 (1991) BCC 436. Similarly, in *3M Australia Limited vs. Kernish* (1986) 10 ACLR 371, a chartered accountant devised a rescue operation to save a financially distressed company. He introduced some cost-cutting measures and sales incentive schemes. He attempted to renegotiate the company's financial arrangements in order to reduce interest, costs and factoring charges. The court found that while he was acting in good faith to save the company, he was deeply involved in the management of the company and therefore he was liable for insolvent trading, the Australian equivalent of wrongful trading in Malawi.

© University of Pretoria

director regardless of what the position is called. This has been shown to be the position both in Malawi and in the comparable jurisdictions, namely the United Kingdom, South Africa and Australia.

It has been made clear in this chapter that what matters is not the title or reference given to the person, but the substance of his activities in relation to the company. The rationale for this broad definition is to trap all persons who exercise the powers of a director of a company without being formally appointed, and who would want to escape liability for failure to fulfil the obligations that come with their said exercise of directorial powers for the company.[370]

The chapter has then provided the requirements for appointment as director under Malawian corporate law, namely that the person should not be an undischarged bankrupt; should not be prohibited from being a director or promotor or being concerned or taking part in the management of a company; should not have been adjudged to be of an unsound mind and lastly that by virtue of the constitution of a company, the person should not fail to comply with any of the qualifications for appointment as director.[371]

On the types of directors, it has been established that there are three main types of directors, namely, *de jure*, *de facto* and shadow directors. Further, it has been established that *de jure* directors include temporary directors, nominee directors, puppet directors, ex-officio directors and alternate directors. In terms of the types of directors and their liability for wrongful trading, it has been established that considering that all types of directors can be liable to the company for their failure to fulfil their obligations, all the three types of directors as above can equally be liable for wrongful trading for the reason that liability for wrongful trading emanates from the directors' failure to fulfil their obligations at the time when the company faces insolvency.[372]

370 See para 3.2 above.

371 See para 3.3 above.

372 See generally para 3.4 above.

© University of Pretoria

Apart from the foregoing three main types of directors, it has been established that there are other persons who may be adjudged to have been directors of companies for the purposes of wrongful trading rule. Broadly, this depends on whether these persons gave instructions to the company on which the company was accustomed to act, or whether the advice they gave to the company was not given at arms-length to the extent that it moved from advising to instructing or directing.

These persons include shareholders of companies, if they are given the powers exercisable by the board and they exercise the power or take part in deciding whether to exercise the power; independent companies; parent companies with respect to their subsidiaries; bankers with respect to borrowing companies; persons occupying positions less than that of a director of the company, e.g. a managers or mere officers and, finally, professional advisors such as public accountants, auditors, legal practitioners, insolvency practitioners in relation to their client-companies *etc*.[373]

In essence, it has been established that any person whatsoever may be adjudged to have been a director for purposes of the wrongful trading rule under Malawian law as the definition does not only relate to those who were appointed as the directors of the company. This will generally depend on whether the person exercised the powers ordinarily exercisable by a director of the company and the exercise of the power was either acted upon by the company or that the company was accustomed to act upon such exercise of the power by the person.

373 See generally papa 3.5 above.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

CHAPTER 4

DIRECTORS' OBLIGATIONS WHEN A COMPANY IS IN THE VICINITY OF INSOVENCY AND WHEN A COMPANY HAS BECOME INSOLVENT

SUMMARY

4.1 Introduction……………………………………………………..……120

4.2 Meaning of vicinity of insolvency………………………………………121

4.3 Origin of the notion of vicinity of insolvency…………………………...122

4.4 Meaning of vicinity of insolvency under common law…………………... 125

4.5 Meaning of vicinity of insolvency under statutory law…………………..128

4.6 Shift of directors' focus from shareholders to creditors upon a company's insolvency…………………………………………132

4.7 Shift of directors' focus from shareholders to creditors when a company is in the vicinity of insolvency…………………….…133

4.8 Rationale for the directors' shift of focus from the company and its shareholder to creditors………………………136

4.9 Shift of directors' focus to creditors and what it entails for directors…...140

4.10 Nature of obligations of directors when a company is navigating the vicinity of insolvency………………………...………141

4.11 Nature of obligations of directors when a company becomes insolvent…147

4.12 Corporate rescue in Malawi and in the comparable jurisdictions………149

4.13 Justification for imposition of personal liability on directors of companies…………………………………………………155

4.13 Chapter conclusion…………………………………………………...158

© University of Pretoria

4.1 INTRODUCTION

The preceding chapter having provided the meaning of the term "director" for purposes of the wrongful trading rule in Malawi, this chapter is aimed at answering the third and fourth sub-questions of the main research question of this study, namely, "what is the nature of the obligations that attach to directors of companies when their companies are navigating the vicinity of insolvency?" And "what is the nature of obligations that attach to the said directors when their companies have become insolvent?" Answering these two questions is important as it highlights the obligations which, when breached, invite liability for wrongful trading on the part of directors of companies.

In doing this, the chapter first defines the meaning of the phrase "vicinity of insolvency" under common law. Vicinity of insolvency having not been defined under statutory law in Malawi and in the comparable jurisdictions in this study, a definition of this concept under statutory law is attempted through deduction from the definition of insolvency under statutory law in Malawi and in the said comparable jurisdictions.

The chapter goes further to discuss the shift of directors' focus from shareholders to creditors upon a company becoming insolvent. This is followed by a new thinking promoted in the study that the said shift must in fact occur from the moment a company begins to navigate the vicinity of insolvency rather than from the time when the company becomes insolvent. To aid this discussion, the chapter begins by discussing the notion of "vicinity of insolvency" right from its origin and its nature. This is done with the aim of providing a clear distinction between the notion and insolvency as defined under common law and under statutory law in Malawi and in the comparable jurisdictions.

On the concept of shifting of the directors' duties from shareholders to creditors when a company is navigating the vicinity of insolvency, rather than when the company has become insolvent, the chapter goes on to discuss the rationale behind this concept. In this vein, the chapter discusses what the said shift entails on the part of the day-to-day activities of the directors of the companies.

© University of Pretoria

In the end, this chapter provides an outline and a discussion of the nature of obligations that attach to directors when their companies begin to navigate the vicinity of insolvency, and winds up by outlining and discussing the nature of obligations that attach to the said directors from the time their companies have become insolvent.

4.2 MEANING OF VICINITY OF INSOLVENCY

The starting point in defining the phrase "vicinity of insolvency" is to understand the views taken by two commentators regarding the phrase. Firstly, Mclaughlin[374] has said that "Unfortunately, vicinity of insolvency remains a phrase in search of definition." Secondly, Byers[375] has said that the phrase "vicinity of insolvency" is incapable of being defined and suggests as follows regarding the rise of directors' duties to creditors in the said vicinity of insolvency:

> If a fiduciary duty towards creditors is found to exist, the precise time at which it is triggered must be established. Demarcating such a point involves the dubious presumption that such a situation can be legally defined. As Major and Deschamps JJ wrote in Peoples Department Stores, the "Vicinity of Insolvency" is a nebulous term which is "incapable of definition and has no legal meaning." Further, supposing that such a situation can be properly defined, imposing a legal test for when this ought to be done would involve a judicial usurpation of directorial discretion.[376]

Much as the foregoing simply highlights the difficulties which legal scholars have encountered in attempting to define the meaning of "vicinity of insolvency," the phrase is not without meaning. The term vicinity of insolvency can properly be defined both under common law and statutory law, although divergent definitions of the phrase appear under common law due to the many courts making their own attempts at providing the best definition. Before providing the meaning of the notion of "vicinity

---

374 Mclaughlin, JM "Directors' and Officers' liability: Vicinity of insolvency claims" (2005) page 1, available online at on 17th March 2017 at http://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub499.pdf?sfvrsn=2

375 Byers, M "Directors duties in the vicinity of insolvency; why a fiduciary duty to creditors should not be triggered" (2011). Pages 4-5, available online at https://www.insolvency.ca/en/whatwedo/resources/3-2011lawaward_byers_m_directors_duties_vicinity_insolvency.pdf#page=1 accessed on 16th September 2018.

376 Ibid, at page 4-5.

© University of Pretoria

of insolvency" under common law and statutory law in Malawi, it is necessary to discuss its origin.

4.3 ORIGIN OF THE NOTION OF VICINITY OF INSOLVENCY

The notion of vicinity of insolvency sprang from an American Delaware decision in *Credit Lyonnais Bank vs. Pathe Communications*[377] in which the court of Chancery found a board of directors not to be liable for breach of their duties to the company when they chose to act in the interest of creditors in a firm which was navigating the vicinity of insolvency. The court began by remarking that the possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behaviour and creating complexities for creditors and therefore that in managing the affairs of a solvent company which is navigating the vicinity of insolvency, the right (both the efficient and the fair) course to follow for the directors may be the choice that the creditors or other stakeholders would make if given the opportunity to act during that particular time.[378]

Although the Supreme Court of Delaware in *Catholic Education Programming Foundation vs Gheewalla*[379] rejected the *Credit Lyonnais* suggestion and held that directors of companies navigating the vicinity of insolvency must owe their obligations and duties to the company for the benefit of its shareholders, the *Credit Lyonnais* judgement seems to have received much approval by commentators for being an approach which is in tandem with the modern trends in insolvency law.

The *Gheewalla* decision, on the other hand, is not without fault. Firstly, the judgement does not seem to address the fact that when a corporation begins to navigate the vicinity of insolvency, its creditors automatically become stakeholders in waiting and therefore that directors cannot be expected to ignore the interests of the said creditors as eventual stakeholders in the event that the corporation proceeds into insolvent liquidation.

---

377 (1991) WL 277613 (Del. Ch. Dec 30, 1991).

378 Ibid. Note that prior to the *Credit Lyonnais judgment*, the view of the courts was that since vicinity of insolvency does not mean a company is insolvent, then there is no justification for extending the fiduciary duties of directors to creditors: *Katz vs. Oak Industries, Inc*., 508 A. 2d 873 (Del. Ch. 1986).

379 930 A.2d 92, 103 (Del. 2007).

© University of Pretoria

Secondly, the *Gheewalla* decision seems not to recognize the fact that the *Credit Lyonnais* decision does not call for total abandonment of the interests of the company and the shareholders by the directors of the near-insolvent company, but rather that the interests of creditors must be part of the community of interests to be borne in mind by the directors of a company in those circumstances.

As rightly observed by Paolini,[380] under the *Credit Lyonnais* approach, directors of companies navigating the vicinity of insolvency are at liberty to consider the interests of both the shareholders and the creditors in deciding the best way forward for the corporation. There is nothing in the *Credit Lyonnais* judgement precluding directors from considering the interests of shareholders, rather, the judgement merely adds creditors to the list of constituents to be considered.

Boxell[381] concurs with the idea of merely adding creditor-consideration to the other duties which directors of near-insolvent firms have by arguing that the prospect of insolvency imposes a set of obligations, both under statute and common law, and adds a new dimension to the fiduciary obligations of directors which reflects the significant position of the company's creditors as opposed to its shareholders.

According to Mclaughlin,[382] the foregoing happens on the understanding that from the time the company begins to linger in the vicinity of insolvency, the directors of the company, in effect, become trustees for the creditors and are therefore required to

380 Paolini, A (Ed) *Research handbook on Directors' Duties* (2016) Edward Elgar Publishing, UK & USA, 286.

381 Boxell, T *A Practitioner's Guide to Directors' Duties and Responsibilities* (2013) Sweet and Maxwell, 163. Note will be taken, however, that in certain exceptional circumstances, employee interests may supersede those of corporate creditors. In *Re Welfab Engineers Ltd,* (1990) BCLC 833, the court sanctioned the sale of an insolvent company as a going concern at an undervalue because the sale protected the employment prospects of the company's workforce.

382 Mclaughlin, JM "Directors' and Officers' liability: Vicinity of insolvency claims" (2005) page 1, available online at http://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub499.pdf?sfvrsn=2#page=3 accessed on 17th March 2018.

© University of Pretoria

preserve corporate assets as a trust fund for the creditors. This appears to tally with the view taken by the court in *Bovay vs. H.M. Byllesby & Co.*,[383] that:

> An insolvent corporation is civilly dead in the sense that its property may be administered as a trust fund for the benefit of creditors. The fact which creates the trust is the insolvency, and when that fact is established, the trust arises and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency.

Mclaughlin[384] argues further that the shift of focus from interests of the company and its shareholders to the interests of creditors when the company is in the vicinity of insolvency is a principle of equity which arises in corporate insolvency simply to alter the traditional economic justification for the requirement that directors manage companies exclusively for the benefit of shareholders.

On the other hand, Coffee and Klein[385] have contended that the shift of fiduciary duties to creditors should broadly be construed to require directors to take actions that would maximize the creditors interests once the corporation becomes insolvent, much as it should also narrowly be construed to require that directors treat all creditors equally and avoid withdrawing corporate assets for their own benefit or for the benefit of shareholders and preferred creditors. In this regard, Cieri and Riela[386] concur that directors and officers owe their fiduciary duties to creditors from the moment the company enters the vicinity of insolvency.

It is interesting to note that courts have expressed willingness to have directors of solvent companies consider the interests of creditors even when contemplating making a transaction at a time when the company's financial condition is such that the transaction would either render the company insolvent, or drag the company into the

383 (1944) 38 A.2d 808 Del.

384 Mclaughlin, JM "Directors' and Officers' liability: Vicinity of insolvency claims" (2005) page 1, available online at http://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub499.pdf?sfvrsn=2#page=3 accessed on 17th March 2018.

385 Coffee, JC & Klein WA "Bondholder Coercion: The Problem Constrained Choice in Debt Tender Offers and Recapitalizations" *58 U. Chi. L. Rev.* 1207, 1208.

386 Cieri, RM and Riela, MJ "Protecting directors and officers of corporations that are insolvent or in the vicinity of insolvency: Important considerations, Practical solutions" (2004) *De Paul Business & Commercial law Journal*, vol 2: 295 at 301.

© University of Pretoria

vicinity of insolvency. In *Brandt vs. Hicks, Muse & Co (In re Healthco Int'l Inc)*[387] the court held that the directors who voted to approve a leveraged buyout that allegedly left the corporation with unreasonably small capital violated their fiduciary duties to creditors.

Considered from the angle that the Delaware state, from where the *Gheewala* decision was made, does not have a wrongful trading rule similar to the one obtaining in Malawi or the United Kingdom, and also the fact that the *Gheewalla* decision was made in 2007, way before the thinking on directors obligations during a period approaching insolvency began to change as evidenced by the fact that UNCITRAL only documented these obligations in its legislative guide of 2013,[388] six years after the *Gheewalla* decision, it is submitted that the *Gheewalla* approach which requires the directors of companies navigating in the vicinity of insolvency to shut their eyes to the interests of creditors of the company and to be focused only on the interests of the company and its shareholders is not in keeping with modern thinking in insolvency law and is therefore retrogressive. The approach in the *Credit Lyonnais* decision, it is submitted, is the right approach as it embraces the modern trends on directors' obligations in insolvency law.

4.4 MEANING OF VICINITY OF INSOLVENCY UNDER COMMON LAW

At common law, the easier way to define the phrase "vicinity of insolvency" is perhaps to begin by understanding the point when a company is said to have become insolvent. Once that period is clearly located, then it becomes clear that the period penultimate to the onset of the said insolvency is what must be described as the vicinity of insolvency. Taken from that angle, it will be seen that although courts have used different phrases to define the phrase "vicinity of insolvency," all the descriptions are consistent with the period being the one penultimate to the onset of the insolvency of the company.

---

[387] (1997) 208 BR 296, 300. Note that being left with unreasonable low capital is, in this case, considered to mean that the company is in the vicinity of insolvency.

[388] United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April2013).

© University of Pretoria

Based on the foregoing, in *Nicholson vs. Permakraft (NZ) Ltd*,[389] vicinity of insolvency was described by the court as a period when a company is nearing insolvency. In *Geneva Finance Ltd vs. Resource and Industry Ltd*,[390] the court referred to vicinity of insolvency as the period when a company is approaching insolvency. In *Eastford Limited vs. Gillespie, Airdrie North Limited*,[391] the court referred to vicinity of insolvency as a period when a company is on the borderline of insolvency, and in *Colin Gwyer vs. London Wharf (Limehouse) Ltd*,[392] the court referred to vicinity of insolvency as a period when a company is on the verge of insolvency.

Further, in *Brady vs. Brady*,[393] the court referred to vicinity of insolvency as a period when a company is of doubtful solvency. In *Grove vs. Flavel*,[394] the court referred to vicinity of insolvency as a period when a company is subject to the risk of insolvency occurring. In *Kalis Enterprises Pty Ltd vs. Baloglow*,[395] and in *Re HLC Environmental Projects Ltd*,[396] the courts referred to the vicinity of insolvency as a period in the life of the corporation when, to the knowledge of the directors, there is a real and not a remote risk of insolvency and that creditors would be prejudiced by the action considered.

There are other instances where the courts do not use the word "insolvency" at all in referring to the "vicinity of insolvency." However, even in those instances, the description given by the courts in defining "vicinity of insolvency" is again compatible with the period being the one penultimate to the onset of insolvency. In *Facia Footwear Ltd (in Administration) vs. Hinchlife*,[397] the court referred to vicinity of insolvency as a

---

389 (1985) 3 A.C.L.C. 453. See also *Re New World Alliance* (1994) 51 F.C.R. 425 and *The Liquidator of Wendy Fair (Heritage) Ltd vs. Hobday* (2006) EWHC 5803.

390 (2002) 20 A.C.L.C. 1427.

391 (2010) CSOH 132.

392 (2002) EWHC 2784.

393 (1988) 3 B.C.C. 535.

394 (1986) 11 A.C.L.R. 161.

395 (2007) NSWCA 191.

396 (2013) EWHC 2876.

397 (1998) 1. B.C.L.C. 218.

© University of Pretoria

period when a corporation is in a dangerous financial position. In *Williams vs. Farrow*,[398] the court referred to the vicinity of insolvency as a period when a company is in a parlous financial state. In *Linton vs. Telnet Pty Ltd*,[399] the court referred to vicinity of insolvency as a period when a company is financially unstable, and in *Re MDA Investment Management Ltd,*[400] the court referred to vicinity of insolvency as a period when a company is in financial difficulties.

From the foregoing, it would be clear that the different descriptions of the phrase vicinity of insolvency given by the courts as above only mean one and the same thing. Lending weight to this analysis, the court in *Re HLC Environmental Projects Ltd (in Liquidation)*,[401] after having referred to the various descriptions of vicinity of insolvency by the courts as above, held that it did not detect any difference in principle behind the said varying verbal formulations.

Similarly, in summing up the varying descriptions of vicinity of insolvency as above, Keay[402] has argued that all the above descriptions envisage a company being in the vicinity of insolvency which is itself a rather vague term. Keay wraps up this debate by remarking that the lack of precision as to when a corporation should be said to be in the vicinity of insolvency requiring a shift in duties of directors from shareholders to creditors might manifest the fact that the law cannot be too prescriptive on the matter.[403]

The lack of precision in the law as to which period in the financial life of a company should the said to be the vicinity of a company's insolvency leads to situations where directors are not sure whether the situation they are faced with entails that the company

---

398 (2008) EWHC 3663.

399 (1999) NSWCA 33.

400 (2003) EWHC 227.

401 (2013) EWHC 2876 (Ch) at 89.

402 Keay, A 'The shifting of director's duties in the vicinity of insolvency' (2015) *International Insolvency Review* 4 (2). 140-164 at 154. Available online at https://doi.org/org/10.1002/iir.1236 or http://eprints.whiterose.ac.uk/84965/accessed on 18th October 2018 accessed on 16th February 2018.

403 Ibid.

© University of Pretoria

is in the vicinity of insolvency. In such instances of doubt, Cieri[404] has contended that it is prudent for directors to adopt a conservative approach in their evaluation of the company's solvency and to assume that the company is insolvent or that it is in the vicinity of insolvency whenever there is any reasonable question about its solvency.[405] The basis of this option is said, in *Official Comm. Of Unsecured Creditors vs Mellon Bank N.A.*,[406] to be that courts will use hindsight bias when deciding the point in time when a company was navigating the vicinity of insolvency having observed what eventually happened in the financial life of the company.

4.5 MEANING OF VICINITY OF INSOLVENCY UNDER STATUTORY LAW IN MALAWI AND IN THE COMPARABLE JURISDICTIONS

The phrase "vicinity of insolvency" has not received direct statutory definition in Malawi or in any known jurisdiction, possibly owing to the same view expressed by Keay[407] that the term is vague, or the view expressed by Byers[408] that the term is incapable of precise definition. However, just as at common law, vicinity of insolvency is capable of being defined under statutory law by first looking at the statutory definition of "insolvency" and then deducing a period penultimate to the onset of the said insolvency.

4.5.1 Inability to pay debts as the measure of insolvency

Going through the statutory positions in Malawi and other jurisdictions, it would become clear that apart from instances where insolvency of corporations is presumed

404 Cieri, RM *et al*, "Breaking up is easy to do: Avoiding the solvency related pitfalls in Spinoff Transactions (1999) 54 Business Law Review, 560.

406 (1995) B.R. 455, 464

407 Keay, A 'The shifting of director's duties in the vicinity of insolvency' (2015) *International Insolvency Review* 4 (2). 140-164 at 154. Available online at https://doi.org/org/10.1002/iir.1236 or http://eprints.whiterose.ac.uk/84965/accessed on 18th October 2018.

408 Byers, M "Directors duties in the vicinity of insolvency; why a fiduciary duty to creditors should not be triggered" (2011). Pages 4-5, available online at https://www.insolvency.ca/en/whatwedo/resources/3-2011lawaward_byers_m_directors_duties_vicinity_insolvency.pdf#page=1 accessed on 16th September 2018

© University of Pretoria

by law, e.g. by voluntary winding up in Malawi and the United Kingdom,[409] or through failure to keep proper accounting records and failure to retain accounting records for 7 years in case of Australia,[410] insolvency is measured largely through inability to pay debts as they fall due.[411]

Section 107 (4) (b) of the Insolvency Act in Malawi provides that a company may be wound up if it is unable to pay its debts as they fall due. In Australia section 95A (1) of the Corporations Act defines solvency as ability to pay debts as and when they fall due.[412] The Australian definition provides that a person who is not solvent is insolvent.[413]

In the United Kingdom, section 122 (1) (f) of the Insolvency Act of 1986 provides that a company may be wound up if it is unable to pay its debts. However, the fact of the liabilities of a company (i.e. the sum of present, contingent and prospective liabilities) exceeding its assets is used, in the United Kingdom, as one of the ways or proving that a company is unable to pay its debts as they fall due.[414] This is unlike the Malawian and the Australian positions where the fact of assets of a corporation being fewer than its liabilities is not regarded as proof of inability to pay debts.

In South Africa, Section 344 of the repealed 1973 Act provides for winding up of insolvent companies.[415] The test of solvency is however provided for under Section 4

409 Section 141 of the Insolvency Act of 2016 in Malawi, and Section 247 of the Insolvency Act 1986 in the United Kingdom.

410 Section 286 (1) and section 286(2) of the Corporations Act respectively.

411 In *Hawcroft General Trading Co Ltd vs. Edgar* (1996) 20 ACRS 54 at 51, Tamlerlin J said that the question of inability to pay debts as they fall due is one of fact, and that in answering this question, attention should be directed to whether a reasonable director or manager operating in a practical business environment would expect that at some point the company would be unable to meet a liability. The learned Judge added that the question involves consideration of the timing of revenue flow and debts incurred and contingencies including the ability to raise funds and that the conclusion ought to be clear from a consideration of a debtor’s financial position in its entirety and not from evidence of a temporary lack of liquidity.

412 Act 50 of 2001.

413 Section 95 A (2) of the Corporations Act.

414 Section 123(2) of the Insolvency Act 1986.

415 Act 61 of 1973.

© University of Pretoria

(1) of the 2008 Companies Act which is to the effect that a company is solvent if its assets are equal or exceed its liabilities[416] and if the company is able to pay its debts as they become due in the ordinary course of its business for a period of 12 months from the date of which the test is considered.[417]

Under section 344 (1) (f) of the repealed 1973 Act, a company can only be wound up if it is unable to pay its debts. Much as the above means that a company is insolvent if its liabilities exceed its assets and if it is unable to pay its debts as they fall due, it is interesting to note that when it comes to petitioning for winding up of an insolvent company in South Africa, only inability to pay debts as they fall due is a ground under section 344 (1) (f) of the companies Act of 1973 and not the fact of assets being fewer than liabilities.

The South African position is therefore clear that while a company may be insolvent by virtue of its liabilities exceeding its assets, this fact alone will not be a basis for petitioning for winding up of the company until it is shown that over and above the fact of the said liabilities being greater than the assets, the company was also failing to pay its debts as they fell due.[418]

---

416 Section 4 (1) (a) of the Act. Note that although the 2008 companies Act provides for the test of solvency as above, winding up of insolvent companies is still regulated by chapter 14 of the repealed 1973 companies Act in South Africa.

417 Section 4 (1) (b). However, the question of inability to pay debts as they fall due must be considered in light of the dictum of Cloete J in *Fourie NO vs. Newton* [2011] 2 All SA 265 (SCA) para 30 who said that:

> A question whether the company is unable to pay its debts when they fall due is always a question of fact to be decided as a matter of commercial reality in the light of all circumstances of the case, and not and not merely by looking at the accountants and making mechanical comparisons of assets and liabilities. The situation must be viewed as it would be by someone operating in a practical business environment. This requires a consideration of the company's financial condition in its entirety, including the nature and circumstances of its activities, its assets and liabilities and the nature of them.

418 It must be noted that in *Boschpoort Ondernemings (Pty) Ltd vs. Absa Bank Ltd* 2014 (2) SA 518 (SCA) the supreme court of South Africa provided some clarity to the interpretation of the transitional provisions in item 9 of Sch 5 of the 2008 Companies Act, as well as on the interpretation of the concepts of "insolvent" and "solvent" in s 79-81. The court remarked that commercially insolvent companies are still to be wound up in terms of chapter 14 of the 1973 Companies Act and that that the grounds for the winding-up of insolvent companies remain unchanged. Further, the court pointed out that factual insolvency may still be of some relevance in the determination of whether a company is able to pay its debts (par 24).

© University of Pretoria

In determining inability to pay debts as they fall due, it is important to bear in mind the test adopted by Enfield J in *Metropolitan Fire Systems Pty Ltd vs Miller*,[419] that:

> There is a necessity, therefore, to consider the whole of the company's resources, including its credit resources. In determining these resources, there is to be taken into account the time extended to the company to pay its creditors on the one hand and the time within which it will receive payment of its debts on the other.[420]

Taken from the perspective that inability to pay debts as they fall due implies that the corporation is insolvent in Malawi, which is also the case in several other jurisdictions as shown above, it would be clear that the penultimate position to this inability to pay debts, be it the dwindling of financial reserves or any other form of financial difficulty, or the existence of massive contingent or prospective liabilities such as an unprecedented increase in pecuniary claims against the corporation, is clearly to be regarded to mean that the company is in the "vicinity of insolvency."

Further, in Malawi, just as it is in Australia, the fact of the corporation's assets being fewer than its liabilities while it is able to pay its debts as they fall due is also to be taken to mean that the corporation is in the vicinity of insolvency for the same reason that this position is penultimate to the onset of insolvency, which is inability to pay debts as they fall due. This is unlike the position in South Africa and the United Kingdom where the fact of assets being fewer than liabilities is taken to be proof of insolvency.

---

[419] (1997) 23 ACRS 699.

[420] Ibid, at page 702. In determining that the company, in this particular case, was unable to pay its debts as they fell due, Einfeld J, on page 705, observed that the creditors of the company were demanding their money while the company's major assets were all locked in as security for the company's two major debts. Further, the learned Judge observed that although the company was owed substantial amounts of money, it was not foreseeable that this money would be realized in the near future to enable creditor demands to be satisfied.

© University of Pretoria

4.6 SHIFT OF DIRECTORS' FOCUS FROM SHAREHOLDERS TO CREDITORS WHEN A COMPANY IS INSOLVENT

In considering the exercise of directors' obligations when a corporation is fully solvent, the interests of shareholders will outweigh the interest of creditors of the corporation.[421] In this regard, it is accepted that when a corporation is fully solvent, the directors owe all their fiduciary obligations only to the corporation and its shareholders and therefore their focus must remain the maximization of profits for the company and its shareholders.[422]

Although the Companies Act in Malawi provides that in discharging their duties to promote the success of the company the directors are required, in certain circumstances, to consider the interests of the creditors of the company,[423] under common law, there has been unwillingness by the courts to extend directors' obligations to include the interests of creditors during the solvent life of a corporation.

The basis of this unwillingness has remained that while a corporation is solvent, creditors' rights are limited by the terms of their contracts with the corporations.[424] Further, it has been argued that creditors may also rely on lawsuits claiming fraud and all such protections afforded to them by state statutes and cannot rely on the special and rare obligations imposed on a fiduciary.[425]

---

421 Griffin, S *Personal liability and Disqualification of Company Directors* (1999) 10. At page 11, Griffin contends that once the company glides into formal insolvency, the interests of creditors do outweigh those of shareholders in the expected realization of corporate assets. See also English cases of *Brady vs. Brady* (1989) AC 755; *Re Horsely Weight Ltd* (1982) Ch. 442, and an Australian case of *Walker vs. Wimbourne* (1976) 137 CLR 1.

422 *Revlon, Inc. vs. MacAndrews and Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986). Generally, See an Article by Lin, L "Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors" *(1993) Vanderbilt Law Review 46:1485.*

423 Section 177(3) of the companies Act, 2013.

424 *Metropolitan Life Ins. Co vs. RJR Nabisco, Inc.,* 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989).

425 Cieri, RM and Riela MJ "Protecting directors and officers of corporations that are insolvent or in the vicinity of insolvency: Important considerations, Practical solutions" (2004) *De Paul Business & Commercial law Journal*, vol 2: 295 at 298.

© University of Pretoria

However, from the moment a company becomes insolvent, creditors interests become so important and hence the directors must shift focus from the interests of the company and its shareholders to the interests of creditors. In line with this view, the New South Wales court in *Kinsela vs. Russell Kinsela Pty Ltd*[426] stated 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 shareholders and directors to deal with the company's assets.

This passage was cited with approval by the English court of appeal in *West Mercia Safetywear Ltd vs. Dodd.*[427] In *Re Pantone 485 Ltd*,[428] the court emphasized that:

> Where the company is insolvent, the human equivalent of the company for the purposes of the directors' fiduciary duties is the company's creditors as a whole, i.e. its general creditors.

4.7 SHIFT OF DIRECTORS' FOCUS FROM SHAREHOLDERS TO CREDITORS WHEN A COMPANY IS IN THE VICINITY OF INSOLVENCY

The notion of vicinity of insolvency has changed the traditional position discussed above by requiring that directors of corporations that are found in the vicinity of insolvency must have regard to the interests of the creditors of company from the point in time when their corporations begin navigating the said vicinity of insolvency.[429]

---

426 (1986) 10 ACLR 395.

427 (1988) BCLC 266.

428 (2002) 1 BCLC 266.

429 Describing "vicinity of insolvency" as the time when a corporation is approaching insolvency, Sarra J, and Davis R, *Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations* (2002) Butterworths Canada Ltd at page 1 have observed that:

> When a corporation is approaching insolvency, it is an anxious time for everyone with a stake in its operations. These stakeholders include the shareholders, employees and creditors of the corporation, as well as those who may have suffered harm as a result of the corporation's operations. Therefore, it is important that those responsible for the affairs of the corporation have the clearest possible understanding of their obligations to these stakeholders for both the accrued liabilities of the corporation and those that may accrue after insolvency. Such an understanding will enable those responsible for the corporation's operation and assets to correctly assess their personal liability to the stakeholders. It will also enable them to avoid taking steps that could result in increased personal liability resulting from inadvertent breaches

© University of Pretoria

The difficulty that comes with comprehending this notion is the fact that a company in the vicinity of insolvency is not an insolvent company, but rather a solvent company having financial difficulties and therefore merely lurking on the border line of insolvency for which reason, to those that are more pedantic, it must be treated as a solvent company.

While the concept of shifting of directors' duties when a company is in the vicinity of insolvency may seem to be a departure from the traditional position that directors of a solvent company owe their obligations to the company and its shareholders alone, it has been argued that the same is not a departure from the traditional position, but a recognition of the fact that from the point in time the company enters the vicinity of insolvency, creditors become eventual stakeholders should the company proceed into insolvent liquidation, and hence that a consideration of the interests of the company from that moment must include a consideration of the interests of creditors who are the eventual stakeholders of the company. This view was well put by the court in *Vrisakis vs. Australian Securities Commission*[430] in the words of Ipp J, with Malcom CJ agreeing, that:

> In determining what is in the 'interests of the company,' the company means the corporate entity itself, the shareholders, and, where the financial position of the company is precarious, the creditors of the company.[431]

of their statutory and common law obligations to the stakeholders during insolvency. For the stakeholders, an understanding of the liability of those responsible for corporate operations will enable them to make a more accurate assessment of the likelihood of recovery, as well as alerting them to the various remedial avenues available to them under both statutes and the common law.

430 (1992-1993) 9 WAR 395.

431 Ibid, per Ipp J at 450, with Malcom CJ agreeing. Note that the formulation by Ipp J was not a strange and radical formulation, as similar views had been expressed by the courts before: in *Chew vs. The Queen* (1991) 4 WAR 21 where Malcom J on page 49 had said that if a company's financial position is precarious, 'the interests of the creditors may become the dominant factor in what constitutes the "benefit of the company as a whole." A similar view had been taken by the House of Lords a decade earlier in *Lonrho Ltd vs. Shell Petroleum Co. Ltd* (1980) 1 WLR 627 at 634 that the best interests of the company 'are not exclusively those of its shareholders but may include those of its creditors'. In *Liquidator of West Mercia Safetywear Ltd vs. Dodd* (1988) 4 BCC 30 the court considered that a director of a solvent company, for the foregoing reasons, owed a duty to have regard to the interests of creditors.

© University of Pretoria

While it may be argued against having the directors' duties shifting from the company and its shareholders to creditors when a company is navigating the vicinity of insolvency for the mere fact that it is difficult or impossible to pin point an exact time when a company can be said to be in the vicinity of insolvency, it must be observed that the same difficulty cannot be an excuse as it also exists in pin pointing a time when a company can be said to be insolvent. This difficulty is acknowledged by Farrar[432] who argues that:

> [There is] difficulty in gauging the point at which shareholders cease to be the dominant concern, as they are when the company is solvent, and creditors become the focus for directors, as they do when the company is insolvent or possibly of doubtful solvency. Identifying the point in time when that shift in emphasis occurs may be difficult.[433]

The difficulty in pinning down the exact time when a company can be said to be insolvent or in the vicinity of insolvency stems from the fact, as observed by the court in *Rees vs. Bank of New South Wales*,[434] that the whole concept of insolvency is fraught with imprecision, and also as observed by Sealy[435] that a company's financial position may fluctuate so that technically it moves in and out of insolvency as it carries on its business. This explains why, as Butcher[436] argues, common usage, case-law and legislation have all crafted the definition of insolvency in different ways.

It must be noted, however, that the principle that directors owe their fiduciary duties to creditors when the company is in the vicinity of insolvency is a more recent development that has, nevertheless, gained much attraction.[437] In New Zealand, the

432 Farrar, JH *et al Farrar's Company Law* (3rd ed) (1991) Butterworth & Co., London.

433 Ibid, at page 389. Note the same point being made by Richardson J in *Nicholson vs. Permakraft (NZ) Ltd* (1985) 1 NZLR 242 at 254.

434 (1963-1964) 111 CLR 210 at 218 per Hayne J.

435 Sealy, L "Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural." (1987) *13 MULR* 164 at 179.

436 Butcher, BS *Directors' duties: A new millennium, a new approach?* (2000) The Hague; Boston: Kluwer Law International 183.

437 Mclaughlin, JM "Directors' and Officers' liability: Vicinity of insolvency claims" (2005) page 1, available online at http://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub499.pdf?sfvrsn=2#page=3 accessed on 17th March 2018.

© University of Pretoria

principle was described as having the potential to breed legal difficulties in the case of *Nicholson vs. Permakraft (NZ) Ltd*,[438] where Richardson J took the following view:

> If a company is solvent in the sense of its assets exceeding its liabilities there can…be no question of a separate duty to creditors: they have their ordinary remedies if their accounts are not paid. If it is insolvent the creditors have an interest in the company and the directors might be said to have a duty to them for creditors' money is then at stake. *It is in the intermediate situation of near insolvency or doubtful insolvency that greater difficulties of legal principle arise*.[439] (emphasis supplied).

4.8 RATIONALE OF THE NEED FOR DIRECTORS' SHIFT OF FOCUS FROM THE COMPANY AND ITS SHAREHOLDERS TO THE CREDITORS

It has been contended that the rationale of the shift of directors' focus from the interests of the company and its shareholders to the interests of creditors is to remove the incentive and therefore produce a deterrence on directors from deploying company assets in a 'high–risk, high–reward' projects in insolvency and its vicinity notwithstanding that this strategy may be favoured by shareholders at that point in time.[440] The reason why shareholders of corporations lingering in the vicinity of insolvency would want to take high-risk decisions which may not be favourable to creditors can be found in the notion of self-interest couched by Kandestin[441] as follows:

> It is human nature to act in one's interest. Though ethicists and psychologists may disagree about the extent to which self-interest is a motivating factor behind human behaviour, most accept that it plays a role. Assuming that human behaviour is at least in part a function of self-interest, laws should be expected to reflect that behaviour. Many already do: the law of agency imposes a duty on the agent to act with obedience towards his principal, [the prohibition of] a lawyer from representing a client when the lawyer's personal interests interfere with the

438 (1985) 1 NZLR 242.

439 Ibid, at p. 254.

440 van Zwieten, K "Director liability in insolvency and its vicinity: West Mercia Safetywear Ltd v Dodd Revisited" (Oxford Legal Studies Research Paper No. 38/2017) 1 available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2970913 accessed 4th Sept 2018. See also the cases of *West Mercia Safetywear vs. Dodd* (1988) 4 B.C.C 30, and *Kinsela vs. Russel Kinsela Pty Ltd (In Liquidation)* (1986) 4 NSWLR722.

441 Kandestin, CD "The duty to creditors in near-insolvent firms: Eliminating the near insolvency distinction" (2007) *Vol 60 Vanderbilt Law Review*, 1236.

© University of Pretoria

> representation. Where money is involved, the need to curb the incentive to advance one's own interests at the expense of another is even greater…

Kandestin has added that primarily, the law of fiduciary duty addresses the problems associated with having one group of people to manage the money of a second group.[442] According to the learned author, while this is easy in healthy and solvent companies, it becomes muddled in financially distressed firms for the reason that while an insolvent company comprises the same constituencies as a solvent company, the interests and risk levels of the respective constituencies are changed in that whereas they are usually harmonious in a solvent corporation, each self-interested constituency might find itself in tension with the others when insolvency is looming.[443]

As a result of the foregoing, Kandestin argues that as a corporation nears insolvency and finally becomes insolvent, the common law's emphasis on shareholder interests makes less and less sense because upon insolvency, shareholders have nothing more to lose as little equity remains in the company, while, at the same time, the said shareholders have everything to gain if the corporation can reverse its financial distress, a fact which incentivizes the shareholders to be high stakes gamblers using creditors' money.[444]

---

[442] Ibid.

[443] Ibid, 237. See also Sarra J, and Davis R, *Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations* (2002) Butterworths Canada Ltd at page 2 who have observed that:

> At the point of insolvency, while directors and officers continue to be obliged to manage in the best interest of the corporation, the focus of those interests shifts from one in which shareholder interests are paramount, to one in which the interests of creditors become important. This is because, by the very nature of insolvency, there is little or no equity (*i.e,* the value of the assets remaining after deducting the company's debts) remaining in the corporation and the creditors of the corporation, broadly defined as secured lenders, lien holders, trade suppliers, employees and others, now become the claimants to the residual value of the corporation.

[444] Ibid. See also Anderson H, "Shelter from the Storm: Phoenix Activity and the Safe Harbour"[2018] 41 *Melbourne University Law Review* 999 at 104 who argues that the gain from a successful risk-taking when a company is in significant financial distress, which involves the gamble to trade out of the financial difficulties, goes to the company's creditors and shareholders, while the loss, if the gamble fails, is for the directors themselves, both financially, through insolvent trading liability (the Australian equivalent of wrongful trading liability in Malawi) and through loss of reputation.

© University of Pretoria

Gerner-Beuerle and Schuster[445] have argued, in line with the foregoing, that while shareholders often effectively control the use of the distressed company's remaining-assets, the devaluation of their residual claim means that they are very likely to externalize the costs of their risky-projects to creditors while fully keeping the claim to the company's potential profits.

The concern of shareholders' pay-outs during the vicinity of insolvency becomes much more important as all or most business projects pose a threat to the thin layer of a company's remaining equity as a result of which shareholders are unlikely to be efficient decision-makers under the circumstances as they do not want to internalise the cost of their decisions but they are, instead, incentivized to 'gamble' their way out of insolvency.[446]

On the question of what incentives will play in the minds of directors, Gerner-Beuerle and Schuster have argued that insolvency is very costly for directors not only due to the risk of reputational loss, but also due to the company-specific human capital they may have invested in the company, and the threat of losing their engagement by the company.[447]

In view of the foregoing, Gerner-Beuerle and Schuster have concluded that the desire to disregard legal constraints and leap into high-risk strategies leading either to the recovery of the company or to the aggravation of the insolvency are very tempting for directors unless they are made to share the costs inflicted on creditors by risky business decisions taken in the vicinity of insolvency.[448]

The temptation on shareholders and directors to jump into risky ventures when a corporation is in the vicinity of insolvency, and the desire to continue trading when the company is insolvent is, to a greater extent, enabled by the very notion of limited

---

445 Gerner-Beuerle, C and Schuster, E "The Evolving structure of Directors' duties in Europe" (2014) *European Business Organization Law Review* 15: 191-223 at 223.

446 Ibid, at p. 224.

447 Ibid.

448 Ibid.

© University of Pretoria

liability. It has been argued that limited liability creates incentives that enable an insolvent company to continue trading. Prentice[449] summed up how this occurs as follows:

> Where a company is insolvent in the sense that its liabilities exceed its assets, its shareholders (and directors) have an incentive to continue trading as they have everything to gain and nothing to lose. Should the company trade out of its difficulties this will benefit the shareholders whereas if it continues to decline they will, because of the principle of limited liability, suffer no additional loses as they will be borne by the company's creditors. Where an insolvent company continues to trade, the persons who make the decision that it should do so are not the persons who will "lose" if the company is unsuccessful. Thus the principle of limited liability creates a perverse incentive for an insolvent company to continue to trade.[450]

This view is echoed by Davies[451] who contends that as a company nears insolvency and the equity capital evaporates, perverse incentives are created for shareholders and directors alike. It is argued that at this point, shareholders and directors have privately optimal risk levels for the company's business operation that would render it inefficient to leave them in charge without regulatory intervention.[452]

Further, Davies argues that actually the opportunism of directors when their companies are navigating the vicinity of insolvency is not confined to embarking on overly risky projects in the hope of turning the company around, but that the greater temptation on the directors (because it demands less entrepreneurial effort) is to spirit assets out of the

---

449 Prentice, D "Creditor's Interests and Director's Duties" (1990) *10 Oxford Journal of Legal Studies*, 265.

450 See Ramsey I, "Company Directors' Liability for Insolvent Trading" (2000) *CCH Australia Limited*, 13, who argues that as insolvency approaches, the shareholders have an even more powerful incentive to engage in risky investments given that most of their funds have been dissipated yet there is a possibility of a bonanza payoff that will prevent the insolvent liquidation of the company. See also Grantham R, "The Judicial Extension of Directors' Duties to Creditors" (1991) *Journal of Business Law*, 1, 3.

451 Davies, P "Directors' creditor-regarding duties in respect of trading decisions taken in the vicinity of insolvency" (2006) *7 European Business Organization Law review*: 302-337 at 301. See also Eidenmuller, H "Trading in times of crisis: Formal insolvency proceedings, workouts and the incentives for shareholders/managers (2006) *7 European Business Organization Law Review*, 239; Bachner, T "Wrongful Trading – Anew European model for creditor protection?" (2004) *5 European Business Organization Law Review*, 293.

452 Gerner-Beuerle, C and Schuster, E "The Costs of Separation: Friction between company and insolvency law in the single market" (2004) 14 Journal of Corporate Law Studies, 301.

© University of Pretoria

company, so that creditors can no longer lay their hands on them, rather than to run the risk of increasing the company's liabilities by undertaking new and risky projects.[453]

4.9 SHIFTING OF DIRECTORS' FOCUS TO CREDITORS AND WHAT IT ENTAILS FOR DIRECTORS

Shifting of the focus of the directors from the company and its shareholders to the creditors requires that the directors should ensure that the decisions which they make from the time the shift occurs should be such that would result in creditors receiving their payments whether the company survives or it is placed under a form of insolvency process. However, this is not an easy task for directors for the reason that even when that shift occurs, i.e. when the company enters the vicinity of insolvency, the expectation still remains for the directors to try and steer the company back to financial glory rather than merely escorting it into insolvent liquidation.

Steering a company back to financial glory requires that the directors should, in certain instances, make purely commercial decisions without being hampered by the obsession of the plight of creditors. To some extent, this entails ignoring the interests of creditors which, at that time, the law requires that they should not be ignored. This situation lands the directors in a very tricky situation where they stand to be criticized whichever way they decide to go. Park J in *Re Continental Assurance Co of London Plc*[454] discussed this difficult position of directors as follows:

> …Whenever a company is in financial trouble and the directors have a difficult decision to make whether to close down and go into liquidation, or whether instead to trade on and hope to turn the corner, they can be in a real and unenviable dilemma. On the one hand, if they decide to trade on and things do not work out and the company, later rather than sooner, goes into liquidation, they may find themselves in the situation of the respondents in this case – being sued for wrongful trading. On the other hand, if the directors decide to close down immediately and cause the company to go into an early liquidation, although they are not at risk of being sued for wrongful trading, they are at a risk of being criticized on other grounds. A decision to close down will almost certainly mean that the ensuing liquidation will be an insolvent one. Apart from anything else, liquidations are expensive operations, and in addition, debtors are

453 Davies, P "Directors' creditor-regarding duties in respect of trading decisions taken in the vicinity of insolvency" (2006) European Business Organization Law review 7: 302-337 at 307.

454 (2007) 2 B. C. L. C. 287.

© University of Pretoria

> commonly obstructive about paying their debts to a company which is in liquidation. Many creditors of the company from a time before the liquidation are likely to find that their debts do not get paid in full. They will complain bitterly that the directors shut down too soon; they will say that the directors ought to have had more courage and kept going. If they had done so, the complaining creditors will say, the company probably would have survived and all of its debts would have been paid. Ceasing to trade and liquidating too soon can be stigmatized as the coward's way out.

This view has also been echoed by Kandestin,[455] who says that:

> Directors trying to comply with their corporate common law duty to shareholders might feel compelled to undertake risky ventures to restore equity to a near-insolvent corporation. The failure of these ventures has, in some instances, exposed the directors to creditor lawsuits. Conversely, directors who consider the interests of creditors in an attempt to avoid liability have been sued anyway, this time by their own shareholders. Without the benefit of predictable law, corporate directors are placed in the untenable position of facing potential liability no matter what they do.[456]

In this kind of difficulty, the right course of action by directors seems to be the one suggested by Keay,[457] namely, that there is need for a balance involving consideration of the fact that directors must be permitted to manage companies in a commercial manner, but that on the other hand, the law must ensure that it does not permit directors to disregard the plight of creditors when a company is in the vicinity of insolvency.

4.10 NATURE OF OBLIGATIONS OF DIRECTORS WHEN A COMPANY IS IN THE VICINITY OF INSOLVENCY

While the obligations outlined herein may not be found to be too novel to the ordinary practice of directors, it needs to be appreciated that the concept of directorial obligations in the vicinity of the company's insolvency is itself a novel concept that has recently gained prominence partly due to the highlight it has received in the UNCITRAL

455 Kandestin, CD "The duty to creditors in near-insolvent firms: Eliminating the near insolvency distinction" (2007) Vol 60 *Vanderbilt Law Review*, 1236.

456 Ibid, at page 1240.

457 Keay, A "The shifting of director's duties in the vicinity of insolvency" (2015) *International Insolvency Review* 4 (2). 140-164 at 154. Available online at https://doi.org/org/10.1002/iir.1236 or http://eprints.whiterose.ac.uk/84965/accessed on 18th October 2018 accessed on 18th October 2018.

© University of Pretoria

Legislative Guide on insolvency law[458] and in the recent works of several commentators and also in the recent trends in insolvency law as it can be seen from the comparable jurisdictions. However, in this study, the UNCITRAL Legislative Guide on insolvency law remains the main source of the obligations that attach to directors when their companies begin to navigate the vicinity of insolvency.

The underlying rationale for considering the directors' obligations to their companies when the said companies begin to navigate the vicinity of insolvency is to enable the directors to act reasonably and take adequate and appropriate steps to monitor the financial position of the company and thereby being able to act accordingly and in time to minimize losses to creditors and to the company and its shareholders by avoiding actions that would aggravate the situation and generally to take appropriate action that would prevent the company from sliding into insolvency.[459]

Further, in respect of wrongful trading, a consideration of the directors' obligations to their companies when the said companies begin navigating the vicinity of insolvency becomes relevant for the reason, as contended by Gerner-Beuerle and Schuster,[460] that it highlights the fact that it is the breach of such obligations which triggers liability for wrongful trading.

While the underlying rationales for highlighting the directors' obligations to their companies when the said companies begin navigating the vicinity of insolvency might be the same in different jurisdictions, the approaches to be taken in formulating the said obligations and determining the standard to be met in fulfilling the said obligations will depend on the legal context of each individual jurisdiction and, for this reason, much as a lot of the obligations may be similar, there can never be universal obligations of directors that arise when their companies begin navigating the vicinity of insolvency.

---

458 United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April2013).

459 Ibid, at page 10.

460 Gerner-Beuerle, C and Schuster, E "The Costs of Separation: Friction between company and insolvency law in the single market" (2004) 14 *Journal of Corporate Law Studies*, 225.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

The following set of obligations may be found ideal for Malawian companies navigating the vicinity of insolvency:

a) Directors will be required to ensure that proper and up to date accounts are being maintained by the company in the manner required.[461]

b) Directors will be required to ensure that they obtain accurate, relevant and timely information and keep themselves independently informed (rather than relying solely on the advice by management) of the financial position of the company as well as the extent of creditor pressure, the extent of court claims or recovery actions taken by creditors against the company or indeed any other disputes the company may have with the creditors.[462]

c) Directors will be required to ensure that regular board meetings are conducted to monitor the financial situation of the company with comprehensive minutes being kept on all commercial decisions made during the meetings, including dissenting opinions and reasons for them.[463] In particular, crucial decisions such as the decision to continue trading rather than placing the company into an immediate insolvency process such as rescue procedure, where applicable, will have to be minuted together with the reasons why it is considered that there is a reasonable prospect of the company returning to success and avoiding insolvent liquidation.

---

[461] UNCITRAL Legislative Guide, page 10, para 5(a). In Malawi, this is a statutory obligation under Section 251 of the Companies Act of 2013. Note that this obligation also requires that the directors must understand the company's accounts and be able to draw independent conclusions on what is going on in the company. In finding against a director who, in defending an insolvent trading claim, argued that she depended on her husband who was her co-director to inform her of the precarious financial position of the company, Enfeld J in *Metropolitan Fire Systems Pty Ltd vs. Miller* (1997) 23 ACSR 699 at page 712 said:

> She may have believed that her husband would inform her if the company was in trouble but as a director she had a duty to take an interest in and demand information on the financial state of the company, especially as she undoubtedly knew that it was at best "in trouble". As a working director, she had a duty to observe and draw reasonable and obvious conclusions from facts coming to her attention.

[462] UNCITRAL Legislative Guide, page 10, para 5(b).

[463] Ibid, para 5(c).

© University of Pretoria

On this point, it is important to note that even in circumstances where the directors are of the opinion that the company may not avoid plunging into insolvent liquidation, continuing to trade may still not be a bad decision as there may be assets of the company which may be sold profitably if the sale is done while the company is a going concern rather than when a company is in liquidation.[464] Further, a decision to incur further liabilities when it is believed that the company may not avoid plunging into insolvent liquidation may equally not be impugned as this might be done in order to finance the continued trading designed to enable profitable sale of assets while the company is a going concern.[465]

The obligation to keep minutes became a contentious issue in the American case of *Re The Walt Disney Company Derivative Litigation*[466] where the court refused to dismiss a derivative action against the Walt Disney Company's board of directors in which shareholders alleged that the directors breached their fiduciary duties in connection with the hiring and subsequent resignation of Michael Ovitz, who was the president of Disney for a short period of time.

According to the plaintiffs, after meeting for less than one hour, the Disney's compensation committee recommended Mr. Ovitz's hiring to the full board, even though the minutes of that meeting reflected that the committee reviewed only an incomplete summary of a draft of Mr. Ovitz's employment agreement and did not review several internal memoranda that criticized the proposed terms of Mr. Ovitz's employment as being too generous.

In an ensuing meeting, the full board approved Mr. Ovitz's employment. The minutes of the compensation committee meeting had been fifteen pages long, but only a page and a half were devoted to the board's consideration of Mr. Ovitz's employment. The minutes did not indicate that the directors asked any questions about the details of Mr. Ovitz's salary, stock options, or the termination provisions in his employment agreement. The minutes also did not

---

464 Ibid.

465 Ibid.

466 (2003) Del. Ch. 825 A. 2d. 275.

© University of Pretoria

indicate that the compensation committee made any report to the board concerning its decision to hire Mr. Ovitz.

The court held that because there was no evidence that the directors seriously undertook their duty to consider the terms of Mr. Ovitz's hiring and subsequent termination, it appeared that the directors "*consciously and intentionally disregarded their responsibilities*" adopting a "we don't care about the risks" attitude concerning a material corporate decision. The court also stated that there was "reason to doubt whether the board's actions were taken honestly and in good faith". Accordingly, the court allowed the shareholders derivative lawsuit to proceed.

The above case illustrates the importance of keeping adequately detailed minutes of major corporate decisions. It is possible that Disney's directors did indeed consider and discuss all of the material information related Mr. Ovitz's employment. However, because the minutes of the compensation committee and board meetings did not give such an indication, the court concluded that the directors did not fulfil their obligation.

d) Directors will need to seek specialist assistance or advice, including, where applicable, advice from insolvency practitioners. Legal advice and any other relevant advice may also be sought by the directors at that stage. However, considering that the key issues at that stage will be the financial position of the company and the ramifications of the same, specialist financial and insolvency advice will be found to be key.[467] The reason for seeking specialist advice may be to ensure that any decision that the directors may take during this period must be such as would withstand objective and independent scrutiny by the courts or other relevant authorities. It must be noted that since each and every director has an obligation to inform himself independently of the position of the company, the advice may be sought collectively but also individually by each director.

[467] UNCITRAL Legislative Guide, page 11, para 5(d).

© University of Pretoria

e) The directors may also need to have early discussions with auditors, and, where necessary, external auditors.[468]

f) The directors may need to reconsider the structure and functions of the company with a view to examine viability and reducing expenditure. This may, in certain circumstances, require the holding of restructuring negotiations or commencing reorganization.[469] The directors may also consider whether the existing management should be retained or replaced.

g) Directors may need to ensure that the assets of the company are protected and that the company does not take action that may result in the loss of key employees or enter into transactions that might be subsequently avoided, such as transactions at an undervalue or voidable dispositions. It must be noted that not all payments made at that time may be questioned. Some payments may be necessary in order to continue a constant supply of key goods or services. These payments may not constitute a preference. Prudently, directors with substantial stock holdings or who represent major shareholders may be considered so much interested and hence they must be cautious when voting on transactions when a company begins navigating the vicinity of insolvency.

h) The composition of the board could also be reviewed and possibly increase the number of independent directors.

i) A shareholders' meeting could be called if it is considered from the balance sheet that a stipulated proportion of the share capital has been eroded. This is generally applicable in businesses which, by law, have a stipulated capital maintenance requirement.

j) In the event that the directors take a considered view that insolvent liquidation of the company may not be avoided, the directors will need to prioritize the interests of creditors who will be eventual stake-holders once insolvency proceedings commence and thus the directors will be expected to start holding

468 UNCITRAL Legislative Guide, page 11, para (5)(e).

469 UNCITRAL Legislative Guide, page 11, para (5)(f).

© University of Pretoria

meetings with relevant groups of creditors as a mechanism of assessing their interests.[470]

4.11 NATURE OF OBLIGATIONS OF DIRECTORS WHEN A COMPANY BECOMES INSOLVENT

As discussed herein, insolvency of a company is defined by its inability to pay its debts as they fall due.[471] A company may thus be wound up in Malawi if it is unable to pay its debts as they fall due.[472] From the moment therefore that a company begins to be unable to pay its debts as they fall due, the directors of the company have some obligations to perform. The said obligations pertain to placing the company in a rescue process or indeed placing it into immediate liquidation.

The choice either to place the company into a rescue process or into immediate liquidation depends on the extent of the financial distress of the company as well as the hope which the directors may have in achieving a turnaround for the company. It is therefore not an easy choice as it is a choice that must be made upon a thorough analysis of all relevant factors surrounding the company.

4.11.1 Obligation to place a company under corporate rescue or liquidation in Malawi.

In Malawi, a company which is financially distressed may be rescued under the process of administration, or it may be placed straight into liquidation. Placing a company under administration is a mandatory obligation for directors who believe that their company is unable to pay its debts as they fall due, unless they have reasons to believe that administration may not rescue the company from insolvent liquidation, in which case the nature of the obligation changes to require that the directors place the company into an immediate liquidation.

470 UNCITRAL Legislative Guide, page 11, para 5 (g).

471 Section 107 (4) (b) of the Insolvency Act 2016.

472 Ibid.

© University of Pretoria

Section 222 of the Companies Act in Malawi is to the effect that a director of a company who believes that the company is unable to pay its debts as they fall due shall forthwith call a meeting of the board to consider whether the board should appoint a liquidator, (whether the directors are of the view that administration will not rescue the company) or to appoint an administrator, (where the directors believe that the company may be rescued).

It must be noted that the obligation of an individual director only extends to calling for the meeting of the board and proposing and voting, at such meeting, for either administration or liquidation as the case may be. The resolution to go for either administration or liquidation can only be made by the board, and therefore a director will not be liable for breach of his obligations merely because the board of directors disagreed with his recommendation as he will have discharged his obligation of calling for the meeting and recommending and voting for either administration or liquidation.

It is important to note that when such meeting is called, the board is not only bound by the two options of appointing either a liquidator or an administrator. The board may resolve to ignore these two options and resort to allowing the company to continue carrying on its business as usual.[473]

However, failure to call for the board meeting to consider the three options above has serious consequences on a director who believes that the company is unable to pay its debts as they fall due for the reason that if it is shown subsequently that such failure occurred at a time when the company was indeed unable to pay its debts as they fall due,[474] and the company is eventually placed into liquidation,[475] the court may, on the application of the liquidator or a creditor of the company, make an order that the said director be liable for the whole or any part of the loss suffered by the creditors of the company as a result of the company having continued to trade at a time when it ought to have been placed under administration or liquidation.[476]

473 Section 222 (3) of the Companies Act of 2013.

474 Section 222 (3) (b) of the Act.

475 Section 222 (3) (c) of the Act.

476 Proviso to Section 222 (3) (c) of the Act.

© University of Pretoria

Choosing to continue trading equally has serious consequences on directors who vote at the board meeting to do so, for the reason that if it is subsequently shown that at the time of the said board meeting, there were no reasonable grounds for believing that the company was able to pay its debts as they fall due,[477] and the company is eventually placed into liquidation,[478] the court may, on the application of the liquidator or a creditor of a company, make an order that the directors, other than those who attended the meeting and voted in favour of appointing a liquidator or administrator, be liable for the whole or any part of any loss suffered by creditors of the company as a result of the company having continued to trade when it ought to be placed under administration or liquidation.[479]

4.12 CORPORATE RESCUE IN MALAWI AND IN THE COMPARABLE JURISDICTIONS.

4.12.1 Malawi

Corporate rescue is referred to as company reorganization in Malawi and it is done at the instance of the court on an application by the directors of a company;[480] the company itself;[481] one or more creditors of the company,[482] or a combination of these persons.[483] Under the Insolvency Act in Malawi, a court can only make a company reorganization order if it is satisfied that the company is, or is likely, to become unable to pay its debts as they fall due,[484] and if the court is satisfied that placing the company under reorganization will achieve the following:

477 Section 222 (4) (b) of the Act.

478 Section 222 (4) (c) of the Act.

479 Proviso to section 222 (4) (c) of the Act.

480 Section 18 (1) (b) of the Act.

481 Section 18 (1) (a) of the Act.

482 Section 18 (1) (c) of the Act.

483 Section 18 (1) (d) of the Act.

484 Section 17 (a) of the Insolvency Act of 2016.

© University of Pretoria

a) Rescuing the company as a going concern, restoring the company to solvency and thereby preserving the company and its business operations as a going concern.[485]

b) Achieving a better result for the company's creditors as a whole than would be likely if the company was to be wound up without first being in company reorganization, which may include a sale or a transfer of any business of the company as a going concern.[486]

c) Realizing property in order to make distribution to one or more secured or preferential creditors.[487]

4.12.2 United Kingdom

In the United Kingdom, directors equally have an obligation to rescue their companies before placing them under liquidation.[488] The Insolvency Act of 1986 in the United

---

485 Section 14 (1) (a) of the Act. However, not all failing companies need to be rescued. Before a decision to rescue a company is made, it is important to bear in mind an interesting observation made by Mmakola D "South Africa's SMME policy – the challenge remains" 2009 39(2) *Africanus* 66, 71 who said that:

> …there are people who end up being in business due to factors such as inability to secure paid employment. Such people are not necessarily entrepreneurs and are likely to leave their business as soon as job opportunities become available. There is need to categorize business owners so that limited financial and other support to SMMEs can go to business owners that are truly entrepreneurs, as part of industrial policy. The remaining category of business owners can then be the focus of welfare policy. As a result of this confusion, considerable effort and resources have gone into attempts to improve management and access to finance for enterprises that have no realistic prospects of graduating into productive concerns.

486 Section 14 (1) (b) of the Act. As it has been observed by Boraine, A and van Wyk, J "Various Aspects to Consider with Regard to Special Insolvency Rules for Small and Medium-Sized Enterprises in South Africa" (2016) *International Insolvency Review*, v25 3-35, 11 accessed online on 13th May 2017 at https://UnivofPretoria.on.worldcat.org/oclc/5982844292, the primary consideration for the development and implementation of alternatives to deal with failing businesses, such as the corporate rescue alternative, is the viability of the business.

487 Section 14(1)(c) of the Act.

488 When recommending the enactment of a corporate rescue process in the United Kingdom Insolvency Act of 1986, the Cork Committee (Report of the Review Committee on Insolvency Law and Practice, (Cork Committee Report, 1982 (Cmnd 8558)) para 204, observed that "a concern for the livelihood and well-being of those dependent upon an enterprise which may well be the lifeblood of a whole town or even a region is a legitimate factor to which a modern law of insolvency must have regard. The chain reaction consequences upon any given failure can potentially be so disastrous to creditors, employees and the community that it must not be overlooked."

© University of Pretoria

Kingdom embraces the objective of promoting recovery of financially distressed companies by providing two rescue procedures, namely, the Company Voluntary Arrangement procedure covering companies prior to inception of formal insolvency and Administration, covering companies on the verge of insolvency.

Under Company Voluntary Arrangements, directors of a company, other than such companies which are already under Administration or winding up, have an obligation (where the company is unable to pay its debts as they fall due) to make a proposal to the company and to its creditors for a composition in satisfaction of its debts or for a voluntary arrangement.[489]

It must be noted that under Section 1(3) of the UK Insolvency Act of 1986, this proposal may also be made where the company is under Administration or winding-up. Under this process, a nominee, who must be a qualified insolvency practitioner is appointed to act in relation to the voluntary arrangement either as a trustee or otherwise for the purpose of supervising the implementation of the arrangement.[490]

The rationale for the introduction of the Company Voluntary Arrangements in the United Kingdom was stated by the Cork Committee[491] to be the desire to achieve an inexpensive, quick and efficient method of dealing with financial difficulties plaguing a company without engaging in formal procedures.

Omar and Gant[492] have argued that Company Voluntary Arrangements in the United Kingdom involve companies dealing with creditors and negotiating terms with them under the guidance of an insolvency practitioner and arriving at an agreement on compromise through which debts could be settled and the company could survive.

489 Section 1 of the UK Insolvency Act of 1986.

490 Section 1 (2) of the Act.

491 Insolvency law and practice: Report of the review committee (cmnd.8558) (HMSO, 1982) ("Cork Report") at para 204.

492 Omar, PJ and Gant, J "Corporate rescue in the United Kingdom; past, present and future reforms" (2016) page 9, available online, accessed on 25th October 2018, at http://irep.ntu.ac.uk/id/eprint/27854/1/Pubsub5402_Omar.pdf#page=28

© University of Pretoria

According to the learned commentators, Company Voluntary Arrangement practically involve partial waiver of the debts due with a rescheduling of payments with the overriding objective being a compromise or settlement of claims by creditors.[493]

Administration is a second rescue procedure available under the UK Insolvency Act. Administration is more formal and it requires suspension of debt enforcement proceedings under the protection of a moratorium.[494] Under this process, the director of a company which is, or is likely to be, unable to pay its debts as they fall due can apply for the administration order if he can show that the order will achieve any of the following:[495]

a) The survival of the company, and the whole or any part of its undertaking as a going concern.[496]

b) The approval of a company voluntary arrangement.[497]

c) The sanctioning of a compromise or an arrangement involving the company.[498]

---

493 Ibid.

494 Ibid.

495 Section 9 of the Insolvency Act of 1986. Other persons who may apply for an administration order include the company itself, the creditors or a combination of all these persons. It must be noted that for purposes of this procedure, a company in the United Kingdom, particularly in England, is deemed to be unable to pay its debts;

a) If a creditor (by assignment or otherwise) to whom the company is indebted in a sum exceeding £750 then due has served on the company, by leaving it at the company's registered office, a written demand (in the prescribed form) requiring the company to pay the sum so due and the company has for 3 weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor or,

b) If, in England and Wales, execution or other process issued on a judgement, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part, or

…

c) If it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.

496 Section 8 (30 (a) of the Act.

497 Section 8 (30 (b) of the Act.

498 Section 8 (30 (c) of the Act.

© University of Pretoria

d) A more advantageous realization of the company's assets than would be effected in a winding up.[499]

It is important to note that it is a requirement that the administration order must specify the purpose or purposes for which it is made.[500] With respect to administration under the UK Insolvency Act, Omar and Gant[501] have contended that it is a secure court-supervised framework that would benefit all creditors and avoid the ravages caused by a secured creditors' minded recovery of assets. The learned commentators add that administration is a debtor friendly process which encourages directors of companies to seek assistance at an early stage of financial distress and avoid the publicity associated with receiverships by promoting rescue as a joint effort between the debtor and its creditors.[502]

4.12.3 South Africa

In South Africa, a board of directors of a financially distressed company has an obligation to place the company under a business rescue procedure or to enter a compromise with its creditors.[503] Under voluntary business rescue, the board of

499 Section 8 (30 (d) of the Act.

500 Proviso to section 8 (3) of the Act.

501 Omar, PJ and Gant, J "Corporate rescue in the United Kingdom; past, present and future reforms" (2016) page 12, available online, accessed on 25th October 2018, at http://irep.ntu.ac.uk/id/eprint/27854/1/Pubsub5402_Omar.pdf#page=28

502 Ibid.

503 Note that under Section 155 of the Companies Act 71 of 2008, compromise between a company and its creditors occurs whether or not the company is financially distressed. Nwafor, AO "Exploring the Goal of Business Rescue through the Lens of the South African Companies Act 71 of 2008" (2017) *28 Stellenbosch L. REV. 597* at p. 597 has said the following in respect of the South African business rescue process:

> South Africa as an emerging economy has, in realizing the importance of the corporate entities in the evolutionary courses of the commercial world (especially in the areas of the production of goods and services as well as the creation of ever increasing demands for employment opportunities for the teeming working populations in the country), adopted an innovative path in the Companies Act 71 of 2008 ("Companies Act"). The new scheme is geared towards ensuring sustainability rather than the demise of corporate entities where this could be avoided. This new legislative scheme is reflected in chapter 6 of the Act. The provisions are tailored in such a manner so as to attain one of the stated purposes of the Act namely to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.

© University of Pretoria

directors of a company which appears to be reasonably unlikely to be able to pay all its debts as they become due and payable within the immediately ensuing six months[504] or if it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months,[505] may resolve that the company voluntarily begin business rescue proceedings and place it under supervision.[506] The resolution will only be taken if the board has reasonable grounds to believe that there appears to be a reasonable prospect of rescuing the company.[507]

Similarly, the board of directors of a company in the above circumstances may propose an arrangement or a compromise of its financial obligations to all of its creditors or to all of the members of any class of its creditors.[508]

---

504 Section 128 (1) (f) (i) of the Companies Act 2008.

505 Section 128 (1) (f) (ii) of the Act.

506 Section 129 (1) of the Act.

507 Section 129 (1) (b) of the Act. In *Koen vs Wedgewood Village Golf & Country Estate (Pty) Ltd* 2012 2 SA 378 (WCC), Binns-Ward J (at para 14) made the following interesting remarks with respect to the South African business rescue procedure under South African corporate law:

> It is clear that the legislature has recognized that the liquidation of companies more frequently than not occasions significant collateral damage , both economically and socially, with attendant destruction of wealth and livelihoods. It is obvious that it is in the public interest that the incidence of such adverse socio-economic consequences should be avoided where reasonably possible. Business rescue is intended to serve that public interest by providing a remedy directed at avoiding the deleterious consequences of liquidations in cases in which there is a reasonable prospect of salvaging the business of a company in financial distress, or of securing a better return to creditors than would probably be achieved in an immediate liquidation.

508 Section 155 (2) of the Act. In *Chetty vs Hart* 2015 4 All SA 201 (SCA), Cachalia J observed (at para 28) that the obvious purpose of placing a company under a business rescue process is to afford the company a breathing space so that its affairs may be assessed and restricted in a manner that allows its return to financial viability. In *Oakdene Square Properties (Pty) Ltd vs Farm Bothasfontein (Kyalami) (Pty) Ltd* 2012 2 All SA 433 (GSJ), Claassen J (at para 12) observed that the general philosophy permeating through the business rescue provisions in South Africa is the recognition of the value of the business as a going concern rather than the juristic person itself and that this is why the process is referred to as business rescue and not company rescue.

© University of Pretoria

4.12.4 Australia

In Australia, part 5.3A of section 435 of the Corporations Act 50 of 2001 provides for corporate rescue, highlighting that the objective of that part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:

(a) Maximises the chances of the company, or as much as possible of its business, continuing in existence; or

(b) If it is not possible for the company or its business to continue in existence---results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

In *Bidald Consulting vs Miles Special Builders*[509] the New South Wales Supreme Court gave the following judicial expression with regard to the Australian business rescue provision above:

> "Section 435A regards it as something to be aimed at that the company *or* its business continue in operation, in whole or part. This includes the possibility that, even though the company does not continue in existence, the business or part of it continues, perhaps run by some other entity. It is within the policy of the Part for the business to be kept alive so far as it can, regardless of who might be running it, rather than have the destruction of the business which sometimes comes with a liquidation where it is not possible for the liquidator to sell the business as a going concern."[510]

4.13 JUSTIFICATION FOR THE IMPOSITION OF PERSONAL LIABILITY ON DIRECTORS OF COMPANIES

While the case for the need to afford protection to creditors through the creation of mechanisms such as the wrongful trading rule against delinquent directors seems to

---

509 2005 NSWSC 1235.

510 Per Campbell J, at para 220. In *Sydney Land Corp (Pty) Ltd vs Kalon (Pty) Ltd* 1997 26 ACSR 427 at p 430, an interesting remark was made by Young J in respect of the Australian business rescue culture who said that the reason for the enactment of the business rescue provisions under Australian corporate law was "undoubtedly because the company's business was employing Australians and it was in the interest of Australia that as much employment as possible be maintained. Thus, things were to be structured so as to maximize that chance."

© University of Pretoria

have been made, one question that remains to be answered is "why should directors be the target of the said exercise when they are mere agents of their companies?"

In answering the above question, Davies and Worthington[511] have argued that much as the law could, in certain circumstances, remove the protection of the doctrine so as to make the shareholders personally liable to creditors of the company, it is the case that in many cases, the opportunistic conduct induced by the doctrine is not initiated by the shareholders directly but by the directors of the company, acting in the interests of the shareholders. In this situation, the learned commentators have argued, the law may want to reduce the incentives of the directors to respond to this particular shareholder interest, and the response of the law in that case is to create liabilities for directors rather than shareholders of the company.[512]

In line with this view, Davies[513] has argued that much as the incentive to make perverse decisions when the company is in financial difficulties operate most strongly on shareholders, the legal techniques of corporate law normally identifies the directors of the company as subjects of duties and liabilities for the decisions taken. The reason for this, according to Davies, is that shareholders, as shareholders, are in a weak position

---

511 Davies, P and Worthington, S *Gower and Davies Principles of Modern Company Law* (2012) 213.

512 Ibid. Note however, as it has been observed in paragraph 3.5.1 of this study, shareholders of companies can be liable under the wrongful trading rule in Malawi. For emphasis on why personal liability for directors is necessary, see the sentiments made by Sarra J, and Davis R, *Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations* (2002) Butterworths Canada Ltd at page 14, who have contended that:

> Since the corporation has all the legal powers of a natural person, it also has the power to commit wrongs, such as breach of contract, tort or a violation of statutory provisions. Yet wrongful acts can only be performed through the acts of natural persons – directors, officers and their agents, such as lawyers or actuaries. The corporate personality can be used as a "veil" behind which directors or officers are shielded from liability from conduct that is harmful or prejudicial to consumers, employees, creditors and other third parties, particularly where such conduct is viewed as " in the best interest of the corporation". The question is whether the people who direct these actions that result in the commission of a wrong should be held personally liable. The reality is that directors and officers have a different role in the corporation than shareholders as passive investors, although for closely held corporations these roles frequently overlap. It is directors and officers who perform, direct and acquiesce in the wrongful acts, yet many of them try to set up defences, specifically, that directors and others are not liable, but the corporation is.

513 Davies, P "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency" (2006) 7 *European Business Organization Law Review* 312.

© University of Pretoria

to cause the company to make decisions which respond to those incentives as they normally need to act as directors or through the directors.[514]

For this reason, Davies sums up, imposing liabilities on directors will help to catch shareholders who act as directors and also provide a counterincentive to directors to do what the shareholders want them to do in circumstances where the controlling shareholder sits outside the board.[515] Lending weight to the above, Kandestin[516] has argued as follows:

> The corporate form is afflicted by the classic agency problem. Shareholders invest money in the firm, becoming its theoretical owners, but they have no say in how the firm is run. Instead, directors are charged with managing the business and affairs of the corporation.

In concurring with the idea of imposing personal liability on directors, Bruni[517] argues that the extent of powers conferred on an officer also implies his correspondent degree of responsibility for the use or abuse of the said powers. However, Bruni has cautioned that directors are not liable for decisions that prove to be wrong in the long run, and that wrong decisions 'even mismanagement' are not sources of liability whenever directors can prove that they acted with ordinary diligence.[518]

The rationale for the imposition of personal liability on directors of companies is also well explained by Varzaly,[519] who argues that the fundamental goal of any liability regime and associated liability framework is to fulfil the regulatory aim of deterrence. The learned commentator argues that because of the imposition of personal liability, the conduct of agents such as directors will undoubtedly be influenced by the perceived

---

514 Ibid

515 Ibid.

516 Kandestin, CD 'The duty to creditors in near-insolvent firms: Eliminating the near insolvency distinction' (2007) Vol 60 *Vanderbilt Law Review,* 1261.

517 Bruni, G "Corporate Officers' Liability in The Event of Insolvency or Winding Up in Italy" (2006) 6 *Journal of International Banking and Finance Law* 219.

518 Ibid, 222.

519 Varzaly, J "The enforcement of directors' duties in Australia: An empirical analysis" (2015) 16 *Eur Bus Org Law Rev*, 288.

© University of Pretoria

probability of enforcement as well as the potential penalty to be imposed and this will force them to re-evaluate prospective behaviour.[520]

Butcher[521] also supports the view of making directors responsible for a company's failure to satisfy creditors' demands. The learned commentator argues that that while it is fortunate that in most cases the company will meet the creditors' requirements and there is no reason to look further, in instances where the company cannot pay, creditors need to look to the directors personally.[522] This, according to Butcher, happens against the backdrop that while the company is insolvent, the directors, as persons who presided over the failure of the company to satisfy the creditor demands, are themselves not insolvent.[523]

The justification for targeting directors instead of shareholders cannot be explained any better than it was put by the South African court in the case of *R vs. Kritzinger*[524] where the court said that a company is an artificial person that cannot read a written representation or hear a spoken representation but that it reads and hears representations through the eyes and ears of, among others, its directors acting in the course of their duty. Taken from the angle that the company similarly makes representations through the minds of the very directors, a case for personal liability on the said directors for representations that are detrimental to creditor interest seems to be made out.

4.14 CHAPTER CONCLUSION

This chapter has discussed the difference between insolvency and "vicinity of insolvency" in Malawi with comparisons from the positions in the comparable jurisdictions, namely, the United Kingdom, South Africa and Australia. The aim of this discussion has been to isolate the nature of directorial obligations that arise when a

520 Ibid.

521 Butcher, BS *Directors' duties: A new millennium, a new approach?* (2000) The Hague; Boston: Kluwer Law International, 165

522 Ibid.

523 Ibid.

524 (1971) 2 SA 57.

© University of Pretoria

company is said to be navigating the vicinity of insolvency, as well as the nature of directorial obligations that arise when a company is insolvent. This discussion is pertinent for the reason that it is the breach of either of such obligations that triggers liability for wrongful trading on the part of the directors of a company in Malawi.

On the definition of the phrase "vicinity of insolvency," it has been established that the phrase has no precise legal meaning, but that there are several ways of describing the period in the life of the company which is meant by the phrase. This can be seen from the fact that various courts have described this phrase in different ways.

It has been established that in *Nicholson vs. Permakraft (NZ) Ltd,*[525] vicinity of insolvency was described by the court as a period when a company is nearing insolvency; in *Geneva Finance Ltd vs. Resource and Industry Ltd*[526] the court referred to vicinity of insolvency as the period when a company is approaching insolvency; in *Eastford Limited vs. Gillespie, Airdrie North Limited*[527] the court referred to vicinity of insolvency as a period when a company is on the borderline of insolvency, and in *Colin Gwyer vs. London Wharf (Limehouse) Ltd*,[528] the court referred to vicinity of insolvency as a period when a company is on the verge of insolvency.

Further, it has been established that in *Brady vs. Brady,*[529] the court referred to vicinity of insolvency as a period when a company is of doubtful solvency; in *Grove vs. Flavel*[530] the court referred to vicinity of insolvency as a period when a company is subject to the risk of insolvency occurring; in *Kalis Enterprises Pty Ltd vs. Baloglow*[531] and in *Re HLC Environmental Projects Ltd*[532] the courts referred to the vicinity of

525 See paragraph 4.4 above.

526 Ibid.

527 Ibid.

528 Ibid.

529 Ibid.

530 Ibid.

531 Ibid.

532 Ibid.

© University of Pretoria

insolvency as a period in the life of the corporation where, to the knowledge of the directors, there is a real and not a remote risk of insolvency and that creditors would be prejudiced by the action considered.

From the foregoing divergent expressions of the meaning of "vicinity of insolvency," it has been established that a common feature that comes out from the expressions is an attempt to describe a period in the financial life of the company immediately preceding the onset of insolvency.

It has also been established in this chapter that the meaning of insolvency under the Insolvency Act in Malawi is inability to pay debts as they fall due.[533] However, it has been established that even under statutory law, the phrase "vicinity of insolvency" is equally not defined, but that the meaning can be deduced from the definition of insolvency. Given that the definition of insolvency under the Insolvency Act is inability to pay debts as they fall due, it can be deduced that the period in the financial state of the company immediately preceding the inability to pay its debts as they fall due can be said to be the vicinity of the company's insolvency.

In view of this, it has been established that the foregoing descriptions of the phrase "vicinity of insolvency" may be true when it is considered that in *Facia Footwear Ltd (in Administration) vs. Hinchlife*,[534] the court referred to vicinity of insolvency as a period when a corporation is in a dangerous financial position; in *Williams vs. Farrow*, [535] the court referred to the vicinity of insolvency as a period when a company is in a parlous financial state; in *Linton vs. Telnet Pty Ltd,*[536] the court referred to vicinity of insolvency as a period when a company is financially unstable, and in *Re MDA Investment Management Ltd,*[537] the court referred to vicinity of insolvency as a period when a company is in financial difficulties.

[533] See paragraph 4.5.1 above.

[534] See paragraph 4.4 above.

[535] Ibid.

[536] Ibid.

[537] Ibid.

© University of Pretoria

From the meaning of vicinity of insolvency and the meaning of insolvency, it has been established that when a company is in the vicinity of insolvency or when it is insolvent, the focus of the directorial duties needs to shift from the shareholders of the company to the creditors of the company. This shift, it has been established, is predicated on the fact that in that state of the company's finances, the creditors do replace the shareholders as eventual stakeholders of the company in the event that the company goes into insolvent liquidation.

On the question what this shift of focus entails on the day to day activities of the directors of the company, it has been established that when the company is in the vicinity of insolvency, the directors of the company will have to ensure that proper and up to date accounts are being maintained by the company in the manner required;[538] that they obtain accurate, relevant and timely information and keep themselves independently informed of the financial position of the company;[539] that they conduct regular board meetings to monitor the financial situation of the company with comprehensive minutes being kept; that they seek specialist assistance or advice;[540] that they have early discussions with auditors, and, where necessary, external auditors; [541] that they reconsider the structure and functions of the company for possible reorganization,[542] as well as ensuring that the assets of the company are protected, among others.

It has also been established that where the company has become insolvent, the obligation that attaches to the directors at that point is to ensure that the company is immediately placed under a form of an insolvency process. In this vein, it has been established that in Malawi, the directors would have to ensure that they initiate a rescue process by seeking a company reorganization order. Where this may not achieve a

[538] See paragraph 4.10 above.

[539] Ibid.

[540] Ibid.

[541] Ibid.

[542] Ibid.

© University of Pretoria

better outcome for the company, it has been established that the directors will have an obligation to place the company under liquidation by making a resolution to appoint a liquidator rather than seeking company reorganization.[543]

Finally, on the question of whether it is justifiable to impose personal liability, such as liability for wrongful trading, against directors of companies who are mere agents of the corporation, it has been established that this is justifiable on the basis that while the temptation to gamble with the assets of the company when insolvency looms lie so much with the shareholders of the company, the said gamble is actualized by directors of the company even though they have the power to prevent the shareholders from undertaking the gamble. For this reason, it has been established that imposing personal liability on directors will help to catch shareholders who act as directors and also provide a counterincentive to directors to do what the shareholders want them to do in circumstances where the controlling shareholder sits outside the board.[544]

---

543 See paragraph 4.11 above.

544 See paragraph 4.13 above.

© University of Pretoria

CHAPTER 5

DEFENCES IN WRONGFUL TRADING PROCEEDINGS

SUMMARY

5.1 Introduction……………………………………………………………163

5.2 The "no step" defence……………………………………………….…165

5.3 The "every step" defence………………………………………………167

5.4 Chapter conclusion…………………………………………………..…210

5.1 INTRODUCTION

Having highlighted in the preceding chapter that liability for wrongful trading in Malawi stems from the directors' breach of the obligations that attach to them both when their companies are navigating the vicinity of insolvency as well as when the said companies have become insolvent, this chapter is designed to answer the fifth sub-question of the main research of this study, namely, "what are the defences available to directors during wrongful trading proceedings?" A discussion on this question is pertinent to this study as it shows how directors may escape or face liability for wrongful trading in Malawi.

According to section 187(1) of the Insolvency Act of 2016 in Malawi, a director will not be liable for wrongful trading if he can prove that *at some time before the commencement of the winding-up* of the company he *knew* or *ought to have concluded* that the company would not avoid going into insolvent liquidation, and that based on that knowledge or conclusion, he took *every step with a view to minimizing the potential losses to the company's creditors* as he ought to have taken.

From the foregoing, it becomes clear that a respondent director in wrongful trading proceedings has two defences available to him. The first line of defence, which is considered non-main in this study, is for a director to plead that **at no time** before the commencement of the winding-up did he know or conclude that the company would

© University of Pretoria

not avoid going into insolvent liquidation. The essence of this plea is that the director, in this instance, will be expected to have taken "**no step**" towards minimization of the potential losses to the company's creditors. In this study, this defence will be referred to as the "no step" defence. The chapter begins by discussing the conditions for the availability of this "no step" defence to a director in wrongful trading proceedings.

The second line of defence, which is considered in this study to be the main defence to a wrongful trading action in Malawi, is that of the director having taken "**every step**" with a view to minimizing the potential losses to creditors of the company, from the point in time that he knew or concluded that the company would not avoid going into insolvent liquidation. In this study, this defence will be referred to as the "every step" defence.

In order to outline the conditions for the availability of this "every step" defence to a director in wrongful trading proceedings, this chapter will, first, discuss the meaning of the phrase *at some time before the commencement of the winding-up.* The chapter will then go on to discuss the meaning of *taking every step*. This is done in order to highlight which steps will attract the sympathy of the courts in absolving a director from liability for wrongful trading.

Further, considering that the steps which the director will show to have taken must also be shown to have culminated into a reduction of losses to the creditors of the company as a whole, this chapter will discuss the important link between the said taking of "every step" and the minimization of losses to the company's creditors as a whole. The chapter will also discuss what becomes of the defence of taking every step when a director is, for no fault of his or hers, precluded from taking *every step*.

After the foregoing, the chapter discusses other pertinent questions that arise in the process of a director proving the defence of taking every step, such as; whether the absence of professional warnings by the company's advisors can absolve a director from liability for wrongful trading, as well as whether directors are not prejudiced by the courts' hindsight bias in proving the "every step" defence.

© University of Pretoria

Related to the foregoing, this chapter discusses some of the steps taken by directors which have previously impressed the courts in wrongful trading proceedings, as well as some of the steps that are likely to impress the courts. These include the seeking of professional advice; resignation; cessation of business as well as placing the company under an insolvency process. Connected to placing a company under an insolvency process, the chapter goes on to discuss whether the fact that directors allowed the company to continue trading having become aware that the company was insolvent is, by itself, a basis for liability for wrongful trading on the part of the said director.

In the end, given the wider latitude which the directors of companies are allowed through the "Business Judgement Rule" to make decisions which, in their view, are aimed at, in good faith, promoting the success of the company, this chapter concludes by discussing the business judgement rule in detail.

The detailed discussion of the business judgement rule is undertaken with the aim of establishing whether or not directors can escape liability for wrongful trading if they can show that from the moment they knew or concluded that their company began to navigate the vicinity of insolvency, they made a good faith business judgement decision although the decision failed to save the company from insolvent liquidation. In other words, the chapter will wind up by discussing the question of whether the business judgement rule in corporate law affords directors a third line of defence in wrongful trading proceedings. [545]

5.2 THE "NO STEP" DEFENCE

As it has been alluded to in paragraph 5.1 above, section 187 (2) (a) of the Insolvency Act in Malawi is to the effect that liability for wrongful trading will attach to a director if, at some time before the commencement of winding-up of the company, the director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and having so known, or having been faced with the situation where he would reasonably conclude so, he failed to take every step with the view to minimizing the potential losses to the company's creditors.

[545] Note that the business judgment decision is a legal principle defined under statute in Malawi. For a detailed discussion of the parameters of a business judgement decision, see paragraph 5.4 of this chapter.

© University of Pretoria

This entails that it is a defence in a wrongful trading claim for a director to show that at no time before the commencement of the winding-up proceedings did he know or become faced with a situation from where he could have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. This is referred to in this study as the "no step" defence. The essence of this defence is that since the director will be pleading that he did not know or conclude at any time before the commencement of the winding up that the company would not avoid going into insolvent liquidation, the director took "no step" with a view to minimizing the potential loss to the company's creditors because, according to him, no loss was going to be occasioned to any creditor since no insolvent liquidation was going to occur.

However, chances of the success of this defence are minimal due to the stringent test of knowledge, skill and experience of the director which will be used by the court to decide if the defence is made out.

Section 187 (4) of the Insolvency Act in Malawi is clear that in order for a director to rely on the "no step" defence, the facts which the director ought to know or ascertain or the conclusions which he ought to reach are those that could be known or ascertained or reached by a reasonably diligent person having the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried on by that director in relation to the company,[546] and the general knowledge, skill and experience which the particular director has.[547]

The foregoing entails that the test of knowledge, skill and experience that will be applied in respect of the director who chooses to rely on the above defence is both the subjective test as well as the objective test. For this reason, a director is not able to rely on his or her inexperience as a reason for not doing what a reasonable director would have done in the circumstances, nor is an experienced director who is above average able to escape liability by arguing that he or she did what an average director would

546 Section 187 (4) (a) of the Act.

547 Section 187 (4) (b) of the Act.

© University of Pretoria

have done.[548] What this means is that where the standard expected of a reasonable person would be less than that of a person with the director's experience and skill, then the court is expected to use the higher standard that matches with the directors' experience and skill to judge what the director should have done.[549]

It is therefore clear that while it might be easy for a director to plead the "no step" defence, the defence will fail if a liquidator can successfully prove that the general knowledge, skill and experience that is expected of a person carrying on the functions which this director was carrying on, and indeed the general knowledge, skill and experience which this director actually possessed, were all such as would make the director to have known or to have been able to conclude at some point before the commencement of the winding-up of the company that there was no reasonable prospect that the company would avoid going into insolvent liquidation.[550]

5.3 THE "EVERY STEP" DEFENCE

Considering the difficulty of proving the "no step" defence on the part of a respondent director during wrongful trading proceedings, it would be argued that it is far much easier for a director to plead the "every step" defence as provided for under section 187 (3) of the Insolvency Act in Malawi, namely, that ***at some time before the***

[548] Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 112.

[549] Ibid.

[550] In respect of the South African equivalent of the wrongful trading rule, the reckless trading rule under section 424 of the 1973 Companies Act, the test of recklessness similarly involves the use of both the objective test and the subjective test. In *Fourie vs. Newton* [2011] 2 All SA 265 (SCA) the court stated (at para 28) that:

> [T]he test of recklessness has both the objective and subjective elements. It is objective, to the extent that the defendant's actions are measured against the standard of conduct of a notional reasonable person. Accordingly, a defendant's honest but mistaken belief as to the prospects of payment of a claim by the company when due is not determinative of whether he was reckless; if a reasonable person or business in the same circumstances would not have held that belief, the defendant's *bona fides* is irrelevant. The test is subjective, to the extent that it must be postulated that the notional person belongs to the same group or class as the defendant, moving in the same sphere and having the same knowledge or means of knowledge. In the context of s 424, the court should have regard, amongst other things, to the scope of operations of the company, the role, functions and powers of the directors, the amount of the debts, the extent of the company's financial difficulties and prospects, if any, of recovery. If when credit was incurred a reasonable man of business would have foreseen that there was a strong chance, falling short of a virtual certainty, that creditors would not be paid, recklessness is established.

© University of Pretoria

commencement of the winding-up, the director **knew** or **ought to have concluded** that there was no reasonable prospect that the company would avoid going insolvent liquidation, and that having so known or concluded, he took ***every step*** with a view to minimizing the potential losses to the company's creditors as he ought to have taken. However, this "every step" defence has several components and they are unpacked and discussed as follows:

5.3.1 Meaning of "At some time before commencement of the winding-up"

In order for liability for wrongful trading to be triggered, the courts do identify what has been described as the "moment of truth" or the "crisis point" at which the directors of a company should know or conclude that there is no longer a reasonable prospect of the company avoiding insolvent liquidation.[551] However, what is difficult is to exhaustively enumerate all the factors or signs which are expected to be seen by the directors before they can obtain such knowledge or reach that conclusion.

Rajak[552] has defined the so called "moment of truth" as the 'point when the reasonably diligent person would have said, "Oh dear (or words to that effect), while yesterday I thought that we could pull through, today I see that that is highly unlikely."' In *Re CU Fittings Ltd*,[553] the court seemed to concur with this view when it said that there comes a point in time when an honest businessman recognizes that he is only gambling at the expense of his creditors on the possibility that something may turn up.

It has been observed that factors that may signal the arrival of this "crisis point" or "moment of truth" include a prolonged cash-flow problem, balance sheet insolvency, the loss of major customers, increasing pressure from creditors and the refusal by suppliers to make further deliveries on credit.[554]

---

551 Hirt, HC "The wrongful trading remedy in UK law classification, Application and practical significance" (2004) *1 ECFR* 71, 106.

552 Rajak, HH "Wrongful Trading" (1989) *NLJ* 1458, 1459.

553 (1989) BCLC 556 at 559.

554 Bailey, E *et al*, *Corporate Insolvency law practice* (2001) Butterworths, 16.29. see also Goode, R *Principles of Corporate Insolvency law* (1997) Sweet & Maxwell, 472-475

© University of Pretoria

In this regard, it has been suggested that the main task for directors of a company is to pick up warning signs regarding insolvency and obtain specialist advice rather than spending time in trying to predict insolvency themselves.[555] According to Pasban,[556] the duty imposed on directors to determine the point when they should know or be able to conclude that the company would not avoid going into insolvent liquidation is a duty of monitoring and prediction in the sense that it is only through monitoring of the company's affairs and financial records that the directors will be able to reach a conclusion that the company is in, or is headed for, a financial depression.

In this vein, Pasban has added that to be able to predict a company's financial destination before it becomes too late requires directors to have a systematic and constant monitoring of the financial affairs of the company which, among other things, requires having a good accounting record.[557]

5.3.2 What if financial records are unavailable at the relevant time?

It must be noted that even where financial records are not available at the time when it is alleged that the director ought to have known or concluded that the company would not avoid proceeding into insolvent liquidation, the court will expect the director to have utilized any information available to him in order to discern the financial position of the company. Absence of financial records will therefore not exonerate a director who fails to discern the precarious financial position of a company as for him not to allow the company to continue trading when it ought to stop.

In *Brooks and Willets (Joint liquidators of Robin Hood Centre Plc) vs. Armstrong and Walker*,[558] a company which ran a Robin Hood themed tourist attraction in England began experiencing financial difficulties in the course of its business. These financial difficulties were greatly compounded by a substantial VAT[559] liability payable to

555 Cooke, TE and Hicks, A "wrongful trading; predicting insolvency" (1993) *BL* 338 at 349.

556 Pasban, MR "*Directors' Duties and Liabilities in Corporate Insolvency*" PhD Thesis, (1996) University of Sheffield, 84

557 Ibid.

558 (2015) EWHC 2289.

559 Value Added Tax.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

HMRC[560] and an increase in rent from a recent rent review. HMRC upheld the VAT determination in May 2007 and confirmed that position to the company. The company subsequently went into creditors' voluntary liquidation on 6th February 2009 and the liquidators brought proceedings for wrongful trading seeking contribution from the former directors for losses sustained by the creditors.

Two questions fell to be determined by the court in this matter. First was the issue of interpretation of the company's financial statements and other records in determining the directors' knowledge that there was no reasonable prospect of the company avoiding proceeding into insolvent liquidation. The directors had contended that the fact that at the relevant point in time the financial statements of the company had not been produced yet meant that they had no opportunity of knowing that the company was in a precarious financial position to the extent that insolvent liquidation had become unavoidable.

To this contention, the court held that although financial statements were not produced until the next financial year, the directors should have used the information which they would ultimately contain in order to assess commercial solvency of the company. In the court's view, while knowledge of the poor financial position of the company could not be clear to the directors when the company failed to pay VAT to HMRC by January 2007, the knowledge ought to have been conceived in May 2007 when HMRC upheld their VAT determination. The court said that at that point, the directors ought to have been aware that the company could not meet its next payment of rent, and therefore that liability for wrongful trading was incurred from this point.

It must be noted, however, that although the court will expect directors to discern the precarious financial position of a company from other sources where the company's financial records are not available and be able to conclude that the company is headed for insolvent liquidation, the courts are mindful that there are times when it is difficult for the directors to reach that conclusion. In view of this factor, the courts have shown

---

560 Her Majesty's Revenue and Customs.

© University of Pretoria

sympathy to directors who could not be expected to reach that conclusion due to the complex situation they were faced with.

In *Nicholson and Another vs Fielding and Others*,[561] a question arose as to whether the directors must have known or concluded that there was no reasonable prospect of their company avoiding insolvent liquidation on a particular date. The court was unable to make that finding and said that the economic circumstances which the directors were faced with could not support such a finding. The court noted that:

> The question of wrongful trading cannot be addressed by looking at the company's business in an economic vacuum. [The company] was operating in a market direct[ly] affected by the global financial shock, not only in the cost of financing but in its core business.[562]

The court made the above observation having noted that the problems which Mainland, the company, had been facing at the time carried a great deal of uncertainty in the sense that as the market contracted, sales fell severely falling by 15.1% in 2008 compared to the previous year. Apart from this, the court noted as well that several major contracts were delayed as manufacturers sought to reduce their own exposure. Further, the court noted that as this was happening, fuel costs rose dramatically, and the company was greatly affected by this rise as it bought its fuel weekly rather than through futures.[563]

Despite the foregoing, the court found that the management accounts for the company were being maintained in good order, the company kept on re-evaluating its strategy, e.g. by laying up unused equipment, making redundancies, chasing payments of outstanding invoices, reducing an invoice discounting facility to save costs and engaging an external advisor to independently assess the situation.

Most importantly, the court found that the car haulage industry (in which the company was) had a practice of very short notice periods for varying the contractually agreed volumes and prices for orders, leaving the company unable to predict long term

561 (2007) All ER (D) 156.

562 Ibid, at para. 62.

563 Ibid, at para. 62-63.

© University of Pretoria

revenues with much accuracy.[564] In view of the foregoing, the court took a firm view that the directors were doing their best to take account of all those variables and could not be held accountable for not predicting that the company would not avoid proceeding into insolvent liquidation.[565]

`

5.3.3 Meaning of "Taking Every Step"

Once it is established that a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, the onus is on the director to establish that he "took every step" with a view to minimizing the potential loss to creditors as he ought to have taken.[566] In *Re Ralls Builders Ltd (In Liquidation),*[567] Snowden J said that this is a high hurdle for a director to overcome. The learned Judge went on to explain that for a director to make out this defence, he must demonstrate not only that the continued trading was intended to reduce the net deficiency of the company, but also that it was designed appropriately so as to minimize the risk of loss to individual creditors. The court also emphasized that the onus is on the director to show that he took every step, and not on the liquidator to show that the director did not take every step. [568]

---

564 Ibid, at para. 65.

565 Ibid, at para. 98.

566 Section 187(3) of the Insolvency Act 2016. See *Re Idessa (UK) Ltd* (2012) I BCLC 80 at para. 113 and 120; *Brooks and Willets (Joint liquidators of Robin Hood Centre Plc) vs. Armstrong and Walker*. With respect to insolvent trading in Australia, the equivalent of wrongful trading in Malawi, it has been agued by Anderson H, "Shelter from the Storm: Phoenix Activity and the Safe Harbour" (2018) 41 *Melbourne University Law Review* 999 at 103 that:

> …the policy behind insolvent trading liability and its current defences is to deter directors from gambling with creditors' money, while at the same time protecting honest directors who have done their best prior to the company's insolvency. The rationale is that the fear of liability ought to curb improper behaviour, to the benefit of creditors' ability to recover their debts from the company. Directors will avoid decreasing the few assets left for the creditors or incurring further debts which will compete for payment.

According to this learned commentator, at 103, where directors manage the affairs of the company with fear for potential liability for insolvent trading, the said affairs may be managed prudently and therefore it may be less risky for entrepreneurs to deal with the company on credit, and the fact that securing credit will be cheaper for the company will translate into a better return for shareholders where the company is successful. From this argument, it is clear that the learned commentator is suggesting that insolvent trading provisions, (and similarly wrongful trading provisions) have the potential of maximizing wealth for shareholders of companies, apart from providing creditor protection.

567 (2016) Bus LR 555 at para 245.

568 Ibid.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

It has been made abundantly clear that the steps which the director ought to take after knowing or concluding that there is no reasonable prospect that the company will avoid going into insolvent liquidation are those steps which would be taken by a reasonably diligent person having the general knowledge, skill and experience that may reasonably be expected of a person carrying on the same functions as were carried on by the director in question,[569] as well as the general knowledge, skill and experience which the particular director actually has.[570]

It must be noted that section 187(5) of the Insolvency Act in Malawi also assists the court in interpreting section 187(4). The section provides that the reference in section 187(4) to functions carried out in relation to the company by the director includes any functions which the director does not carry out but were entrusted in him. This clearly invites liability upon a director who fails to do what he or she should have done.

Although there is no detailed statutory or judicial guidance of the factors for establishing if a director "took every step" in a bid to minimize potential loss to creditors, Griffin[571] contends that a director will be required to establish that from the moment he realized that there was no reasonable prospect that the company would avoid going into insolvent liquidation, his participation in the running of the affairs of the company was both active and geared towards the protection of the interests of the company's creditors.

Hirt[572] has argued that the requirement that directors must take "every step" is a demanding test particularly given the combination of the subjective and objective standards required of the director, as indicated above, and the fact that there is no

569 Section 187 (4) (a) of the Act.

570 Section 187 (4) (b) of the Act.

571 Griffin, S *Personal Liability and disqualification of Company directors* (1999) Hart Publishing Co.74-75.

572 Hirt, HC "The wrongful trading remedy in UK law classification, Application and practical significance (2004) 1 ECFR 71, 91.

© University of Pretoria

qualification of the directors' obligation in the sense of a limitation to take all reasonable steps.

Further, Hirt argues that the other difficulty in relying on the defence of taking every step stems from the fact that since the test of knowledge is both subjective and objective, in the sense that if the allegation of the liquidator is not that the director knew, but that he should have known, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, it will be even more difficult to make out the defence because by definition, the director could not begin to take steps to minimize the loss to creditors until realizing that the company was heading for insolvent liquidation.[573] Put simply, the allegation that the director should have known is made in hindsight but the director is still expected to have taken the steps when subjectively he did not know that the company would not avoid going into insolvent liquidation.

Commenting on the requirement for the directors to take "every step," Keay[574] has argued that what the director must do is heavily dependent on the particular situation he is faced with and for that reason, what might be appropriate to do in one case might totally be inappropriate to do in another case. In this sense, Keay concludes that it is possible to say that what the directors should not do is nothing.[575] Milman,[576] on the other hand, has argued that if the directors can demonstrate that from the moment they became aware of the financial difficulties of the company they adopted a frugal approach to business as well as in relation to their own salary entitlements, this may well impress the court to want to rule in their favour.

---

573 Ibid, 92

574 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 112.

575 Ibid.

576 Milman, D "Strategies for regulating managerial performance in the 'twilight zone' – familiar dilemmas; new considerations" (2004) *JBL* 493 at 505.

© University of Pretoria

Interestingly, Sealy[577] has argued that the phrase "taking every step" is too broad that it is capable of rendering liability for "incompetence, ignorance and indifference as well as conscious wrong doing." Keay[578] argues in line with this that it is critical for directors to keep on top of the financial position of their company and that, considering what the law now seems to require, directors must be able to understand company accounts.[579] In *Re HH Co. Ltd*[580] the court remarked that if directors are not able to understand company accounts, they must at least employ a person who will be able to advise them of the same.

In *Re Brian D Pierson Ltd,*[581] the court took the view that the phrase "every step" was intended to apply to cases where, for example, the directors take specific steps with a view to preserving or realizing assets or claims for the benefit of creditors even if eventually they fail to achieve that result. Sealy[582] has added that the use of the words "every step" suggests that there is no room for any conduct that falls "short of the very best." Professor Sir Roy Goode, [583] on the other hand, has contended that "every step" means no more than, given the reference in wrongful trading to the reasonably diligent person, requiring the taking of "every reasonable step".

In *Re Continental Insurance Assurance Co. of London Plc.*,[584] a case which involved the collapse of an insurance company in 1992, unexpected and large losses had arisen

577 Sealy, L "Personal liability of directors and officers for debts of insolvent corporations: a jurisdictional perspective (England)" in Zeigel, J (ed) *Current Developments in International and Comparative Corporate Insolvency Law,* 1994, *Oxford: Clarendon Press*, p.492.

578 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 94.

579 See the comments in *Re DKG Contractors Ltd* (1990) BCC 903 as referred to in Milman, D "Strategies for regulating managerial performance in the 'Twilight zone' – familiar dilemmas: New considerations" [2004] *JBL* 493 at 497.

580 (1995) 2 BCLC 63.

581 [1999] BCC 26 at 54.

582 Sealy, L "Personal liability of directors and officers for debts of insolvent corporations: a jurisdictional perspective (England)" in Zeigel, J (ed) *Current Developments in International and Comparative Corporate Insolvency Law,* 1994, Oxford: Clarendon Press, p.492.

583 Goode, R *Principles of Corporate Insolvency law*, (1997) 2nd (ed), *London: Sweet 2 Maxwell*, P.471.

584 (2001) BPIR 733.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

in the company which came to the attention of the board of directors around mid-1991. Although the company appeared to face financial difficulties, it was technically solvent. During wrongful trading proceedings taken against the directors subsequent to the collapse of the company, a question arose whether the directors, given the financial difficulties that surrounded the company in mid-1991, should have realized at that stage that there was no reasonable prospect of the company avoiding insolvent liquidation.

It was shown during the said proceedings that when the losses of the company were first reported, the board of directors had specifically deliberated on the question of whether the company could properly continue to trade. The finance director and the auditors of the company had been instructed to conduct a detailed assessment of the company's financial position and that at every subsequent board meeting, both the finance director and the auditors gave assurances to the board that the company was still solvent.

When further losses in the company were reported at the end of 1991, which finally made the directors to reach a conclusion that the company had become insolvent, the directors gave instructions that the company should not carry out any more new business and they took advice from insolvency practitioners. The question for the court was whether by allowing the company to continue to trade around mid-1991 the directors could be liable for wrongful trading, or whether, in the generality of the circumstances, the directors could be said to have taken "every step" with a view of minimizing potential losses to creditors" as for them to escape liability for wrongful trading.

In finding for the directors, the court observed that the directors took a "wholly responsible and conscientious approach, both to the [company's] position and to their own responsibilities as directors" and that they had acted reasonably in deciding that the company could continue to trade in mid-1991.

© University of Pretoria

According to Hirt, [585] this case seems to suggest that where, in circumstances when a company experiences financial difficulties, the directors seriously consider the company's financial position and future prospects on the basis of up-to-date information and they seek and follow professional advice if possible, they should generally be able to escape liability in a wrongful trading action if the company subsequently plunges into insolvent liquidation.

In *Re produce Marketing Consortium Ltd (No. 2)*,[586] Produce Marketing Consortium Ltd ('PMC'), a company incorporated in 1964, carried on the business of importing fruit. PMC was trading as a commission agent charging a commission of 3.5 percent on the gross scale of the fruit it imported. Since PMC's potential gross profit was thus directly related to its turnover, it could relatively be easily calculated. At the material time, PMC had two directors one of whom owned a significant portion of the shares. From 1981 onwards, PMC began trading at a loss in the sense that its liabilities exceeded its assets and its bank overdraft. On a number of occasions, PMC's annual accounts were prepared out of time. The accounts for the year ending 30th September 1985, for example, were not available for PMC's directors until January 1987.

By the summer of 1986, there were signs that PMC's financial position had sharply deteriorated in the sense that PMC frequently exceeded its bank overdraft and there were substantial amounts of outstanding cheques. If allowance had been made for those cheques, PMC would have been placed even further in excess of its overdraft limit. At the end of 1986, PMC exceeded its £75, 000 overdraft by approximately £16, 000 and a number of its cheques were returned.

In January of 1987, draft accounts for the years 1984-1985 and 1985-1986 were submitted to PMC. The accounts, signed in February 1987, showed that PMC was in a difficult financial position and the auditor's certificate for both accounts stated that PMC was insolvent and could only continue its activities because of the bank facilities. In February 1987, PMC's auditors wrote a letter to the directors pointing out that in the

585 Hirt, HC "The wrongful trading remedy in UK law classification, Application and practical significance (2004) 1 *ECFR* 71, 94.

586 (1989) BCLC 520.

© University of Pretoria

light of PMC's trading activity, there was a possibility that the directors could be liable for fraudulent trading on the ground that the directors had continued to trade and to incur debts at a time when there was no reasonable prospect of those debts being paid.

The bank overdraft of PMC was decreased during 1986-1987. However, this decrease was, to a large extent, financed by PMC's increased indebtedness to its principal supplier of fruit. Subsequently, negotiations took place between PMC and its said principal supplier to work out a commercial solution, but these failed to produce a result.

In October 1987, PMC went into creditors' voluntary winding up with an estimated deficiency of £317, 700. In April 1998, PMC's liquidator sought an order that the two directors of PMC should be liable for wrongful trading and be made to contribute £107, 946 to the assets of PMC.

On the question of whether the two directors could escape liability by relying on the defence of having taken 'every step towards minimizing potential loss to creditors' of PMC, Knox J, finding against the directors, held that the directors simply continued to trade at the time when they should have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

In reaching this finding, Knox J emphasized the objective test of knowledge of facts by the directors and remarked that the facts which the directors of PMC ought to have known or ascertained and the conclusions that they ought to have reached were not limited to those which the directors, showing reasonable diligence and having the general knowledge, skill and experience which they respectively had, would have known, ascertained or reached, but also those which a person with the general knowledge, skill and experience of someone carrying out their functions would have known, ascertained or reached.[587]

587 Ibid, 548h-i-549a.

© University of Pretoria

It is interesting to note that apart from emphasizing the need for the court to make use of both the subjective and the objective tests as above, Knox J added that before imputing the knowledge on respondent directors in a wrongful trading claim, the court should also take consideration of "the particular company and its business".[588] The learned judge's view was that the general knowledge, skill and experience required of directors would be less extensive in a small company with a simple accounting system than it would be in a large company with sophisticated accounting procedures.[589]

Another point made by the learned judge in that case pertained to knowledge which a director has and the knowledge which the said director can acquire if his company complies with statutory obligations. The respondent directors having argued that the inability for the company to produce accounts within the statutory period made it impossible for the directors to acquire knowledge of the true financial position of the company in time for them to conclude that there was no reasonable prospect that the company would avoid going into insolvent liquidation, Knox J expressed the view that the directors were to be taken to know the information which should have been made available to them had the company complied with its obligations under the Companies Act to prepare and publish annual accounts in time.

In the words of the learned judge, PMC directors ought to have been taken to know "not only what was actually there, but what, given reasonable diligence and an appropriate level of general knowledge, skill and experience, was ascertainable.[590]

It is clear from the view taken by Knox J in this case that what the learned judge was trying to avoid is a situation where directors could be allowed to rely on their own neglect of duty, in causing accounts to be produced and published in accordance with the statutory requirements, as a defence in wrongful trading proceedings in the sense of being allowed to successfully argue that since the accounts were not available, then the directors had no way of knowing the precarious financial position of the company as

588 Ibid, at para. 550b.

589 Ibid, at para. 550 b-c.

590 Ibid, at para. 550 g-h.

© University of Pretoria

for them to know or to conclude that insolvent liquidation of the said company had become unavoidable.

The learned judge assumed, for the purposes of imputing knowledge on the PMC directors, that the financial results for the year ending 30 September 1985 had been known by them at the end of July 1986 (when the said financial results should have been available had the directors ensured compliance with the Companies Act 1985 for timely preparation of financial results) even though in actual fact the accounts were not made available to the said directors until January 1987.[591]

It has been argued that a director who is focused on the day-to-day task of trying to keep the business of the company afloat will simply be able to realize well in time if the task he is undertaking has no prospect of success.[592] Park J in *Re Continental Assurance Co. of London Plc.*[593] said that in the typical case in which directors have been held to be liable, the directors will have been shown to have:

> …closed their eyes to the reality of the company's position and carried on trading long after it should have been obvious to them that the company was insolvent and that there was no way out for it. [594]

In *Mond (As Liquidator of Langreen Ltd) vs. Bowles and Others*,[595] the liquidator of Langreen Ltd "Langreen" brought claims for wrongful trading against the four company directors. The liquidator's claims against two of the directors had been settled leaving out claims against two directors, Mr. and Mrs. Bowles who had invested heavily in Langreen's business to the tune of £ 500, 000.00 and they were by far Langreen's largest creditors. Langreen's business was the provision of broadband wireless internet services to rural communities. The company was itself dependent on a satellite connection provided by a company called Aramiska.

591 Ibid.

592 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 95.

593 (2007) 2 BCLC 287

594 Ibid, at page 769.

595 (2011) Lexis Citation 99.

© University of Pretoria

The business was a start-up, having started around March 2004, and was short lived, going into creditor's voluntary liquidation about 2 years later in April 2006. It was shown to the satisfaction of the court that the company was balance sheet insolvent soon after it commenced trading and also that it was cash flow insolvent throughout most of its history. The liquidator's contention was based on four isolated dates, three of which are relevant to this discussion, and the court found as follows with respect to the liquidator's relevant contentions;

(i) Approximately 5 months after trading commenced.

In respect of this date, the liquidator argued that the directors should have known early on that the company's insolvent liquidation was unavoidable due to the fact of it having been both balance sheet and cash flow insolvent almost right from its inception. To this, the court disagreed, observing that the situation was not unusual for a start-up business and that there was evidence to show that Mrs. Bowles was actively managing the finances of the company. The court thus concluded that the liquidators' claim in this regard was marked by a large measure of hindsight bias.

(ii) Seven months after commencing trading

The liquidators contended that at this point, the directors continued to trade and to incur debts when they ought to have known at this point that there was no reasonable prospect of the company avoiding insolvent liquidation. The court disagreed. First, the court was of the view that the debts which were being referred to by the liquidators were not large when looked at individually and that this was an important factor against placing the company into liquidation at that time. According to the court, the start-up nature of the business necessitated the directors taking time to see how the business was going to develop rather than closing shop immediately. In making this observation, the court also took account of the fact that there is no duty on the part of the directors not to allow a company to trade while insolvent.[596]

(iii) One year seven months after trading commenced.

596 *Hawkes vs Hill Publishing Co. Ltd* (2007) BCC 937.

© University of Pretoria

After a potential investor reneged, the directors took steps to improve cash flow by selling equipment and leasing it back and exploring new wireless network opportunities abroad. The management accounts, however, painted a gloomy picture with turnover at about £ 120, 000.00 and losses at around £ 140, 000.00 so that the company was unable to trade unsupported. The liquidator contended that at this point, the directors ought to have concluded that insolvent liquidation had become inevitable.

The court rejected the contention as being predicated on hindsight bias. In the view of the court, it is easy to say the directors were refusing to accept that the company they had invested large amounts in could not succeed, but this was not the case. The court thus rejected the contention that on a balance of probabilities, the directors should have foreseen that this was a time when the company could not continue to trade without going to insolvent liquidation.

The court's decision on this point was based on the fact that three months subsequent to this period, (i.e. in January 2006) Aramiska, the supplier of satellite services to the company, turned off its services on less than three hours' notice, apparently because of its own difficulties. It was not possible to find a commercially viable alternative to Aramiska and therefore the company was unable to supply broadband services to its customers that were reliant on satellite connection.

Within days of this occurrence, the directors wrote to the company's customers advising that owing to the demise of Aramiska, it could no longer continue to supply the services. The directors also wrote to the company's bank advising that the company intended to cease trading.

In view of the foregoing, the court found that the directors' conduct was in line with the measured approach which they had taken throughout their involvement with the company. The court therefore concluded that the liquidator had failed to make out a case of wrongful trading. Interestingly, the court went on to add that even if the liquidators had made out a case of wrongful trading, the defence of taking "every step" would have been successfully relied on by the directors as they took all the steps which they reasonably could to minimize loss to creditors once they finally realized that the company could not avoid going into insolvent liquidation.

© University of Pretoria

5.3.4 "Every step" and the minimization of losses to creditors as a whole

There is a requirement under common law that the steps taken by the respondent director must be such as would minimize losses to creditors as a whole. Where the said steps have minimized losses only in relation to some creditors, leaving out others, the courts are likely to find that the defence has not been made out. In *Re Ralls Builders Ltd (in Liquidation)*[597] a question arose as to whether the respondent directors who were shown to have settled the claims of all creditors except two of them could be adjudged to have taken "every step" with a view to minimizing losses to creditors and therefore be eligible to benefit from the "every step" defence.

The court noted that whilst the directors had, by May 2007, ensured that trade creditors were paid in full, they had not done so with VAT and rent liabilities and this meant that as a class, HMRC[598] and the landlord were prejudiced and therefore the directors could not establish that they had minimized losses to the company's creditors as a whole and hence they could not benefit from the "every step" defence.

Similarly, in *Nicholson and Another vs. Fielding and Others,*[599] the English High Court refused an application by liquidators of a company to hold its former directors liable for wrongful trading despite significant losses being suffered by creditors. In this case, the respondents were former directors of Mainland Car Deliveries Limited (Mainland) which transported new and used cars manufacturers.

The company had been greatly affected by the aftershock of the financial crisis and showed a net deficiency of assets from July 2008. In order to mitigate its loss, the company started delaying payments to creditors and from March 2008, it fell behind on

597 [2016] EWHC 243 (Ch).

598 Her Majesty's Revenue and Customs.

599 (2007) AII ER (D) 156.

© University of Pretoria

PAYE[600] and NIC[601] payments to HMRC.[602] Several other payments were missed altogether. The directors engaged external advisers and corresponded with HMRC to work towards a repayment plan to enable the company to continue to trade.

The trend continued until HMRC presented a winding up petition in August 2009. Mainland went into administration in October 2009 and into liquidation in July 2010. The liquidators sought a declaration that the directors knew or ought to have concluded that Mainland had reasonable prospects of insolvent liquidation either by 1st June 2008 or on 31st October 2008.

On the question whether the directors could benefit from the "every step" defence, the court noted that the directors could not benefit from the defence because, following the decision in *Re Ralls Builders Ltd (In Liquidation)*,[603] the directors took steps that were meant to benefit one creditor, HMRC, but not the rest of the creditors as a whole.

5.3.5 What if "taking every step" is practically impossible?

At the time of conducting this study, the wrongful trading rule had not been tested against a situation where a director has sought to be absolved from liability on the basis that at the relevant period when the obligations giving rise to liability for wrongful trading were breached, he was ill or out of the jurisdiction or for some reason not available to attend to his directorial duties.

This situation has, however, been dealt with under the Australian counterpart of wrongful trading, the insolvent trading rule. In the Australian case of *Androrin vs. Figlomeni,*[604] a director was held not to be liable for insolvent trading because the breach of the directorial obligations giving rise to the said liability occurred when he was overseas and that before his departure, the director had indicated to the other

600 Pay As You Earn.

601 National Insurance Contributions.

602 Her Majesty's Revenue and Customs.

603 [2016] EWHC 243 (Ch).

604 [1996] 14 ACLC 1461.

© University of Pretoria

directors that he would not be in a position to accept his responsibilities during his absence.

While the approach taken in the *Andorin* decision above may have been justified on other grounds, the approach is not ideal as it encourages temporary abdication of directorial duties in situations where the law put in place mechanisms to prevent such abdication. The concept of a temporary director is one such mechanism. A director who is taken ill or who, for some reason, is away from the jurisdiction and unable to fulfil his directorial obligations may simply initiate the appointment of a temporary director to ensure that the discharge of his directorial obligations to the company is not interrupted.

Further, the approach taken in the *Andorin* decision may not be justified in the modern technological world in which directors can make use of modern technology such as skype or zoom for teleconference in discharging their duties to the company when they are away from a jurisdiction.

In view of the availability of the mechanism of temporary directors, and considering the existence of modern technology where a person who is abroad may ably attend a meeting without being physically present in a jurisdiction, it is submitted that there can never be a situation where a director is unable to take every step due to a situation beyond his fault.

5.3.6 Does the absence of professional warning entail absolution from liability?

It has been said that the absence of professional warnings regarding the state of the company's finances does not absolve a director from liability in wrongful trading proceedings if there are other factors that suggested financial problems for the company.[605]

In *Re produce Marketing Consortium Ltd (No. 2)*[606] discussed above, the other question that was raised for the determination of the court was whether the directors of PMC,

605 *Re Brian D. Pierson (Contractors) Ltd* (1999) BCC 26 at 54.

606 (1989) BCLC 520.

© University of Pretoria

who were not given the financial records of the company for the relevant period as for them to know or to conclude that insolvent liquidation of the company was unavoidable, could still be found liable for failure to obtain such knowledge or to reach that conclusion.

The court took the view that although the said directors did not receive the 1986 Accounts until January 1987, the fact that the potential gross profit of PMC was directly related to PMC's turnover for which reason it could be relatively easily calculated meant that the directors still had an opportunity of discerning the financial position of PMC by reason that PMC's turn-over had tremendously gone down causing a decline in the commission received by PMC which in turn meant an increase in the deficit of PMC's assets over its liabilities.[607]

Similarly, In *Re DKG contractors Ltd,*[608] the court concluded that as soon as the directors knew that a supplier refused to make further deliveries, they should have instituted some form of financial control of the affairs of the company which would have enabled them to conclude that insolvent liquidation of the company was unavoidable.

The foregoing shows clearly, therefore, that the courts are willing to impute knowledge of the parlous financial position of a company on its directors when, even in the absence of financial records or warnings to that effect by the company's professional advisers, other factors exist in the financial situation of the company which would make it possible for the directors to easily discern that the company's financial situation has worsened.

5.3.7 Are directors not prejudiced by the courts' hindsight bias in the "every step" defence?

---

607 Ibid, at p 550, paras h-i and p 55, para a.

608 [1990] BCC 903.

© University of Pretoria

In practice, the hindsight bias will affect a director's defence in wrongful trading proceedings in the sense that in considering if the director took every step in minimizing potential loss to creditors, the courts and the liquidators will be looking into the conduct of the said directors with hindsight, an advantage which the directors will not have had as they could not foresee what will happen next after their decision.

It has been observed that the hind-sight bias, through which there is usually a tendency by judges to assign erroneously high probability of occurrence to a probabilistic event simply because it ended up occurring,[609] is very likely to prejudice a director's defence of taking every step as the courts, with the advantage of hindsight, are likely to find any step that was taken by the director, but which failed to save the company from liquidation, to have been obviously wrong right from the start and incapable of saving the company from liquidation.

Concurring with the foregoing observation, Nimmerfal and Peissl,[610] have argued that due to the hindsight bias, courts would deem loss bringing events as having been predictable even though there might have been no objective basis for predicting that the event would happen subsequent to the decision.

However, while this may seem worrisome to directors, it is comforting to note that when faced with the question of whether a director took every step to minimize potential loss to creditors, the courts are cautious not to be prejudiced by hindsight bias.[611] This entails that when determining whether a director took every step, the determination will not be considered in light of later developments that could not reasonably have been foreseen by the directors.[612]

609 Bainbridge, S "The Business Judgement rule as Abstention doctrine UCLA Law and Econ Research paper [online]. 2003, School of law, no. 03-18 p.112 available at SRN: http://ssrn.com/abstract...429260 see also Keay, A and Loughrey, J "The Concept of Business Judgement" available online at http://eprints.whiterose.ac.uk/129655/ accessed on 4th November, 2018.

610 Nimmerfall, P and Piessl, LJ "The Business Judgement Rule and its impact on Australian Law"(2015), page 352 available online at https://journals.muni.cz/cpvp/article/viewFile/5273/4359#page=1 accessed on 16th June 2018.

611 *Re Sherbone Associates Ltd [1995] BCC 40*. See also *Re Brian D. Pierson (Contractors*) [1999] BCC 26.

612 Mokal, R *Corporate Insolvency; Theory and application,* (2005) Oxford: Oxford University Press, p.298

© University of Pretoria

The unwillingness on the part of the courts to judge the conduct of the directors with hindsight bias was seen clearly in *Re Continental Assurance Co of London Plc.*[613] In that case, the liquidators had argued that while the respondent directors tried their best, they got things wrong and that it was their fault that they got things wrong. In rejecting this argument, Park J labelled the argument by the liquidators as being guided by an "austere attitude" and being prejudiced by the liquidators' benefit of hindsight and failure by the said liquidators to appreciate the realities of being a director.

5.3.8 Some of the steps that are likely to impress the courts in the "every step" defence

Although it has been said that the steps which a respondent director ought to take depend on the circumstances of each given case and that there can never be universal steps to be taken by all directors in all kinds of circumstances, it will be noted that the courts have shown sympathy to directors who have taken the following particular steps:

5.3.8.1 Seeking professional advice

In *Re Continental Assurance Co of London Plc.*[614] the court, in making a finding in favour of directors in a wrongful trading claim, placed emphasis on the fact that the directors sought and listened to professional advice. There is merit in suggesting that directors who seek but do not heed the advice given may not benefit from the courts' sympathy.[615]

---

613 [2001] BPIR 733 at 770.

614 (2007) 2 BCLC 287.

615 In respect of the insolvent trading rule, the Australian version of the wrongful trading rule, it has been said that one of the ways in which a director can show that they have developed a course of action that is reasonably to lead to a better outcome for the company (the equivalent of taking every step with respect to the wrongful trading rule in Malawi) is for the director to show that he obtained appropriate advice when his company was faced with insolvency; Explanatory Memorandum, *Treasury Laws Amendment* 2017 Enterprise Incentive No 2 Bill (Cth) 12 [1.43]. According to Anderson H, "Shelter from the Storm: Phoenix Activity and the Safe Harbour" [2018] 41 *Melbourne University Law Review* 999 at 1010, the pre-existing defence under the insolvent trading rule in Australia in section 588H(3) makes it clear that the advice which the director should be seeking is whether the company is solvent, and not whether the company could trade out of its financial difficulties or whether a work-out with creditors would be more beneficial to creditors than an immediate liquidation.

© University of Pretoria

In *Re Brian D. Pierson (Contractors) Ltd*,[616] the directors who were subject to wrongful trading proceedings had ignored indications, although not warnings, from professional advisers with regard to the precarious financial position of the company. The court did not show sympathy for the said directors and found them liable to contribute 70% of the losses incurred by the company from the date when the accounts of the company were such that the said directors should have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation.[617]

An important question that arises with regard to seeking and following advice on the part of a director is whether when the advice is sought and it is given and it is followed but, as fate would have it, the company still collapses, the director will still be held liable for wrongful trading.

Absurd as it may sound, the answer to this question seems to be in the affirmative in that following the advice of a professional adviser, by itself, is not a guarantee that the director will be absolved from liability for wrongful trading, although it may go a long way in doing so.[618]

In *Re Purpoint Ltd*,[619] the respondent director was found liable on the basis that despite seeking and receiving professional advice about the parlous financial status of the company, the director did not heed the advice and did not cease trading for six months and did not place the company in liquidation for nearly a year.

616 (2001) 1 BCLC 275.

617 Ibid, 302-308.

618 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*,114. See also Odittah, F "Wrongful Trading" (1990) *LMCLQ* 205 at 208 where the learned commentator takes the view that if a director acts on an informed advice of professional adviser, a strong case should be able to be made against the director being held liable for wrongful trading.

619 (1991) BCC 121, 125.

© University of Pretoria

Finally, while not being purely wrongful trading cases, it is interesting to note that the courts in *Re Bath Glass Ltd*,[620] and in *Re Douglas Construction Services Ltd,*[621] manifested sympathy for directors who were facing disqualification proceedings on the basis that they sought professional advice on what to do when they were faced with their respective circumstances.

5.3.8.2 Resignation

Although resignation has never been regarded by the courts as a fool-proof way of extricating oneself from liability for wrongful trading, it is believed that it can be a consideration in a director's favour, especially in circumstances where the director's advice or recommendations to the board have not been heeded.[622]

The dangers associated with resignation, however, are that firstly, the court may regard the resignation as having been predicated on the desire to protect the interests and integrity of the individual director rather than seeking to confer any benefit on the company in respect of minimizing the potential loss to its creditors.[623] Secondly, if a director who resigns is later found to be liable for wrongful trading, his liability could not be limited to the loss suffered to creditors up to the time of his resignation, but rather it could be greater because of what was done by the other directors after his resignation.[624]

Griffin[625] has contended that in the majority of cases, a resignation will probably be viewed as an indication of the fact that the director has failed to take "every step" to

620 [1988] BCLC 329.

621 [1988] BCLC 397.

622 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 115.

623 Griffin, S *Personal Liability and disqualification of Company directors* (1999) Hart Publishing Co. 77.

624 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 115.

625 Griffin, S *Personal Liability and disqualification of Company directors* (1999) Hart Publishing Co. 76.

© University of Pretoria

minimize the potential losses to the company's creditors.[626] While this may be true in other cases, it is submitted that the court will have to look at the reasons behind the resignation and where the resignation comes as a result of the directors' advice or recommendations not being heeded, the resignation should be regarded as an indication of the fact that the director was denied an opportunity of taking "every step" towards the minimization of the potential losses to the company's creditors. Obviously, the court would have to consider what other options were available to the director apart from the resignation.

It must be noted however that the mere fact that a director did not resign does not necessarily mean that he will be liable for wrongful trading.[627] There are times when a director may feel that resignation is not the right thing to do even though his advice or recommendation is not heeded by the board. Under such circumstances it is prudent for the director to ensure that his or her concern is minuted in board meetings and also that the director should initiate the seeking of professional advice. In *Secretary of State and Industry vs. Taylor,*[628] the court said that if a director protests against continued trading and does what he can do to bring about the cessation of trading, it is more likely that no liability for wrongful trading will attach to him.

5.3.8.3 Cessation of Business

While the cessation of business may seem to be the ideal thing to do when the directors realize that the company is heading towards insolvent liquidation, there are times when this may be detrimental to the interests of the creditors if, for example, continuing to

---

626 It must be noted that while resignation may save the directors from potential personal liability for wrongful trading, it may invite liability for breach of the duty to act in the best interest of the company. In *Minister of Water Affairs and Forestry vs. Stilfontein Gold Mining Co Ltd* 2006 (5) SA 333 (W) all directors of a listed public company resigned. The directors' justification for their resignations was that they had been advised by their lawyers of their potential exposure to personal liability for reckless trading because the company did not have sufficient funds to comply with the directives of a court order. The court, citing the directors' duty to act in good faith and in the best interest of the company, held that the directors' resignations had precluded them from discharging their duties to the company and its members and therefore the resignations were not in the best interest of the company. The court emphasized that by accepting appointment as directors of the company, the directors had accepted the duties and obligations that come with the appointment and therefore they could not be allowed to abdicate their duties merely because it was convenient to them to do so.

627 *Secretary of State for Trade and Industry vs. Taylor* (19997) I WLR 407.

628 (1997) I WLR 407.

© University of Pretoria

trade for a short term could rescue the company from its parlous financial state.[629] As was rightly observed by Finch:

> If directors reasonably believe that creditors may fare worse in a premature forced sale of assets, and that this combined with the cost of liquidation proceedings may well be disastrous from unsecured creditors' point of view, the directors' duty…may well include a duty to attempt a company rescue or to stay at the helm. [630]

In line with the foregoing, Keay[631] has warned that directors need not be cavalier, but nor must they be overly cautious as this might compel them to take an action that will not benefit creditors such as an impromptu cessation of business. In this regard, it must be emphasized that directors are not precluded from taking some risks as inherently business involves the taking of risks. It must also be acknowledged, as it was observed by Sir Richard Scott V.C. in *Facia Footwear Ltd (In Administration) vs. Hinchliffe*,[632] that the boundary between an acceptable risk that an entrepreneur may properly take and an unacceptable risk is not always clear-cut.

In some cases, however, cessation of business is the appropriate thing to do particularly in closely held companies set up by a director-owner who identifies with the company and who would be tempted to trade on for too long in order to try and glide the company back in business.[633]

However, from the moment the directors decide to cease trading, they will be required to place the company into a formal insolvency process such as administration or liquidation. The reason for an urgent initiation of a formal insolvency process is to enable the creation of a moratorium which will prevent dismembering of the residual assets of the company through individual claims by creditors.

---

629 *Re Heffron Kearns Ltd (No. 2)* [1993] 3 IR 191.

630 Finch, V "Directors' duties: Insolvency and the unsecured creditor" in Clarke, A (ed) current issues in insolvency law, (1991) London: Stevens, p.96.

631 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 95.

632 (1198) 1 BCLC 218.

633 Mokal, R "An agency cost analysis of the wrongful trading provisions; redistribution, perverse incentives and the creditors' bargain" (2000) 59 *CLJ* 335 at 354.

© University of Pretoria

5.3.8.4 Placing the company into a formal insolvency process

While liquidation might minimize further company losses, it may sometimes not be the most beneficial action as far as creditors are concerned. Keay[634] has supported this point by arguing that for instance if assets of a company in liquidation are sold off piecemeal in what is referred to as a "fire sale," the liquidator will recover less than he could recover if the assets were sold off strategically or as part of the sale of the business as a going concern.

Given the existence of two possible insolvency regimes in Malawi, directors might clearly prefer to place a company under administration rather than liquidation. This might be a deliberate move to escape possible liability for wrongful trading. In *Re Farmizer (Products) Ltd*,[635] the liquidator in a wrongful trading proceeding was only seeking contribution up to the time when the company entered administration. It is therefore clear that placing a company under administration, while it might not be a complete escape route from wrongful trading claims, it can nonetheless reduce the extent of contribution payable by a director upon being found liable for wrongful trading.

Keay[636] has warned, however, of the danger of rushing to place a company under an insolvency regime arguing that sometimes the company may not be "finished" or even in need of a rescue and therefore its placement in administration or liquidation may be premature.

While directors may be influenced by the fear of wrongful trading claims in placing the company under an insolvency regime, the said placement is not a guaranteed escape route since if it is shown that the placement did not result in the minimization of losses

---

634 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*,116.

635 [1997] BCC 655.

636 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*,117.

© University of Pretoria

to creditors, and that continuing to trade was going to be more beneficial to the creditors, the directors will still face wrongful trading claims.[637]

Adding to what may impress the court, in *Brooks vs Armstrong (also known as Joint Liquidators of Robin Hood Centre Plc.) vs. Armstrong*,[638] the court outlined the following as steps that may also impress the court if they were undertaken by a director whose company entered the zone of insolvency:

a) Ensuring that accounting records are kept up to date with a budget and cash flow forecast.

b) Preparing a business plan and considering whether future trading will minimize losses.

c) Keeping creditors informed and reaching agreements to deal with the debt and the supply where possible.

d) Regular monitoring of the trade and financial position of the company.

e) The director asking himself every time whether loss is being minimized.

f) Ensuring adequate capitalization.

g) Obtaining professional advice (both legal and financial).

h) Considering alternative insolvency remedies.

It must be noted that in this case, the court rejected a submission by the liquidator that in addition to the foregoing steps, it was inappropriate for the directors of *Robin Hood Centre Plc* to continue drawing salaries due to the difficult financial situation which the company was in. In the court's view, the directors had been working hard to reorganize the business and deserved a recompense.

637 Ibid.

638 (2015) EWHC 2289 (Ch).

© University of Pretoria

The foregoing notwithstanding, it has been argued that it is far much safer for directors to place a company in administration rather than to embark on some form of rescue process such as compromise with creditors or company voluntary arrangement on an informal scheme as such methods are laden with the danger that because they could take a long time to finalize, with no moratorium being operational, one or more creditors could obtain a winding-up order thereby making wrongful trading claims against the directors more likely.[639]

5.3.9 Continuing to trade when a company is insolvent and the "every step" defence

An important question that arises with respect to the defence of taking "every step" in wrongful trading proceedings is whether continuing to trade while the company is insolvent entails that the director will have no defence to wrongful trading.

To this question, it is pertinent to note that under the wrongful trading rule, there is no duty on the directors of a company not to allow the company to continue trading merely because the company is insolvent. This must be contrasted with the Australian counterpart, the insolvent trading rule, which places an active duty on the directors not to allow a company to continue to trade and to contract a debt when the company is or is expected to be insolvent.

In *Re Ralls Builders Limited (In Liquidation)*,[640] Snowden J pointed out that the fact that the company was insolvent on a cash flow or balance sheet basis but carried on trading does not mean that the director, whether or not he has knowledge of the fact of the said insolvency, will be liable for wrongful trading if the company eventually fails to survive.[641]

---

639 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*,117.

640 (2016) EWHC 1812 (Ch).

641 This view has been echoed by Anderson H, "Shelter from the Storm: Phoenix Activity and the Safe Harbour" [2018] 41 *Melbourne University Law Review* 999 at 1000 who observes that:

> Choosing the 'right' course of action when insolvency looms has always been difficult for directors. On the one hand, a prompt liquidation ensures that further creditors are not exposed to losses from the company's collapse, and that available assets are distributed in the liquidation

© University of Pretoria

In *Hawkes Hill Publishing Co. Ltd*,[642] the court observed that allowing the company to continue trading while it was insolvent was not unjustifiable as directors are not clairvoyant and that the court should avoid applying hindsight so as to hold that the directors' decision to continue trading constituted wrongful trading merely because it eventually proved to be wrong. The court took the firm view that the proper question to be asked in all circumstances is not whether or not the company was insolvent, but whether the respondent director knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation.[643]

This view is supported by the court in *Re CS Holidays Limited*[644] where Chadwick J in respect of the foregoing remarked that directors may take a proper view, even where the company is insolvent, that it is in the interest of the company's creditors as a whole to continue to trade through its difficulties and making some losses in the reasonable anticipation of future profit.

Allowing a company to continue to trade while insolvent may also be justified if the basis for doing so is to minimize losses which the company may otherwise incur by proceeding into insolvent liquidation too soon. Such losses, which come as natural consequences of insolvency, are such as the fact that asset value will be depreciated in liquidation; that a fire sale on liquidation would achieve significantly less than a timely sale; and that the failure to trade would cause a loss of goodwill and potential difficulty in realizing debt owed to the company.[645]

---

only to those creditors whose losses have become unavoidable. On the other hand, continuing to trade in appropriate circumstances might see a turnaround in the company's fortunes so that all creditors are paid or at least receive more than they would have if the company were quickly liquidated."

642 (2007) BCC 937.

643 Ibid.

644 (1997) I WLR 407.

645 With respect to the South African equivalent of the wrongful trading rule, loosely referred to as the reckless trading rule, the courts have considered the question of whether any situation where directors of a company have allowed the company to continue to trade and it eventually failed to pay its debts should be regarded as recklessness on the part of the said directors as for them to be liable under Section 424 of the 1973 Companies Act, the reckless trading provision. In answering this question, the Supreme Court of South Africa in *Fourie vs. Newton* [2011] 2 All SA 265 (SCA) at para 44 gave a practical explanation that:

© University of Pretoria

While allowing a company to continue trading when it is insolvent will not, on its own, result into liability for wrongful trading, it must be noted that the courts are reluctant to find that a defence of "every step" is made out if the directors allowed the company to trade too long while insolvent with no reasonable prospect that they may save the company and eventually the company fails to survive. In the *Robin Hood* decision discussed above,[646] the court held that the directors could not rely on the defence of "every step" for the reason that they had continued trading for 18 months without a sale and they had traded by discriminating against the landlord and HMRC,[647] who effectively provided trade capital to the business.

5.3.10 Can directors rely on the business judgement rule as a defence in wrongful trading proceedings?

An important question that arises with respect to defences in wrongful trading proceedings is whether section 187 of the Insolvency Act of 2016, which provides for wrongful trading and its defences in Malawi, is exhaustive of the defences available to a director in wrongful trading proceedings, or whether a director is at liberty, over and above the statutory wrongful trading defences, to avail himself of the other general corporate law defences.

> [I]f an essential…source of funding of a company is intra-group support, and that support has been or may be withdrawn, that would be a factor, or it may be decisive, in considering whether the actions of the board in continuing to trade were reckless…But where there are sufficient other potential or existing sources of funding it does not follow that where group support is or may be withdrawn, the members of the board would immediately have to shut shop on pain of contravening s 424. The essential question is whether the board would be acting recklessly in seeking to exploit the other sources of funding. The answer to that question would in the first place depend on the amount of funding required, for how long it would be required, and the likelihood of it being obtained – whether timeously or at all; and in the second place, on how realistic the possibility is that the company's fortunes will be turned around. The second consideration will materially depend on whether there is a credible business plan or strategy that is being or could be implemented to rescue the company. A business that may appear on analysis of past performance to be a hopeless case, may legitimately be perceived as a golden opportunity for a turnaround strategy.

646 *Brooks and Willets (Joint liquidators of Robin Hood Centre Plc) vs. Armstrong and Walker* (2016) EWHC 2289.

647 Her Majesty's Revenue and Customs.

© University of Pretoria

Although section 187 of the insolvency Act appears to be exhaustive with regard to the defences that can be relied on by a director during wrongful trading proceedings, there seems to be no reason why a director in wrongful trading proceedings cannot rely on other defences, whether under statutory law or common law, which may be applicable in the said proceedings.

One well known defence which protects directors from liability emanating from the business decisions they make in the running of the affairs of the company when the said decisions fail to pay off is the so-called Business Judgement Rule. A consideration of the nature of this defence and the extent to which it is applicable, if at all, in wrongful trading proceedings, is therefore necessary.

5.3.10.1 The Business Judgement Rule

The Business Judgement rule is a common law rule that was developed by the American judiciary particularly the Louisiana Supreme Court in the case of *Percy vs. Millaudon*[648] to protect directors from liability that would attach to them for negative consequences of their otherwise honest and reasonable business decisions that turned out to have been wrong. The rule requires that as long as directors perform their responsibilities dutifully and make their corporate decisions in good faith, they are not to be held personally liable for the outcome of the said decisions.[649] In *Hodges vs. New England Screw Co.*[650] the court stated that:

648 (1829) 8 Mart. (n.s.) 68 La. 1829). The originality of the Business Judgement Rule must however be considered in light of the position taken by Pasban, MR "*Directors' Duties and Liabilities in Corporate Insolvency in England and the US*" PhD Thesis, (1996) University of Sheffield, 84, who argues that the rule owes its development from the English common law principles emanating from the case of *Charitable Corporation vs Sutton* (1742) 2 Atk. 400 and that it has been part of the common law for nearly two centuries but that it only emerged for the first time in the United States case of *Percy vs. Millaudon.* Unfortunately, Pasban does not discuss the *Charitable Corporation* case, nor does he say anything said by the court in that case.

649 Nimmerfall, P and Piessl, LJ "The Business Judgement Rule and its impact on Australian Law"(2015), page 352 available online at https://journals.muni.cz/cpvp/article/viewFile/5273/4359#page=1 accessed on 16th June 2018.

650 3R. I.9, 18 (1853).

© University of Pretoria

> "We think a board of directors acting in good faith and with reasonable care and diligence who nevertheless fall into a mistake, whether as to law or fact, are not liable for the consequences of such mistake."

The foregoing statement is particularly important as it outlines the philosophy behind the business judgement rule, namely, that it is accepted that directors can err or make mistakes, but what should matter is whether they have been honest and diligent in arriving at the good faith decision, even though the said decisions turn out to be wrong. This philosophy was highlighted by the court in 1847 in the case of *Goldbold vs. Branch Bank*[651] when the court said the following in respect of the undertaking to serve as directors of companies:

> The undertaking implies a competent knowledge of the duties of the agency assumed by them, as well as the pledge that they will diligently supervise, watch over, and protect the interests of the institution committed to their care. They do not in our judgement undertake that they possess such a perfect knowledge of the matters and subjects which might come under their cognisance, that they cannot err, or be mistaken, either in their wisdom or legality of means employed by them.

It has been argued that by its nature, the business judgment rule is designed to achieve a compromise between two competing values, namely, authority and liability.[652] The Authority element exists to ensure that directors maintain their decisional powers while the liability element pertains to holding directors liable for business decisions in order to prevent and correct their inappropriate conduct.[653]

5.3.10.2 Rationales of the Business Judgement Rule

There are three remarked rationales of the business judgement rule. First is to encourage directors to serve and take risks. This is premised on the fact that business decisions,

---

651 (1847) 11 Ala 191.

652 Ponta, A and Catana, RN "The Business Judgement Rule and its Reception in European Countries" (2015) 4 *The Macrothene Review* 127.

653 Ibid.

© University of Pretoria

even when made by the utmost competent directors can, in hindsight, turn out to have been improvident thereby plunging the company into undesired losses.[654]

The second rationale is to avoid judicial encroachment into directors' business decisions. The basis for this rationale is, firstly, that judges are generally considered not to possess the experience, expertise and information necessary to make complex business decisions.[655] One of the commentators who is sceptical about the suitability of the courts to assess the business judgements of directors is Professor Dale Oesterle.[656] According to the learned commentator, judges lack the business experience and clever lawyers and paid-up experts add to the confusion.[657]

Secondly, judicial encroachment into directors' business decisions is considered undesirable due to the hind-sight bias through which there is usually a tendency by judges to assign erroneously high probability of occurrence to a probabilistic event simply because it ended up occurring.[658] Nimmerfal and Peissl[659] have argued that due to the hindsight bias, courts would deem loss bringing events as having been predictable even though there might have been no objective basis for predicting that the event would happen subsequent to the decision.

---

654 Block, DJ *et al* "The Business Judgement rule: Fiduciary duties of corporate directors and officers" *The Business Lawyer* (1987), vol 42, No. 3 pp. 995-997.

655 See *Airline Pilots Association International vs. UAL Corp*, 717 F. Supp 575, 582 (N.D. III 1989.

656 Oesterle D, 'Corporate directors' personal liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England. A recipe for timid directors, hamstrung controlling shareholders and skittish lenders' in IM Ramsay (ed) *Company director's liability for insolvent trading* (Melbourne: Centre for Corporate Law and Securities Regulation and CCH Australia, 2000).

657 Ibid, page 38. See however the contrary view expressed by Keay, A in his article "Wrongful Trading and the Liability of Company Directors: a Theoretical Perspective" (2005) 25 *Legal Studies* 431, who argues, on page 439, that Oesterle's argument overlooks the fact that directors are equally able to hire clever lawyers and to pay experts to substantiate their contention that they have acted properly. Keay goes on to say, on the same page, that with directors, we are not talking about naïve, vulnerable persons in society.

658 Bainbridge, S "The Business Judgement rule as Abstention doctrine UCLA Law and Econ Research paper [online]. 2003, School of law, no. 03-18 p.112 available at SRN: http://ssrn.com/abstract...429260 See also Keay, A and Loughrey, J "The Concept of Business Judgement" available online at http://eprints.whiterose.ac.uk/129655/ accessed on 4th November, 2018.

659 Nimmerfall, P and Peissl, LJ "The Business Judgement Rule and its impact on Australian Law"(2015), page 352 available online at https://journals.muni.cz/cpvp/article/viewFile/5273/4359#page=1 accessed on 16th June 2018.

© University of Pretoria

The third rationale for the business judgment rule pertains to the desire to maintain directors as the central decision-making authorities in corporations. The basis for this rationale is that it is an unimpeachable fact that the authority to direct the corporation's fortunes and affairs vests in the directors and, therefore, by limiting judicial review of directorial decisions through the business judgement rule, the scheme of centralizing authority in the board of directors is preserved.[660]

The review of the decisions of directors by the courts being an accountability mechanism, it is important to ensure that this accountability mechanism should not be utilized in a way that is tantamount to allowing the courts to exercise the powers which were bestowed on the directors. The business judgement rule therefore serves to prevent such a shift in the locus of decision-making authority from directors to judges.[661] A Nobel laureate economist, Kenneth Arrow,[662] writing about the purpose of accountability mechanisms, such as the courts' review of directorial decisions, argued that:

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.

It is interesting to note that the courts themselves accept that as far as running the affairs of a company is concerned, the directors are better placed to make business decisions than the courts. In *Kamin vs. American Express Co*.,[663] the court said that:

---

660 Dooley, MP and Veasy, EN "The role of the board in derivative litigation; Delaware law and the current AU proposals compared, (1989) 44 *Business Lawyer*, 503 -542 at 522.

661 Bainbridge S, "Much ado about little? Directors' fiduciary duties in the vicinity of insolvency" (2005) Law & Economics Research paper series, 38 accessed online at http://ssrn.com/abstract=832504 on 17th December 2018.

662 Arrow, KJ, *The Limits of Organization* (1974), George J. McLeod Limited, 78.

663 N.Y.S. @d 807 (Sup (t 1976).

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

> "The directors' room rather than the court room is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices competitive situations or tax advantages."[664]

Apart from being applicable in Malawi as a common law rule, the business judgment rule has also been codified under the Companies Act in Malawi. According to the Act, "business judgement" means any decision to take or not to take action in respect of a matter relevant to the business operations of a company.[665] Under the rule, a director or officer of a company who makes a business judgement is taken to have exercised the powers and discharge the duties of his office honestly, in good faith and in the best interest of the company,[666] and also to have exercised the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances if:[667]

(a) He makes the judgement in good faith for a proper purpose;[668]

(b) He does not have a material personal interest in the subject matter of the judgement;[669]

(c) He informs the company of the subject matter of the judgement to the extent he reasonably believes to be appropriate;[670] and

---

664 In *Regentcrest plc. vs. Cohen* 2001 2 BCLC 80, Parker J (on page 105) observed the following with respect to the business judgement rule:

> The question is not whether, viewed objectively by the court, the particular act or omission which is challenged was in fact in the interests of the company; still less is the question whether the court, had it been in the position of the director at the relevant time, might have acted differently. Rather the question is whether the director honestly believed that his act or omission was in the interest of the company. the issue is as to the director's state of mind. No doubt, where it is clear that the act or omission under challenge resulted in substantial detriment to the company, the director will have a harder task persuading the court that he honestly believed it to be in the company's interest.

665 Section 220(6) of the Companies Act of 2013.

666 Section 220(4) as read with section 220(1)(a) of the Act.

667 Section 220(4) as read with section 220(1)(b) of the Act.

668 Section 220(4)(a) of the Act.

669 Section 220(4)(b) of the Act.

670 Section 220(4)(c) of the Act.

© University of Pretoria

(d) He reasonably believes that the judgement is in the best interests of the company.[671]

However, the Act is clear of the test that will be applied in measuring the director's belief in the sense that the director's belief that the judgement was in the best interests of the company shall be taken to be a reasonable one unless the belief is one that no reasonable person in the director's position would hold.[672] Clearly an objective test will be applied in measuring the director's said belief.[673]

Apart from it being enacted in Malawi, the Business Judgement rule has also been adopted in several other jurisdictions outside America including the United Kingdom, South Africa, and Australia. Keay[674] has remarked that while the rule has not been officially recognized in the United Kingdom, the approach has been adopted in a broad range of case law. In *Shuttleworth vs. (Maiden head) Ltd*[675] Scrutton LJ extrapolated the rule as follows:

> "When persons endeavouring to decide what will be for the benefit of the company and to act accordingly, decide upon a particular course, then, provided there are grounds on which reasonable men could come to the same decision, it does not matter whether the court would or would not come to the same decision or a different decision. It is not the business of the court to manage the affairs of the company. That is for the shareholders and directors. The absence of any reasonable ground for deciding that a certain course of action is conducive to the benefit of the company may be a ground for finding lack of good faith or for finding that the directors, with the best motives, have not considered the matters which they ought to have

---

671 Section 220(4)(d) of the Act.

672 Section 220(5) of the Act.

673 In a Canadian case of *Maple Leaf Foods Inc. vs. Scheider Corp* 1998 Can LII 5121 (ONCA), Weiler JA (at para 92) observed the following with respect to the essence of the business judgement rule:

> The court looks to see that the directors made a reasonable decision not a perfect decision. Provided the decision taken is within the range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination. As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision.

674 Keay, A and Loughrey, J "The Concept of Business Judgement" (2018), page 4, available online at http://eprints.whiterose.ac.uk/129655/ on 4th November 2018.

675 (1942) Ch. 304 (CA).

© University of Pretoria

> considered…but I should be sorry to see the court go beyond this and take upon itself the management of concerns which others may understand far better than the court does." [676]

This position was echoed by Lord Greene MR in *Re Smith and Fawcett Ltd*[677] who said that the directors must exercise their discretion in what they consider to be in good faith and in the best interest of the company, and not what a court may consider to be in the best interest of the company. In *Howard Smith Ltd vs. Ampol Petroleum Ltd,*[678] the court remarked that the courts are not to act as a supervisory board over directors' decisions that are honestly arrived at within the powers of management. In *Hogg vs. Cramphorn Ltd*,[679] the court took a firm view that it is not for the court to review the substantive merits of a decision that the directors have arrived at honestly.

Keay[680] has argued that identifying what a business judgement is, and therefore what kind of actions or decisions of directors are not challengeable and those that might be challengeable is necessary to promote commercial certainty. It must be noted that the United Kingdom, courts rarely use the term Business Judgement. Courts seem to prefer the use of terms such as "commercial judgement" or "commercial decision."[681]

In South Africa, the Business Judgement rule has been codified in the Companies Act.[682] Section 76(4) of the said Act relates to the director's duty to act in the best interest of the company[683] and with care, skill and diligence.[684] In terms of the rule, a

676 Ibid, at page 306.

677 (1942) Ch. 304.

678 (1974) AC 821. In the words of Lord Wilberforce (at p. 832), there is no appeal on the merits from management decisions to courts of law where such decisions are shown to have been made in good faith.

679 (1967) Ch 254 at 268.

680 Keay, A and Loughrey, J "The Concept of Business Judgement" (2018), page 4, available online at http://eprints.whiterose.ac.uk/129655/ on 4th November 2018.

681 *Cobden investments Ltd vs. RWM Langport Ltd* (2008) EWHC (Ch) at 754.

682 Companies Act 71 of 2008.

683 Section 76 (3) (b).

684 Section 76(3)(c).The standard care, skill and diligence expected is one that may be reasonably be expected of a person: Carrying out the same functions as those carried out by that director(Section 73 (3) (c) (i) and, Having the general knowledge, skill and experience of that director (Section 73(3)(c)(ii).

© University of Pretoria

director will be protected from allegations of breach of duty to act in the best interest of the company and with care, skill and diligence in relation to a matter where that director has: (i) taken reasonable diligent steps to become informed about the matter; (ii) either had no conflict of interest in relation to the matter or compiled with the rules of conflict of interest; and (iii) had a rational basis for believing, and did believe, that his decision was in the best interest of the company.[685]

According to one South African commentator, Muswaka,[686] the business judgement rule is a shield for directors against liability imputations whose rationale is to promote innovation by providing the right balance between the competing interests of commercial risk-taking by directors and, on the other hand, their accountability. Muswaka also argues that in determining compliance with the business judgement rule, not only will compliance with legislation be considered, but that consideration will also be had on compliance with governance codes and good governance criteria[687]which, for South Africa, entails compliance with updated reports of the King committee on corporate governance.[688]

---

685 See section 76 (4) generally. In *Fourie vs. Newton* [2011] 2 All SA 265 (SCA) (at para 45) the court said the following with regard to the need for the courts not to unnecessarily interfere with directors' decisions made in the course of the business of their companies:

> "[i]n evaluating the conduct of directors, courts should not be astute to stigmatize decisions made by businessmen as reckless simply because perceived entrepreneurial options did not in the event pan out. What is required is not the application of the exact science of hindsight, but a value judgement bearing in mind what was known, or ought reasonably to have been known by individual directors at the time the decisions were made. In making this value judgement, courts can usefully be guided by the opinions of businessmen who move in the world of commerce and who are called upon to make these decisions in the performance of their functions as directors of companies, and by experts who advise businessmen in the making of such decisions or who evaluate them at the time they are made."

686 Muswaka, L, "Directors' Duties and the Business Judgement Rule in South African Company Law; An Analysis" (2013) *International Journal of Humanities and Social Science*, Vol 3, No. 7 p.89

687 Ibid.

688 Established in 1992 by the Institute of Directors in Southern Africa, the King Committee reviews corporate governance and makes recommendations on the same to the corporate world in order to improve the standard of corporate. Currently, the committee has produced a new report, KING IV report. According to Muswaka, L, "Directors' Duties and the Business Judgement Rule in South African Company Law; An Analysis" (2013) *International Journal of Humanities and Social Science*, Vol 3, No. 7 p.89, in order to be protected by the business judgement rule in South Africa, a director must show that apart from the law, he also complied with King IV Report on Corporate governance which itself is not law. But derives its application, according to Muswaka, from Section 5(i) of the Companies Act as read with Section 7(b) (iii) to the effect that the purpose of the Act is to promote the development of the South African economy by encouraging transparency and high standards of corporate governance…"

© University of Pretoria

This position is similar to the one obtaining under the Companies Act in Malawi where, under section 184 of the Act, directors are required to comply with any code of corporate governance as may be prescribed.[689] The Act provides further that where a specific sector code of corporate governance exists, the directors shall also comply with the provisions of the sector code.[690] The Act is however clear that while any code of corporate governance prescribed will only be directory in nature, the court, the registrar of companies or any authority shall be entitled to have regard to such code in interpreting and applying any provisions of the Act.[691]

In Australia, just as in South Africa and Malawi, the Business Judgement rule has also been codified. Section 180(2) of the Corporations Act[692] makes provision for the business judgement rule to operate as a defence to both the common law and statutory duties of care owed by directors. Section 180(3) of the Australian Corporations Act defines business judgement as any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.[693]

Section 180 (2) of the Act provides that a director or other officer of the corporation who makes a business judgement is taken to meet the requirements of subsection 1, (relating to care and diligence),[694] and their equivalent duties in common law and in equity, in respect of the judgment if they make the judgement in good faith and for a

Muswaka argues that the king reports should be the starting point for the courts to measure compliance with corporate governance (Muswaka 94) as the combination of the two provisions provide justification for the use of the King Reports.

689 Section 184(1) of the Companies Act of 2013.

690 Section 184(2) of the Act

691 Section 184(3) of the Act.

692 Act 50 of 2001.

693 Ibid.

694 Under section 180(1) of the Act, a director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they: (a) were a director or officer of a corporation in the corporation’s circumstances; and (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

© University of Pretoria

proper purpose,[695] and do not have a material personal interest in the subject matter of the judgement,[696] and inform themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate,[697] and rationally believe that the judgement is in the best interest of the corporation.[698] Further, the Act is clear that the director's or officer's belief that the judgement is in the best interest of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.[699]

5.3.10.3 Applicability of the Business judgment rule in wrongful trading proceedings.

As it has been discussed herein, liability for wrongful trading is triggered by the decisions of directors of financially distressed companies from the moment they know, or ought to conclude, that their companies would not avoid going into insolvent liquidation. An important question that arises in respect of this is whether the said directors can argue, as a defence to a wrongful trading claim, that the decisions which they took in such circumstances, and which turned out to be wrong and failed to save the company from insolvent liquidation, were protected by the business judgment rule and therefore that the said decisions cannot give rise to wrongful trading claims. An answer to this question will certainly entail whether the defence of "business judgment" is applicable in wrongful trading proceedings as a third line of defence.

---

695 Section 180(2)(a) of the Act.

696 Section 180(2)(b) of the Corporations Act.

697 Section 180(2)(c) of the Act.

698 Section 180(2)(d) of the Act.

699 See the proviso to section 180(2) of the Act. Note that In Australia, this desire to ensure commercial certainty saw the Australian Institute of Company Directors resisting the introduction of integrated Corporate Reporting for directors because the institute was unsure if directors' decisions on the content of such reports would be Business Judgements covered by the Business judgement Rule: Response to II RC Consultation on Business Reporting (July 2013).

© University of Pretoria

The starting point in answering the foregoing question is to consider the sentiments of the court in *Production Resources Group, L.L.C. vs. NCT Group Inc.,*[700] where the court said:

> The *Credit Lyonnais* decision's holding and spirit clearly emphasized that directors would be protected by the business judgement rule if they, in good faith, pursued a less risky business strategy precisely because they feared a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituents.[701]

Spindler,[702] on the other hand, has provided a very interesting answer to this question. He argues that it is not easy to draw a line between the business judgement rule for a solvent company and a company in the vicinity of insolvency in that for as long as the directors of a company navigating the vicinity of insolvency embark on reasonable rescue projects (as opposed to overly risky projects) which promise a turnaround for the company, there would be no reason not to allow for some sort of a business judgement rule for companies in the vicinity of insolvency.

Nevertheless, Spindler has cautioned that the ambit of the protection offered by the business judgement rule for directors of companies navigating the vicinity of insolvency has to be narrower than it is normally the case when a company is fully solvent.[703]

Concurring with this view, while offering a good practice approach, Cieri and Riela[704] have argued that when companies enter the vicinity of insolvency, directors should approach every corporate decision with the objective of enhancing the wealth generating ability of the corporation, rather than expecting to be protected by the business judgement rule for the decisions they make. According to Cieri and Riela, it

---

700 (2004) 862 A.2d 772.

701 Ibid, at page 797.

702 Spindler, G "Trading in the vicinity of insolvency" (2006) *European Business Organization Law Review* 7: 339 341.

703 Ibid.

704 Cieri, RM and Riela, MJ "Protecting directors and officers of corporations that are insolvent or in the vicinity of insolvency: Important considerations, Practical solutions" (2004) *De Paul Business & Commercial law Journal, vol 2*: 295 at 312.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

is safer for the directors to assume that they will not be able to take advantage of the business judgement rule and that they will have to defend the intrinsic or the entire fairness of the decisions they make.[705]

In view of the foregoing, it would be concluded that to a certain extent, directors can escape liability for wrongful trading by relying on the defence of the business judgement rule by showing that when their company was navigating the vicinity of insolvency, or precisely that at the moment when they knew or concluded that their company would not avoid going into insolvent liquidation, they made the decisions in question in good faith and that the decisions were not unjustifiably risky in the circumstances.

As Kandestin[706] put it, a board of directors should be free to make good faith plans to maximize the value of a company navigating the vicinity of insolvency as fear of potential lawsuits from disgruntled creditors concerned about the riskiness of the plans would encourage the abandonment of potentially profitable plans. This conclusion was well summarized by the court in *Production Resources Group, L.L.C. vs. NCT Group Inc.*[707] as follows:

> I doubt the wisdom of a judicial endeavour to second-guess good-faith director conduct in the so-called [vicinity of insolvency]. Although it is easy to posit extreme hypotheticals involving directors putting cash in slot machines, the real world is more likely to generate situations when directors face a difficult choice between pursuit of a plausible, but risky, business strategy that might increase the firm's value to the level that equity holders will receive value, and another course guaranteeing no return for equity but preservation of value for creditors. Absent self-dealing or other evidence of bad faith, by what measure is a court fairly to critique the choice made through an award of damages?[708]

705 Ibid.

706 Kandestin, CD "The duty to creditors in near-insolvent firms: Eliminating the near insolvency distinction" (2007) *Vol 60 Vanderbilt Law Review,* 1236 at 1268.

707 (2004) 862 A.2d 772.

708 Ibid, at page 790.

© University of Pretoria

5.4 CHAPTER CONCLUSION

In this chapter, which was aimed at outlining and discussing the defences that are available to directors during wrongful trading proceedings in Malawi, it has been established that there are two statutory defences available to a director during wrongful trading proceedings in Malawi and that there is also one possible general corporate law defence which may be relied on by the directors during the said proceedings. The defences have been discussed as follows:

Firstly, it been established that it is a defence for the director during wrongful trading proceedings to prove that at no time before the commencement of the winding-up of the company did he know or conclude that the company would not avoid proceeding into insolvent liquidation. This will entail that the director could not be expected to take any step with a view to minimizing the potential loss to the company's creditors, because with this defence, the director would be contending that according to him, no loss was going to occur to creditors because the company was not going to go into insolvent liquidation.

This defence has been referred to as the "no step" defence in this chapter, and it is regarded in this study as a non-main wrongful trading defence. However, it has been observed in this chapter that this "no step" defence is difficult to prove for the reason that apart from the subjective knowledge test which the court will apply to test the "lack of knowledge" which the director will be pleading, the court will also apply an objective test of knowledge which is a stringent test as it will be based on what a reasonably diligent director would have known or concluded in the director's circumstances.

Secondly, it has been established in this chapter that the main defence available to a director during wrongful trading proceedings is for the director to prove that at some time before the commencement of the winding-up of the company, he knew or concluded that the company would not avoid going into insolvent liquidation, and that having so known or concluded, he took every step with the view to minimizing the potential losses to the company's creditors as he ought to have taken. This has been referred to in this chapter as the "every step" defence.

© University of Pretoria

It has been established in this chapter that the "every step" defence is equally difficult to prove because it has several components that are not easy to establish. It has been observed that the first hurdle in establishing the "every step" defence lies in ascribing meanings to some phrases used in the defence, namely, the meaning of the phrase "*at some time before the commencement of the winding-up of the company.*" as well as the meaning of "*every step*."

On the meaning of the phrase "*at some time before the commencement of the winding up of the company*," it has been established that this phrase means the crisis point in the financial life of the company, and that the directors will have to be diligent in monitoring the financial affairs of the company so as to be able to locate this crisis point. Where the financial statements of the company are, for some reason, not produced in time or at all, it has been established that this will not exonerate the directors as they can rely on some financial factors in the company which point to the fact that the financial situation of the company has deteriorated.

Related to the foregoing, it has been established that the absence of warnings of the company's financial difficulty from its advisers, such as public accountants, auditors or insolvency practitioners, will not save directors from liability if it is shown that there were other indicators which would have made it clear to the directors that the company was financially distressed and that it was headed for insolvent liquidation.

On the meaning of "every step" in the defence, it has been established that it is not possible to enumerate all the steps that are likely to satisfy the court in all cases as the sufficiency of the steps will depend on the circumstances of each individual case. In this vein, it has been established that all that the directors should not do in each individual case is to do nothing, and, further, that each and every step that the directors decide to take must be geared towards the minimization of the potential losses to the company's creditors as a whole and not only for particular creditors.

It has also been observed in this chapter that there are some steps which have previously satisfied the courts leading into directors who took the steps being exonerated from liability for wrongful trading. One of such steps is the seeking of

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

professional advice; *Re Bath Glass Ltd*; *Re Douglas Construction Services Lt; Re Brian D. Pierson (Contractors) Ltd*, and *Re Purpoint Ltd*. Resignation has also been considered to be a reasonable step particularly where the director's advice or recommendation before a board is not heeded or is voted out. Cessation of business and immediate placement of the company into some form of an insolvency process has also been shown to be likely to impress the courts.[709]

Related to the issue of prompt cessation of business, it has been established in this chapter that the fact that the director allowed the company to continue trading when he knew that the company was insolvent will not automatically result into liability for wrongful trading as there will be times when continuing to trade is justified on the desire to maintain the value of some assets in readiness for a sale, or even to maintain the value of the business itself for it to sell as a going concern.[710]

Lastly, this chapter has considered whether a director facing wrongful trading proceedings can escape liability by relying on general corporate law defences such as the defence under the Business Judgement rule. In this line of defence, the director would be arguing that in satisfaction of the requirement to take "every step" as required by the defence, he simply made a good faith business judgement decision and hoped that its implementation would save the business, although things may have turned out differently.

It has been established that the courts are likely to uphold this defence on the basis that the making of the good faith business decision is tantamount to taking every step with the view to minimizing loss to the company's creditors. However, it has been noted that this is a difficult and risky defence to be argued on its own, given the stringent factors outlined in the Companies Act in Malawi for the availability of this defence.

Further, the extent of success of the business judgement decision as a defence to wrongful trading is admittedly minimal, as other pedantic judges may opt to restrict

[709] See generally paragraph 5.3.8 above.

[710] See paragraph 5.4 above.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

the defences to only those provided by the wrongful trading rule itself, and there is a possibility of some courts finding a director's reliance on this defence to have been a deliberate attempt to avoid carrying out the complex responsibilities towards the company which could avail the director the statutory wrongful trading defence of taking "every step."[711]

[711] See generally paragraph 5.5 above.

© University of Pretoria

CHAPTER 6

REMEDIES IN WRONGFUL TRADING PROCEEDINGS

SUMMARY

6.1 Introduction……………………………………………………………215

6.2 The contribution order as the sole remedy in wrongful trading proceedings…………………………...…………216

6.3 Purpose of the contribution order………………………………….…216

6.4 Court's discretion to make the contribution order………………………217

6.5 The contribution sum: Calculation of the increase in the net deficiency of the assets of the company………..……………218

6.6 Secured creditors benefitting from the contribution………………………224

6.7 Post-wrongful trading creditors and pre-wrongful trading creditors benefitting equally from the contribution sum…………………229

6.8 The contribution order where liability has attached to more than one director……………………………………..…………231

6.9 Director offsetting the contribution sum with sums owed to him by the company……………………………………232

6.10 **Chapter conclusion……………………………………………..………233**

© University of Pretoria

6.1 INTRODUCTION

The previous chapter having discussed the defences available to a director during wrongful trading proceedings, this chapter discusses the sixth sub-question of the main research question of this study, namely, "what are the remedies available to a liquidator in wrongful trading proceedings in Malawi?" A discussion on this question is relevant to this study as it gives an insight of what a liquidator should expect to gain for the company and its creditors by initiating wrongful trading proceedings in Malawi, as well as the conditions he will have to satisfy before being awarded such a gain and other ancillary issues.

Upon being found liable for wrongful trading, the court may make an order that the respondent director contributes to the assets of the company as the court may think just.[712] In this study, this order is referred to as the "contribution order." The power to make a contribution order is discretionary and therefore there are circumstances when the court will refuse to make the contribution order even where a case for wrongful trading has been made out by a liquidator. This will usually happen where the liquidator has failed to prove an increase in the net deficiency of the assets of the company during the period of the wrongful trading. An increase in the net deficiency of the assets of the company is basically the loss suffered by the company by virtue of the alleged wrongful trading.

This chapter discusses the contribution order in detail as the only remedy in wrongful trading proceedings. The chapter begins by discussing the purpose of the contribution order and how the increase in the net deficiency of the assets of the company is computed. The chapter then discusses other pertinent issues that arise in respect of the contribution order, namely; whether the court can take into account a director's culpability in arriving at the contribution order; the court's discretion even where the computation of the contribution order has been achieved and whether a secured creditor, particularly a holder of a floating charge, is entitled to benefit from the contribution order.

712 Section 187(1) of the Insolvency Act of 2016.

© University of Pretoria

The chapter also discusses other pertinent questions relating to the contribution order, such as whether post-wrongful trading creditors and pre-wrongful trading creditors of the company should benefit equally from the contribution order; the contribution order where liability has attached to more than one director, and, finally, whether a director can off-set the ordered contribution sum with sums owed to him by the company.

6.2 THE CONTRIBUTION ORDER AS THE SOLE REMEDY IN WRONGFUL TRADING PROCEEDINGS

As it would be clear from section 187 of the Insolvency Act of 2016 in Malawi, upon a liquidator successfully making out a wrongful trading claim against a director, the court may order that the director contributes to the assets of the company as the court thinks just. The contribution order is, therefore, the only remedy provided under the wrongful trading provision.

6.3 PURPOSE OF THE CONTRIBUTION ORDER

It has been argued that the purpose of the contribution order made against a director who is found liable for wrongful trading is to compensate the company for the loss occasioned to it through the wrongful trading, and not to compensate the creditors who are directly affected by the said loss.[713] As this argument goes, under the wrongful trading remedy, the creditors' interests are mediated through the company.[714] This view can be traced back to the sentiments of the court in *Re Purpoint*[715] where it was said that:

> The court, in making [a wrongful trading order], is concerned to ensure that any depletion in the assets of the company attributable to the period when the directors knew or ought to have known that there was no reasonable prospect of avoiding an insolvency winding-up – in effect, while the company's business was being carried on at the risk of creditors – is made good…**The purpose is to recoup the loss to the company** so as to benefit the creditors as a whole. The court has no jurisdiction to direct payment to creditors or to direct that monies paid to the

713 Ho, LC "On Deepening Insolvency and Wrongful Trading" (2005) Vol 20, *Journal of International Banking Law and Regulation,* page 9, available at https://ssrn.com/abstract=741024 accessed on 17th December 2018.

714 Ibid.

715 (1991) BCC 121 at 128-129.

© University of Pretoria

> company should be applied in payment of one class of creditors in preference to another. Moreover, creditors whose debts are incurred after the critical date in fact have no stronger claim than those whose debts were incurred before that date. The former class also suffers to the extent that the assets of the company are depleted by wrongful trading. (emphasis supplied).

6.4 COURT'S DISCRETION TO MAKE A CONTRIBUTION ORDER

As it has been mentioned above, Section 187(1) of the Insolvency Act in Malawi is to the effect that where a director has been found liable for wrongful trading, the court "**may**" declare that the director is to be liable to make such contribution to the company's assets as the court thinks proper. The use of the word "may" as opposed to the use of the word "**shall**" in the provision makes it clear that the power to make the contribution order is discretionary. Case law has shown that the court will refuse to exercise this discretion where a liquidator has failed to prove an increase in the net deficiency of the assets of a company.

In *Re Ralls Builders Ltd (in Liquidation)*,[716] the liquidators brought wrongful trading proceedings against directors of the company on the basis that the directors ought to have realized much earlier that the company had no reasonable prospect of avoiding insolvent liquidation or administration. Although the court found the claim for wrongful trading to have been made out, it did not make a contribution order for the reason that it was not clear that the wrongful trading had increased the net deficiency of the company's assets. In the view of the court, although there was a period of wrongful trading, the liquidator failed to prove the loss that was suffered by the company as a result of the said wrongful trading.[717]

---

716 [2016] EWHC 243 (Ch).

717 The need to prove the exact loss suffered seems to be the same with respect to the reckless trading rule in South Africa, although the requirement is relaxed when the claim is not instituted by a liquidator of the company. In *Dorklerk Investments (Pty) Ltd vs. Bhyat* (1980) 1 SA 443 (W) at 448, the court decided that it could not exercise its discretion to award compensation for reckless trading to a claimant when the claimant, as it was in that case, made "so nebulous a claim, which is unliquidated except that it has been admitted as a claim against a company in liquidation". A contrary approach was taken by the court in *Cronje vs. Stone* (1985)3 SA 575 (T) where the court said that there is no requirement that a claim for reckless trading should always be liquidated. In *Retail Management Services (Edms) Bpk vs. Schwarts* (1992) 2 SA 22 (W) the court addressed this issue by distinguishing between applications brought by creditors themselves and applications brought by liquidators. The court said that where the application is brought by a creditor, he should be deemed to possess sufficient information to be able to make a liquidated claim and therefore he should be required to do so. Where the claim is made by a liquidator, the court said, there should be no requirement to make a liquidated claim as the liquidator may not possess

© University of Pretoria

Snowden J in that case said that in order for a court to make a contribution order, it was necessary to ascertain whether the company suffered any loss by virtue of it having continued trading after it's insolvent liquidation became inevitable, and that the starting point in doing this is to ask whether there was an increase or reduction in the net deficiency of the assets of the company after that date so that the losses that would have been incurred in any event by virtue of the company going into liquidation or administration should not be laid at the door of the directors.[718]

6.5 THE CONTRIBUTION SUM: CALCULATION OF THE INCREASE IN THE NET DEFICIENCY OF THE ASSETS OF THE COMPANY

In *Re Continental Assurance Company of London Plc.*,[719] the court said the following regarding computation of the contribution sum in wrongful trading proceedings:

> [T]he maximum quantity of liability [is not based on] a calculation of loss to the [the company's] creditors, but…the 'increase in net deficiency' which…reflects the loss to [the company] itself as a result of liquidation being delayed. The concept is that if the directors had decided on [the relevant date] that [the company] was insolvent, and had caused it to be put in liquidation then or soon or thereafter, there would have been a deficiency in the hypothetical…liquidation of one amount say £ x. In the actual case, [the company] did not go into liquidation until [a year later], and in the actual…liquidation there was a deficiency of a different amount, say £ y. If £ y is greater than £ x the excess is the increase in the net deficiency.[720]

all the sufficient information in respect of the losses incurred by creditors at the time of instituting the claim.

718 Ibid, at paras 241, 242. See also *Re Robin Hood Centre plc.* [2016] EWHC 2893 (Ch.).

719 (2001) B.P.I.R 733.

720 This can be contrasted with the position under the Australian insolvent trading rule where Enfeld J in *Metropolitan Fire Systems Pty Ltd vs. Miller* (1997) 23 CSR 699 said that the compensation to be awarded to the claimant is the amount of the debt, less the likely dividends to be received by the claimant in the company's winding up. Given that in the circumstances of this case the claimant was unlikely to receive any dividend in the winding up of the company, the learned Judge ordered that the claimant should receive the full amount of the debt. While it was not considered in the case, Herzberg A, "Why are there So Few Insolvent Trading cases?" (1998) 6 *Insolvency Law Journal*, 77, 84 has argued that conceivably, the compensation under the insolvent trading provisions could also include consequential losses suffered by creditors.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

Similarly, in *Re Ralls Builders Ltd (in Liquidation)*,[721] the court said that the correct approach to calculate the maximum contribution by directors in wrongful trading claims is to provide a proper account of the increase in net deficiency of assets of the company over the relevant period.

In *Nicholson and Another vs. Fielding and Others*,[722] the court said that where insufficient financial data is available, a simplified calculation may be undertaken where the court estimates the increase in the net deficiency of the assets of the company for the relevant period by prorating an increase between two dates with known data. In this case, the liquidators relied on a comparison of the figures in the statement of affairs for 2009 when the company went into liquidation, with the balance sheet as of 31st October 2008.

The court found this to be an incorrect approach for two reasons. First, the court said that since sufficient financial information was available, a proper account should have been based on the available management accounts for the period and compared with what the position would have been upon liquidation. Secondly, the court said that reliance on the statement of affairs for 2009 was utterly inappropriate as there was uncertainty as to whether any of the creditors had been paid from the time the statement of affairs had been drafted.

Due to the improper method used by the liquidator in calculating the increase in the net deficiency of the assets of the company, the court concluded by remarking that had the wrongful trading claim been successful, it would not have made an order for contribution on the basis of the liquidators' failure to calculate the increase in the net deficiency of the assets of the company during the alleged period of wrongful trading.[723]

721 (2016) EWHC 1812 (Ch).

722 (2007) ALL ER (D) 156.

723 Clearly, the wrongful trading claim was not made out in the *Nicholson* decision. However, the decision remains authoritative to the position that even where the wrongful trading claim is made out by a liquidator, the discretion of the court in making a contribution order may see the court ordering zero or nothing towards the company's assets if a liquidator fails to properly prove an increase in the net deficiency of the assets of the company during the period of the said wrongful trading.

© University of Pretoria

In *Re Pourpoint Ltd*,[724] the court said that where, because of the director's failure to ensure that proper records were kept, it is impossible to ascertain the precise extent to which the company's net liabilities are increased by virtue of the company having continued trading when it ought not to, the loss is to be calculated as the aggregate of the debts incurred after the date when it should have been clear to the director that the company could not avoid going into insolvent liquidation.[725]

From the foregoing, it will be clear that a contribution order will only be made when, over and above making out a successful wrongful trading case, a liquidator proves a nexus between the said wrongful trading and the loss which has been occasioned to a company due to the said wrongful trading. In *Re Continental Assurance Co of London plc.*,[726] Park J expressed the view that there must be some connection between the director's wrongful conduct and the losses that the liquidator wishes to recover from him. This connection between wrongful trading and loss to creditors must be shown by a liquidator through proving an increase in the net deficiency of the assets of the company during the alleged wrongful trading period.[727]

While this connection would be satisfied in the case of normal trading losses, it will not be satisfied where the losses in question have been caused by unforeseen events not

[724] (1991) BCLC 491, 498.

[725] Ibid at p. 499. Note that in *Re DKG Contractors Ltd* [1990] BCC 903, 912 the judge ordered the directors to contribute an amount equal the debts incurred after trading should have ceased.

[726] (2007) 2 BCLC 287.

[727] Although not necessarily with respect to the quantum of compensation, but rather the burden of proof in the South African equivalent of the wrongful trading rule, the reckless trading rule under section 424 of the repealed 1973 Companies Act of South Africa, it has been contended that where a claimant has no means of proving his claim regarding the operations of the company because the facts lie exclusively within the knowledge of the company itself, less evidence will suffice, particularly where the company elects not to lead evidence to reveal the facts or to furnish any explanation of the evidence given by the claimant; *Strut Ahead Natal (Pty) Ltd vs. Burns* 2007 (4) SA 600 (D) at 608. This reasoning, it is submitted, could be extrapolated, with respect to the need to prove an increase in the net deficiency of the assets of the company in a wrongful trading claim, to require that where the facts required to make such proof lie exclusively with the respondent directors and the company itself, and they elect not to lead evidence to reveal the facts or contradict what the claimant alleges, the court should be willing to relax the standards and accept the little measure of proof brought by a claimant, particularly where the claimant is not a liquidator, who would have full records of the company's operations during the relevant period of wrongful trading, but a mere creditor (as it is proposed in chapter 10 of this study that creditors should have standing to commence wrongful trading proceedings).

© University of Pretoria

attributable to the impugned conduct, such as unexpected weather conditions or costly litigation conducted by the liquidator.[728]

6.5.1 Can the court take into account the fact that the director's conduct was culpable when making a contribution order?

The question whether the court should take account of the culpability of a director's conduct when deciding on the contribution sum is an important question that seems to have divided the opinions of the courts. To begin with, the fact that the court has discretion to make a contribution order that it thinks proper may well be interpreted to imply that the court may take account of the director's culpability in arriving at the contribution sum.

However, when one considers that taking account of a director's culpability may require increasing the contribution sum so as to make it punitive, this may not be consistent with the view taken by the court in *Re Continental Assurance Co of London Plc*[729] that the court's discretion only exists in reducing the contribution sum from the sum arrived at after calculating the increase in the net deficiency of the assets of the company during the period of wrongful trading and not in increasing the said sum.

In *Re Produce Marketing Consortium Ltd (No. 2)*,[730] Knox J, while accepting that the contribution sum must be measured by the amount by which the assets of the company have been dissipated by the wrongful trading, left open the possibility of the court having to consider that the conduct of the director in question was culpable. The court said that the jurisdiction of the court is ***primarily*** compensatory than penal,[731] giving rise to the interpretation that while the court may include a penal element in the award against directors who have been culpable than those who have been honest or naive, penalizing directors is not the primary purpose of the contribution order.[732]

---

728 Ibid, at para 21. See also *Morphitis vs. Bernasconi* [2003] Ch. 552 at para 53 (a fraudulent trading case).

729 (2007) 2 BCLC 287.

730 [1989] 5 BCC, 569.

731 Ibid, at p 597.

732 Ibid at p 597-598.

© University of Pretoria

However, the other part of Knox J's judgement, in *Re Produce Marketing Consortium Ltd (No. 2)*,[733] namely, that when making the contribution order, the court should consider whether the director was guilty of deliberate wrongdoing or a failure to appreciate the situation, can also be seen to be in support of the suggestion that the court is at liberty to consider culpability on the part of the director when ordering a contribution.

In *Re Brian D Pierson (Contractors) Ltd*[734] the court also added that some of the factors which a court may take into account in making a contribution order include; the fact that the company's financial position was worsened by influences beyond the director's control or reasonable anticipation; the fact that the director received no warning from professional advisers and, in the event that the said advice was given, the attitude of the director towards the said advice, as well as the fact of whether or not the director relied on the experience and dominance of the other directors.[735]

In *Brooks vs. Armstrong (also known as Joint Liquidators of Robin Hood Centre Plc vs Armstrong*,[736] the court said that the compensation in wrongful trading actions should be linked to the liabilities that result from the wrongful trading, giving an example that if weather had caused loss, this should not be regarded as a fault of the directors who wrongly allowed the company to carry on trading but, rather, that compensation must be seen to flow only from the losses occasioned by the decision to trade wrongfully.

While Knox J's judgement, in *Re Produce Marketing* decisions may arguably be interpreted to mean that culpability in a director's conduct is a factor which should not be ignored by the court in arriving at a contribution sum in wrongful trading

---

733 [1989] 5 BCC, 569.

734 (1999) BCC 26.

735 At p 56-57, 310-311. Note however that the notion of providing for a penal award in making a contribution order was rejected by the court in *Morphitis vs. Bernasconi* (2003) 2 WLR 1521. This having been a fraudulent trading case where culpability was up to the criminal standard of proof, there is reason not to allow the penal element in cases of wrongful trading where the level of culpability may be less.

736 (2015) EWHC 2289 (Ch).

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

proceedings, the *Re Brian D Pierson* and the *Brooks vs. Armstrong* decisions clearly indicate that culpability in the director's conduct is not a factor to be taken into account by the court in arriving at a contribution sum.

In *Re Farmizer (Products) Ltd*,[737] the court of Appeal totally rejected the notion of inclusion of a penal element in the contribution order in a wrongful trading action. In the end, until a contrary decision appears, the position will remain, as Keay[738] has observed, that while the actions of the directors will not lead to a penal award, if the directors act honestly, the contribution award will almost invariably be reduced.

6.5.2 Court's discretion even where the increase in net deficiency is proved

It would appear that even where the increase in the net deficiency in the assets of the company has been proved during the wrongful trading period, the court still retains the discretion to order a contribution sum that it thinks proper in the circumstances of each individual case and not necessarily the exact amount that has been shown to be the loss to the company as indicated by the increase in the net deficiency of the assets of the company. This stems from section 187(1) of the Insolvency Act where the court is given the power, when making the contribution order, to make the order that it thinks proper, and not necessarily to order a contribution of the same amount proved by the liquidator.

In *Re Continental Assurance Co of London Plc*,[739] Park J remarked that while the court has jurisdiction under the wrongful trading provision to order an amount that it thinks proper, the said jurisdiction is not at large in the sense that the court will first have to determine the maximum amount that could be ordered, namely the amount by which the assets of the company have been depleted by the wrongful trading (the so called increase in the net deficiency of the assets of the company during the wrongful trading) and upon such determination, the discretion of the court will be exercised to reduce the said amount as the court thinks proper.

---

737 (1997) BCC 665.

738 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York* 102.

739 (2007) 2 BCLC 287at p 821.

© University of Pretoria

In *Brooks vs Armstrong (also known as Joint Liquidators of Robin Hood Centre Plc vs Armstrong*,[740] although having found that a wrongful trading case was made out, the court acknowledged that there had been some benefit in the decision to continue to trade in that it had reduced the company's bank overdraft by £16,000.00 and trade creditors had been paid to the extent of £89, 000.00. However, the court found this benefit to have been enjoyed at the expense of payment of rentals to the company's landlord; payment of taxes to HMRC and payment to the city council. In the exercise of his discretion, the judge was satisfied that the discrimination in payments, though wrongful, was not dishonest and was not with bad intent and consequently the court reduced the contribution sum by 50%.

It must be noted that although it would appear from the decision in *Re Continental Assurance Co of London Plc*[741] that the court's discretion merely lies in reducing the contribution sum from the maximum determined, the discretion cannot be exercised haphazardly, and therefore determining the order of contribution to be made is still a difficult task for the court. In *Official Receiver vs Doshi*,[742] the court had to admit further evidence and hear new arguments in order to make a determination of the contribution sum. In *Rubin vs Gunner& Another*,[743] the court ordered an account to be conducted in order for it to arrive at a proper contribution sum.

6.6 SECURED CREDITORS BENEFITTING FROM THE CONTRIBUTION SUM

When the court makes a contribution order against directors in a wrongful trading claim, the contribution is to be made to the company's assets for the benefit of the creditors. There are two important questions that arise in this regard. First, considering that there are two types of creditors, secured and unsecured, the question is whether a secured creditor, such as a holder of a floating charge, is entitled to benefit from the

740 (2015) EWHC 2289 (Ch).

741 (2007) 2 BCLC 287.

742 (2001) 2 BCLC 23.

743 (2004) EWCH 316.

© University of Pretoria

contribution sum in a wrongful trading claim and in priority to the unsecured creditors. Second, the question also arises as to whether the creditors who suffered loss during the period of wrongful trading should benefit equally with those creditors whose loss emanates from the period before wrongful trading commenced. These two issues will be discussed separately below.

6.6.1 Whether a holder of a floating charge is entitled to benefit from the contribution sum

In *Re Produce Marketing Consortium Ltd (No 2)*[744] Knox J stated that a floating charge holder would have a charge over the contribution sum which was ordered, although the learned judge indicated that he disagreed with this state of affairs and that he would wish that the contribution sum only benefited unsecured creditors.[745]

The starting point in addressing the question of whether a floating charge holder is entitled to benefit from the contribution sum in wrongful trading proceedings is to answer a preliminary question of whether the contribution sum so ordered by the court against a director becomes an asset of the company, for the reason that if the answer to this question is in the affirmative, then no doubt the contribution sum is subject to a floating charge against the company's assets and indeed that the holder of the floating charge is entitled to priority against unsecured creditors of the company.

In *Re Oasis Merchandising Services Ltd (in Liquidation)*,[746] Robert Walker J, in relation to the question whether the fruits of a wrongful trading action are the 'property of the company' capable of being sold, said the fruits of a wrongful trading action cannot be described as the property of the company because the company must go into insolvent liquidation first, before a wrongful trading action can arise, and therefore that the moment the company goes into insolvent liquidation, it is no longer the beneficial owner of its assets as the said assets automatically become the subject of a statutory

744 (1989) 5 BCC 569.

745 Ibid, at p. 598.

746 (1998) Ch 170.

© University of Pretoria

trust for the creditors.[747] In holding this view, the learned judge relied on the dictum of Millet J in *Re M.C. Bacon (No. 2)*[748] who said:

> In my judgement, the same reasoning applies even with greater force to a claim brought under [wrongful trading] which can be brought only by a liquidator not an administrator and in the absence of an insolvent liquidation cannot be brought at all. In any case, I do not see how in an application for such an order, [a wrongful trading action] can properly be described as an attempt to realize or get in an asset of the company. This must, in my view, mean an existing asset and, until the order has been made and complied with, there is no such asset.[749]

This view is shared by Odittah[750] who wonders why a charge holder can establish entitlement to the wrongful trading payment when the right of action never vested in the company at any stage, but in the liquidator. According to Odittah;

> …if both the action and the recoveries vest exclusively in the liquidator then it stands to reason that the recoveries will be outside the scope of any charge granted by the company over its property….The fact that recoveries comprise 'assets of the company' for the purposes of the Insolvency Act…is of no consequence. In light of the House of Lords' decision in Buchler vs Talbot [2004] UKHL 9; [2004] 2 AC 298, this wording simply denotes the fund of assets available for distribution under the statutory winding-up scheme.[751]

The foregoing view has, however, been criticized and controverted. Look Chan Ho[752] has expressed a contrary view based on three footings. First, quoting with approval the reasoning of the court in *Re Purpoint*,[753] and *Re Continental Assurance Co. of*

---

747 See also *Ayerst vs. C & K (Construction) Ltd* (1976) AC 167 per Lord Diplock at pp.176-180.

748 (1991) Ch. 127; (1990) BCLC 607 at p. 613.

749 The Court of Appeal decision in *Oasis Merchandising* thus overturned the judgement of Knox J in *Re Produce Marketing*.

750 Odittah F. "Wrongful Trading" (1990) *LMCLQ* 205 at 218.

751 Ibid.

752 Ho, LC "On Deepening Insolvency and Wrongful Trading" (2005) Vol 20, *Journal of International Banking Law and Regulation,* page 9, available at https://ssrn.com/abstract=741024 accessed on 17th December 2018.

753 (1991) BCC 121 at 128-129.

© University of Pretoria

London,[754] Ho has argued that the view that the proceeds of a wrongful trading action are not an asset of the company is illogical when one considers that the essence of the wrongful trading action itself is to compensate the company, and not the creditors, for the loss it suffers as a result of trading having been prolonged when it ought to have stopped.[755] According to Ho, the creditors' interests under the wrongful trading remedy are mediated through the company.[756]

Secondly, Ho has argued that the view that the proceeds of a wrongful trading action are not an asset of the company has been implicitly disapproved by the House of Lords in *Smith (Administrator of Cosslett (Contractors) vs. Bridgend County Borough Council*,[757] where in interpreting a provision under the Companies Act which was to the effect that "a charge created by a company…is…void against the liquidator or administrator," the House of Lords held that the phrase "void against the liquidator" means void against the company acting by its liquidator, that is to say, a company in liquidation.[758]

According to Ho, applying the same reasoning to wrongful trading actions, it would become clear that a wrongful trading claim is a claim actionable at the suit of the company acting through its liquidator, that is to say, the company in liquidation, and therefore that a wrongful trading claim belongs to the company in liquidation and the contribution sum ordered in a wrongful trading action is, for that reason, an asset of the company.[759]

754 (2001) B.P.I.R 733.

755 Ho, LC "On Deepening Insolvency and Wrongful Trading" (2005) Vol 20, *Journal of International Banking Law and Regulation,* pages 15-16, available at https://ssrn.com/abstract=741024 accessed on 17th December, 2018.

756 Ibid.

757 (2001) UKHL 58; (2002) 1 A.C. 336.

758 Ibid, at p. 21.

759 Ho, LC "On Deepening Insolvency and Wrongful Trading" (2005) Vol 20, *Journal of International Banking Law and Regulation,* pages 15-16, available at https://ssrn.com/abstract=741024 accessed on 17th December, 2018.

© University of Pretoria

Lastly, Ho argues that the view that the proceeds of a wrongful trading action are not an asset of the company is incompatible with the drafting of the wrongful trading provision itself which is to the effect that the court "on the application of the liquidator, may declare [a] person …liable to make…contribution…to the *company's assets*.[760] According to Ho, the amount of contribution is recognized by the Insolvency Act as an asset of the company and that is why is it ordered to be paid to the company in order to increase the total assets of the company.[761] Ho wonders as follows: "If the said amount of contribution is not already an asset of the company, under what principle will it automatically become part of the assets of the company when it is paid to the company?"[762]

Although currently there seems to be no court decision that contradicts the position set by the court in the *Re Oasis Merchandizing* decision, namely that the proceeds of a wrongful trading claim are not an asset of the company because the said proceeds do arise way after the solvent life of the company, the arguments by Look Chan Ho above seem to make much more sense and they are compatible with the drafting of the wrongful trading rule itself, which is to the effect that the contribution is made to the assets of the company, and if the purpose of the contribution is to increase the said assets, then indeed the contribution sum is already an asset of the company for if it is not, how can it increase the said assets?

Based on the foregoing analysis, there seems to be a good reason to assert that proceeds of a wrongful trading action are an asset of the company, and based on this understanding, a holder of a floating charge is entitled to benefit from the proceeds of wrongful trading proceedings by virtue of the same being part of the assets of the company. By the same reasoning, to the extent that a secured creditor holds a floating charge against the assets of the company, he may be able to benefit from a contribution sum in wrongful trading proceedings.

760 Ibid.

761 Ibid.

762 Ibid.

© University of Pretoria

6.7 POST-WRONGFUL TRADING CREDITORS AND PRE-WRONGFUL TRADING CREDITORS BENEFITTING EQUALLY FROM THE CONTRIBUTION SUM

The wrongful trading remedy was designed to provide compensation for the loss suffered by virtue of the company having been allowed to continue trading when it could not pay its debts as they became due to the extent that trading ought to have been stopped by the directors. When the contribution order is made, it is said that it is designed to compensate the company for the loss it incurs with respect to claims of creditors by virtue of the prolonged trading.

However, it is said that this compensation, being made to the company, is for the benefit of the creditors as a whole, and not for a particular class or group of creditors. This means that the contribution order will be expected to compensate the creditors whose debts were incurred during the wrongful trading period, (the real wrongful trading victims) as well as the creditors whose debts were incurred before wrongful trading commenced. The question that arises is whether the later class of creditors deserve to benefit from the contribution sum in a wrongful trading claim, considering that they are, strictly speaking, not wrongful trading victims.

This question arises from discontent with the current position where it appears that the contribution order, which is a wrongful trading remedy, compensates non-wrongful trading victims, namely, creditors whose debts with the company arose in the normal course of the company's trading and not by virtue of the company having engaged in wrongful trading.[763] As the argument goes, the contribution sum, being a wrongful trading remedy, ought to compensate the company only for the loss suffered by the victims of wrongful trading, namely, those creditors whose debts arose during the period of wrongful trading.

It would appear that the proposition to separate creditors for the sake of having one class of them to benefit from the contribution sum in wrongful trading proceedings is

763 Hicks, A "Advising on wrongful trading: Part 1" (1993) 14 *Co law* 16 at p. 17.

© University of Pretoria

not favoured by the courts.[764] In *Re Purpoint Ltd*,[765] and in *Re Oasis Merchandising Services Ltd*,[766] the courts categorically held that they cannot make orders in favour of particular groups or classes of creditors in wrongful trading actions as the objective of the wrongful trading remedy is to assist a liquidator to recoup the loss to the company so as to benefit the creditors as a whole. In particular, the court in the *Re Purpoint* decision remarked that those who became creditors before the commencement of the wrongful trading are equally prejudiced by the company's loss of funds in the same way that those who became creditors during the period of wrongful trading are.

Keay[767] supports this view and finds it justified on the basis that those who became creditors before the period of wrongful trading are equally prejudiced in the sense that they would have received more on a distribution in liquidation if the directors had not engaged in wrongful trading. The position has also been supported recently by the court in *Brooks vs Armstrong (also known as Joint Liquidators of Robin Hood Centre Plc vs Armstrong*,[768] where the court said that the award would be for the benefit of the creditors as a whole, not just to creditors who may have suffered loss closer to the date

---

764 With regard to the reckless trading rule in South Africa, the court, in *Bowman vs. Sacks* 1986 4 SA 459 (W) stated that sometimes it will be more appropriate to exercise the court's discretion, in awarding compensation for reckless trading, to the advantage of all creditors and not only to the advantage of the creditors who bring up the proceedings. The reason for this, the court said, is that the purpose of the reckless trading rule under section 424 of the 1973 Companies Act is not to alter priorities amongst creditors by allowing favoured treatment. Where the proceedings have been instituted by a liquidator, however, the position is clear as it was stated in *Fundstrust (Edms) Bpk (in likwidasie) vs. Marais* 1997 3 SA 470 (K) that proceeds of a successful action brought by a liquidator will form part of the assets of the company to be distributed to the general body of creditors. Brusser "Actions against Delinquent Directors" 1985 *SA Company LJ* 33 34 is of the opinion that there is no reason why the court should not direct payment to the creditor or creditors who suffered loss as a consequence of the reckless trading as long as the company is not yet in liquidation. However, in *Philotex (Pty) Ltd vs. Synman* 1998 2 SA 138 (SCA), however, the court make an order for payment of specific sums to specific creditors regardless of the fact that the company was in liquidation, prompting Havenga, M "Creditors, Directors and Personal Liability under section 424 of the Companies Act" 1992 *SA Merc LJ* 63 69 to bemoan the uncertainty that exists with regard to the party to whom the court may order the compensation envisaged by the reckless trading rule. To this end, Havenga submits, the reckless trading rule is in need of amendment in this respect in order for it to 'become a truly effective remedy in the hands of company creditors.'

765 (1991) BCLC 491 at p. 499.

766 (1998) Ch 170.

767 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 107.

768 (2015) EWHC 2289 (Ch).

© University of Pretoria

of liquidation,[769] and that the creditors whose debts were incurred after the date of wrongful trading have no greater claim than creditors whose debts had been acquired earlier.[770]

The Irish equivalent of the wrongful trading rule seems to have done away with the difficulty of the rule compensating creditors whose debts were not incurred during the period of the wrongful trading equivalent in the Republic of Ireland. This is done by the statute empowering the court to direct who may and who may not benefit from the contribution sum. Section 297A of the Irish Companies Act 1963 provides that 'the court may determine that the sums recoverable under the provision shall be paid to such persons or classes of persons, for such purposes, in such amounts or proportions at such time or times and in such respective priorities among themselves.'[771] Through this position, the Irish courts are at liberty to direct that only the creditors whose debts arose by virtue of the company being allowed to continue trading when trading ought to cease should be compensated, if, for some reason, the court finds this desirable.

6.8 THE CONTRIBUTION ORDER WHERE LIABILITY HAS ATTACHED TO MORE THAN ONE DIRECTOR

It has been stated in *Re Brian D Pierson*[772] that where more than one director is subject to the wrongful trading proceedings, the court has discretion whether to hold the said

---

769 This will be seen to be an extension to the ambit of this factor as it was stated in the *Re Produce Marketing* decision which seemed to suggest that as long as the contribution order takes account of the plight of unsecured creditors, then it suffices. It is submitted that this extension embodies the spirit behind wrongful trading claims, which is to ensure that the interests of creditors as a whole are taken into account.

770 With regard to the reckless trading rule in South Africa, the position is made clear in *Cronje vs Stone* 1985 3 SA 597 (T) that a court, in exercising its discretion to award compensation in a reckless trading claim, could distinguish between debts incurred prior to the business of the company being conducted recklessly and those incurred thereafter. In that regard, liability for reckless trading could therefore be limited to those debts that were incurred during the reckless trading period. However, a contrary opinion was given in *Kalinko vs. Nisbet* 2002 5 SA 766 (W)777 where the court said that that the time when the debt was incurred is irrelevant but that one should simply look at whether the alleged reckless conduct of the officer in question negatively influenced current debts. In *Nel and Others NNO vs. McArthur* 2003 4 SA 142 (T) where the court said that for the reason that no causal link is required under the reckless trading rule in relation to the conduct of the officer and the debt in question, all debts are covered by section 424 and not only those specifically arising from the reckless conduct.

771 Section 297(7)(b) of the Act.

772 (1999) BCC 26 at p. 57; 311.

© University of Pretoria

directors jointly and severally liable on the one hand, or severally liable on the other hand.[773] In *Re Produce Marketing Consortium Ltd*,[774] and in *Re DKG Contractors Ltd*,[775] the court held the directors to be jointly and severally liable, while in *Re Continental Assurance Co. of England Plc.*[776] the court did not hold the directors liable but remarked that if the directors were to be held liable, it would be inappropriate to hold them jointly and severally liable. In the view of the court, several liability in the circumstances of this case was the starting point, from where the court could exercise its discretion and make the directors liable jointly and severally if it wished so to do.[777]

The basis for this view, as it was expressed by Park J, was that the focus in the wrongful trading provision is on the conduct of an individual director, and not on the collective conduct of the board of directors,[778] for which reason, the judge said, he would have ordered several liability if he felt that the directors were liable.

6.9 DIRECTOR OFFSETTING THE CONTRIBUTION SUM WITH SUMS OWED TO HIM BY THE COMPANY

One important question that remains to be discussed with respect to the contribution order is whether a director who has been held liable for wrongful trading and who has been ordered to pay a particular contribution sum can offset the contribution sum with any sum owed to him by the company.

According to Keay,[779] directors are not able to offset any payment which they may be owed by the company against the contribution sum in a wrongful trading action. The

773 See also *Re Continental Assurance Co of England Plc* (2007) BCLC 287 at p. 847.

774 (1999) 5 BCC 569 at p. 598.

775 (1990) BCC 903 at p. 912.

776 (2007) BCLC 287.

777 Ibid.

778 Ibid, at p. 846.

779 Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*, 108.

© University of Pretoria

rationale for this position was given by the court in *Guinness plc vs Saunders*[780] where the court said that there is an absence of mutual dealings as the debt owed by the company involves a dealing between the director and the company, while the wrongful trading issue is between the director and the liquidator.

Lending weight to the foregoing position, Odittah,[781] has argued that wrongful trading creates 'a liability to contribute to the general assets of the company, and, since it does not give a right of set-off, the statutory ability to contribute extends to the whole amount ordered to be paid. Odittah sums this up by contending that based on policy considerations 'it is not right that a director…guilty of wrongful…trading should have his liability to contribute converted into a debt so as to provide him with a right of set-off. [782]

6.10 CHAPTER CONCLUSION

This chapter has discussed the remedies available to a liquidator who successfully makes out a wrongful trading case against a director in Malawi. According to section 187 of the Insolvency Act of 2016 in Malawi, upon making a finding of liability for wrongful trading against a director, the court may make a declaration that the director contributes to the assets of the company as the court thinks proper. In this study, this order has been referred to as the contribution order, and it has been established in this chapter that the contribution order is the only remedy available to a liquidator in a wrongful trading action.

Further, it has been established in this chapter that the purpose of the contribution order is to compensate the company for the loss it suffers due to the wrongful trading, and not to compensate the creditors who are directly affected by the wrongful trading for the reason that the creditors' interests are mediated through the company.

780 (1998) 1 WLR 838, affirmed on appeal (1990) 2 WLR 324.

781 Odittah, F "Wrongful Trading" (1990) *LMCLQ* 205 at 222.

782 Ibid.

© University of Pretoria

On the question of how the court arrives at the contribution sum after a wrongful trading case has been made out, it has been established that the burden is on the liquidator to prove an increase of the net deficiency of the assets of the company during the wrongful trading period. The increase in the net deficiency of the assets of the company has been shown in this chapter to be the amount with which the assets of the company have been depleted due to the wrongful trading.

On the question of whether the court must take into account the culpability of the director's conduct when making the contribution order against him in a wrongful trading action, it has been established that although there is some indication to this effect in the judgement of Knox J in *Re Produce Marketing Consortium Ltd*, the general consensus from case law and commentaries is that taking account of a director's culpability in arriving at the contribution order makes the contribution order more penal than compensatory and this is contrary to the spirit of the wrongful trading rule as a civil enforcement mechanism.

On the question of the court's discretion in making the contribution order, it has been established that the use of the word "may" in the wrongful trading provision entails that even where the wrongful trading case has been made out, the court is at liberty not to order any contribution to the assets of the company against a director. Usually this occurs where, although having successfully made out a wrongful trading case, the liquidator fails to prove an increase of the net deficiency of the assets of the company.

It has also been established that in its discretion, the court may order a contribution sum that is lesser that the increase of the net deficiency of the assets of the company, where circumstances exist warranting the same. An example has been shown in the decision of *Brooks vs Armstrong (also known as Joint Liquidators of Robin Hood Centre Plc vs Armstrong*, where the court reduced the contribution sum by 50% for the reason that the directors made efforts in paying off some debts of the company during the period of wrongful trading although the payments were found to be discriminatory for disregarding other creditors completely.

It has also been established that the court's discretion as far as the contribution order is concerned only lies in reducing the contribution sum and not increasing it as increasing

© University of Pretoria

it would be more penal than compensatory and that this is contrary to the spirit of the contribution order as it is designed to be more compensatory than penal.

On the question of whether secured creditors, such as a holder of a floating charge can benefit from the contribution sum, it has been established that since the contribution sum automatically becomes an asset of the company for the reason that it is made to increase the assets of the company, a holder of a floating charge can have recourse to the contribution sum as was said in *Re Produce Marketing Consortium Ltd (No 2),* per Knox J.

On the question of whether pre-wrongful trading creditors should benefit from the contribution sum in the same way as post-wrongful trading creditors who are the real victims of the wrongful trading in question, it has been established that even pre-wrongful trading creditors do suffer losses by virtue of the company having gone into insolvent liquidation because of the wrongful trading and for this reason, they are entitled to benefit from the contribution sum in the same way as the post-wrongful trading creditors; *Re Purpoint Ltd;* and *Re Oasis Merchandising Services Ltd.*

On the question of apportionment of the contribution order where the wrongful trading liability has attached to more than one director, it has been established that the court, in those circumstances, has the discretion to hold the directors either jointly and severally liable on the one hand, or severally liable on the other hand; *Re Brian D Pierson; Re Produce Marketing Consortium Ltd; Re DKG Contractors Ltd; Re Continental Assurance Co of England Plc.*

Finally, on the question of whether a director can offset a contribution sum ordered against him with a sum or sums due to him from the company, it has been established that a director cannot have his liability for wrongful trading converted into a debt as for him to secure a right to have the contribution sum set-off with sums due to him from the company.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

CHAPTER 7

FUNDING OF WRONGFUL TRADING PROCEEDINGS

SUMMARY

7.1 Introduction..236

7.2 The funding problem...237

7.3 Funding by the company...240

7.4 Funding by private third parties: maintenance and champerty.........246

7.5 Funding by creditors...254

7.6 Chapter conclusion...254

7.1 INTRODUCTION

The preceding chapter having addressed the question of remedies available to a liquidator in wrongful trading proceedings, this chapter is dedicated to answering the seventh and the last sub-question of the main research question of this study, namely, "how are wrongful trading proceedings funded?" A discussion of this question is pertinent as, apart from outlining all the avenues of funding in wrongful trading proceedings, the discussion will also show that the issue of funding of the wrongful trading proceedings is key to the vibrance of the wrongful trading rule in Malawi.

Funding of wrongful trading proceedings presents one of the greatest obstacles in the success of the wrongful trading mechanism. This chapter discusses three possible sources of funding of wrongful trading proceedings. Firstly, the chapter discusses funding by the insolvent company itself and highlights the challenges that are faced in expecting a company which is already financially distressed, by virtue of it being under insolvent liquidation, to be able to fund prosecution of speculative wrongful trading claims.

© University of Pretoria

Secondly, the chapter discusses funding of wrongful trading proceedings by private third-party arrangements. Under this avenue, the chapter discusses funding through maintenance and champerty arrangements. Under common law, maintenance and champerty are against public policy. For this reason, the chapter discusses the public policy concerns against maintenance and champerty as well as the exception to the said public policy in insolvency proceedings, commonly referred to as "the insolvency exception" to maintenance and champerty.

Further, the wrongful trading rule having been adopted from the UK Insolvency Act of 1986, the chapter discusses the recent reforms that have been made to the said UK Insolvency Act, particularly those reforms that have a bearing on the funding of the wrongful trading proceedings. The chapter then discusses the said reforms in relation to the current position of the law under the Insolvency Act of 2016 in Malawi.

Finally, the chapter discusses the last source of funding of wrongful trading proceedings, namely, funding by creditors of the company. The discussion highlights the challenges which are faced in expecting creditors of the company to fund prosecution of speculative claims which, even if they were to succeed, the creditors who funded the proceedings do not benefit exclusively from the proceeds of the proceedings, but rather, the benefit is enjoyed equally by the general body of creditors, with creditors who are holders of floating charges being able to benefit in priority to creditors who funded the proceedings.

7.2 THE FUNDING PROBLEM

It has been recognized that one of the greatest hurdles in maintaining wrongful trading proceedings is the question of funding, for the reason that without funds to pay costs incidental to the prosecution of wrongful trading claims, liquidators are powerless to help creditors.[783] Commenting on this, Cook[784] has said that the treatment of the liquidators' costs in pursuing wrongful trading proceedings presents one of the major

[783] Armour, J and Walters, A "Funding Liquidation: A Functional Review" (2006) *Law Quarterly Review*, 1.

[784] Cook, C "Wrongful Trading – is it a real threat to Directors of a paper Tiger" (1999) *Insolv L* 99.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

problems associated with the wrongful trading mechanism. Hicks[785] concurs with the foregoing by arguing that the cost of investigating and pursuing wrongful trading claims presents the greatest inhibition to wrongful trading proceedings.

The magnitude of the funding problem in wrongful trading proceedings can be understood from the temptation that has appeared in some judges to strain statutory construction so as to enhance the funds available to liquidators maintaining the proceedings.[786] For instance, although it had been established quiet early in the history of corporate insolvency law that assets subject to a charge, floating or otherwise, did not form part of the assets of the company available for the unsecured creditors in liquidation,[787] in *Re Barleycorn Enterprises Ltd*,[788] a court of Appeal held that a liquidator's expenses were payable out of assets which were subject to a floating charge.

This decision seemed to imply that a liquidator might recoup the costs of an unsuccessful litigation out of floating charge assets, even where the action was a challenge to the validity of the floating charge itself.[789] The position led to further strained constructions as the judiciary tried to protect the well-established principle of "looser pays" which was on the verge of being eroded by the *Re Barleycorn* decision. Unsurprisingly, after a long battle of constructions in the judiciary, the decision in *Re Barleycorn* was overruled by the House of Lords in *Buchler v Talbot.*[790]

The starting point in appreciating the problem of funding of wrongful trading claims is to appreciate the fact that according to Section 187 of the Insolvency Act of 2016 in

785 Hicks, A "Wrongful Trading: Has it been a failure?" (11993) *8 Insolvency Law and Practice*,134.

786 Armour, J and Walters, A "Funding Liquidation: A Functional Review" (2006) *Law Quarterly Review*, 1.

787 Under this notion, the assets of the company were the so-called "free-assets", meaning the company's unencumbered assets. See e.g. *Re David Lloyd & Co* (1877) 6 Ch. D 339 at 344; *Re Wanzer Ltd* (1891) 1 Ch. 305 at 314; *Strong v Carlyle Press* (1893) 1 Ch. 268 at 276.

788 (1970) Ch. 465.

789 Armour, J and Walters, A "Funding Liquidation: A Functional Review" (2006) *Law Quarterly Review*, 1.

790 (2004) UKHL 9.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

Malawi,[791] wrongful trading claims can only be maintained by a liquidator of a company. According to Hirt,[792] one of the sources of the problem of funding of wrongful trading claims is the fact that the liquidator has no access to public funding to support the prosecution of the claims, and therefore that he or she will have to look to either the company or its creditors for funding of the proceedings.

As far as funding by the company is concerned, it has been observed that since the company will be undergoing an insolvent liquidation, the liquidators will always be concerned about the costs and expenses of wrongful trading litigation,[793] and, as it has been argued by Hirt,[794] even in cases where there is a very good chance of success of the claims, a liquidator is more likely to be reluctant to use part of the already inadequate assets of the company to fund the wrongful trading litigation.

Funding of wrongful trading claims by creditors also poses an even greater challenge. According to Hirt,[795] creditors will be unwilling to fund wrongful trading proceedings for the reason that a creditor providing the said funds will not necessarily be entitled to a higher proportion of the proceeds of the litigation in return for the funding, and therefore there will be a general reluctance on the part of the creditors to throw "good money after bad."

In view of the challenges of funding of wrongful trading litigation by the company and the creditors, the liquidator is sometimes compelled to consider entering into private funding arrangements with third parties. However, this too is not without problems. A detailed discussion of these three possible sources of funding and the legal principles and challenges that surround them is made below.

---

791 Insolvency Act of 2013.

792 Hirt HC "The wrongful Trading remedy in UK Law; classification, Application and practical significance" (2004) *I ECFR* 71 at p. 107.

793 Ibid

794 Ibid.

795 Ibid, at p. 108.

© University of Pretoria

7.3 FUNDING BY THE COMPANY

The Insolvency Act in Malawi provides for the funding of the costs and expenses of winding up. Section 297 of the Act provides that the costs and expenses of the winding up or bankruptcy, including the taxed costs of a petitioner, the remuneration of the liquidator or trustee and the costs of any audit carried out pursuant to the Act shall be paid in priority to all other unsecured debts.[796]

Clearly the above does not address the question of where the payment will come from. This question is addressed under the Insolvency Rules[797] made under the said Act. Rule 148 of the said Insolvency Rules provides that all fees, costs, charges and other expenses incurred in the course of the winding-up of a company are to be treated as expenses of the winding up.[798] The said Insolvency Rules then provide that all expenses of winding-up of the company are payable out of the following:

a) Assets of the company available for payment of general creditors, including proceeds of any legal action which the liquidator has power to bring in the liquidator's own name or in the name of the company;[799]

b) Proceeds arising from any award made under any arbitration or other dispute resolution procedure which the liquidator has power to bring in the liquidator's own name or in the name of the company;[800]

c) Any payments made under any compromise or any agreement intended to avoid legal action or recourse to arbitration or to any other dispute resolution procedure;[801] and

---

796 Section 297 (1) as read with Section 297 (1) (a) of the Insolvency Act 2016.

797 Insolvency Rules, 2017, made pursuant to the Insolvency Act of 2016.

798 Rule 148 (1) of the Act.

799 Rule 148 (2) (a) of the Insolvency Rules, 2017.

800 Rule 148 (2) (b) of the Insolvency Rules.

801 Rule 148 (2) (c) of the Insolvency Rules.

© University of Pretoria

d) Payments made as a result of a settlement of any such action, arrangement or procedure in lieu of, or before, any judgement being given or award being made.[802]

While the foregoing is clear that the company is responsible for payment of the expenses of winding up, a problem that arises, considering the fact that the assets of a company undergoing insolvent liquidation will always be insufficient to cover all debts, is the question of priority of payment of the expenses. Given that funding for wrongful trading litigation is to be treated as a winding up expense, what is the priority of payments among all winding up expenses?

7.3.1 The position in the United Kingdom

In the United Kingdom, this question has vexed the courts and legal scholars alike. The problem of priority in the UK existed due to the framing of the UK Insolvency Rules of 1986.[803] Under rule 4.218 (i) (a) of the said Insolvency Rules, the first priority in the payment of the expenses of winding up were expenses "*properly chargeable or incurred by…the liquidator in preserving, realizing or getting in any assets of the company.*"

In *Re MC Bacon Ltd (No. 2)*,[804] M.C. Bacon Ltd (hereinafter referred to as MC) went into creditors' winding up with an estimated debt of around 330 000 British Pounds made up of claims of unsecured creditors. However, MC had a floating charge over its assets to secure an overdraft facility with its bank. MC's liquidator then commenced proceedings seeking to have the floating charge set aside on the basis that the charge was either a voidable preference or a transaction at an undervalue. Further, the liquidator argued that the bank was liable for wrongful trading as a shadow director of MC and therefore amenable to make contributions to the assets of MC during MC's insolvent liquidation. The bank applied to strike out the liquidator's proceedings but it was not successful.

[802] Rule 148 (2) (d) of the Insolvency Rules.

[803] These rules were made in order assist in the application of the Insolvency Act of 1986.

[804] (1991) Ch 127.

© University of Pretoria

Subsequently, the liquidator abandoned the wrongful trading claim against the bank, and the court dismissed the claim and ordered the liquidator to pay costs incurred. The liquidator then applied for an order that the costs incurred by the bank in defending the wrongful trading claim, as well as his own costs in maintaining the said abandoned claim, be paid out of the assets which were subject to the bank's floating charge.

The first issue for the determination of the court was whether costs in an unsuccessful wrongful trading action could be treated as expenses "*properly chargeable or incurred by…the liquidator in preserving, realizing or getting in any assets of the company*" within the meaning of rule 4.218 (i) (a) of the said UK Insolvency Rules, bearing in mind that a liquidator's function is to secure the assets of the company as are realized and distribute the same to the company's creditors.

The court held that the liquidator could not recoup the costs of his unsuccessful proceedings as a winding up expense since the relevant causes of action in the case, including the wrongful trading claim, were not assets of the company as they vested in the liquidator as opposed to the company and, further, that the said causes of actions did not exist at the commencement of liquidation, as per the definition of assets of the company, but only arose after liquidation had commenced and, as such, the said costs were not incurred in realizing or getting in "*any assets of the company*" for the purposes of the rule.[805]

Besides the foregoing, the court remarked that even if the said costs were to be described as expenses incurred in realizing the assets of the company, the fact that the proceedings in this case were unsuccessful and did not recover anything could not make the expenses incurred in the said proceedings to be described as expenses incurred in *securing* assets of the company under the rule.[806]

805 Ibid, at p. 137-139.

806 Per Millet J at p. 138.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

The *Re MC Bacon Ltd* decision thus stood authority for the position that although the expenses incurred by a liquidator in pursuing wrongful trading claims may fall within the definition of winding up expenses, the same do not enjoy priority of payment to all other liquidation expenses under rule 4.218 (i) (a) of the said Insolvency Rules as they did not belong to the category of expenses incurred in realizing the "assets of the company."

By virtue of this decision, it became clear that expenses incurred in maintaining wrongful trading proceedings could only be paid out of the assets remaining for distribution to the unsecured creditors.[807] This meant, however, that where the proceedings had not been successful, the liquidator could likely end up shouldering a large portion if not all of the said expenses personally since, according to Hirt,[808] there is no automatic right to have the costs of an unsuccessful litigation paid as a liquidation expense.[809]

Although the view taken by the court in *Re MC Bacon Ltd* decision was heavily criticized by the court in *Re Exchange Travel (Holdings) Ltd, Katz vs. Mc Nally*,[810] it was nonetheless supported by a differently constituted court of appeal in *Re Floor Fourteen Ltd, Lewis vs. Inland Revenue Commissioner*.[811] According to Walters,[812] the *Re Mc Bacon Ltd* decision remained an authority for the proposition that the liquidator's costs of wrongful trading proceedings could only be recouped from assets available for distribution to the unsecured creditors and therefore that the said costs ranked as an unsecured claim.

807 See *Re Wilson Lovatt & Sons Ltd* (1977) I AII ER 274, 286.

808 Hirt, HC "The wrongful Trading remedy in UK Law; classification, Application and practical significance" (2004) I ECFR 71 at p. 108.

809 See also Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 70, for the possibility of a liquidator paying the wrongful trading costs personally by virtue of the said claims being office-holder claims.

810 (1997) 2 BCLC 579 (CA).

811 [2001] 2 BCLC 392 (CA).

812 Walters, A "Re Floor Fourteen Ltd in the court of Appeal" (2001) *Co Law* 215.

© University of Pretoria

Much as the foregoing seemed to give no incentive to liquidators seeking to commence wrongful trading proceedings, a ray of hope in respect of funding of wrongful trading proceedings emerged in the said *Re Floor Fourteen Ltd*[813] decision when the Court of Appeal, after voicing out support for the view taken by the court in the *Re MC Bacon Ltd* decision, said that it assumed that a court had residual discretion to allow a liquidator to recoup costs not falling within the meaning of expenses "*properly chargeable or incurred by…the liquidator in preserving, realizing or getting in any assets of the company*" under rule 4.218 (i) (a) of the said UK Insolvency Rules in priority to other liquidation expenses.

By virtue of the *Re Floor Fourteen* decision, the position of the law was, for some time, that it was a matter of a court's discretion to categorize the expenses incurred by a liquidator in maintaining wrongful trading proceeding as expenses incurred in realizing the assets of the company and therefore authorize that the same be paid in priority to all other expenses of winding up.

Considering the position taken by the courts in *Re MC Bacon Ltd* decision, namely that the cause of action in wrongful trading proceedings could not lawfully be described as an asset of the company, it followed that adverse costs incurred in wrongful trading proceedings could not be described as costs incurred in realizing an asset of the company. This position appeared to have been supported by the House of Lords decision in *Re Toshoku Finance (UK) Plc*,[814] in which it was said that if an expense is not covered under rule 4. 218 of the Insolvency Rules 1986, then it cannot be deducted under that provision.

With respect to the adverse costs, Keay[815] has argued that the fear of funding of adverse costs should not deter the liquidator in bringing up wrongful trading proceedings because if the liquidator has a good case against the director, then there is no cause for

---

813 (2002) BCC 198

814 (2002) BCC 110.

815 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 70.

© University of Pretoria

worry because all or a significant part of the liquidator's costs will have to be paid by the respondent director.

The learned commentator has however cautioned that it is not in all cases where a liquidator succeeds in wrongful trading claims that the costs will be paid as there are times when the defendant may prevaricate in making the payment, or he may disappear or indeed he may be impecunious making the liquidator to recover little or nothing in terms of his costs.[816] Another problem observed by Keay[817] in this regard is that the liquidator's legal advisers may want payment or part of their fees before completion of the proceedings and there will be no funds to be paid to them at that stage until the claim is successful and the respondent director is made to pay.

7.3.2 The position in Malawi

While problems of funding of wrongful trading proceedings have existed in the United Kingdom before the amendment to the UK Insolvency Rules, Malawi has never had the same problems owing to the fact that the Insolvency Act in Malawi only came into force in 2016, thirty years after the enactment of the UK insolvency Act. The wrongful trading rule in Malawi was therefore adopted from the United Kingdom at a time when the problems which the rule posed in the United Kingdom with respect to funding had already been discovered and when some pertinent reforms had already been made to the UK Insolvency Rules.

In view of the above, it will be noted that according to Rule 148(3)(a) of the Insolvency Rules of 2017 in Malawi, the first priority in payment of winding up expenses are those expenses which are properly chargeable or incurred by the liquidator in preserving, realizing or getting in any of the assets of the company *or otherwise in the preparation or conduct of any legal proceedings, arbitration or other dispute resolution procedures, which the liquidator has power to bring in the liquidator's own name or bring or defend*

816 Ibid.

817 Ibid. At common law, adverse costs in winding-up are paid in priority to the general expenses and costs of the liquidation and any subsequent priority claims such as preferential creditor claims; *Re London Metallurgical Company* [1895] 1 Ch 758; *Re MT Realisations Ltd* (2003) EWHC 2895 (Ch).

© University of Pretoria

in the name of the company or in the preparation or conduct of any negotiations intended to lead or leading to a settlement or compromise of any legal action or dispute to which the proceedings or procedures relate.[818]

As it will be clear from the above, funding of wrongful trading proceedings enjoys priority of payment under the Insolvency Rules in Malawi by virtue of it being a payment incurred in the conduct of legal proceedings which the liquidator has power to bring in the liquidator's own name or in the name of the company.

7.4 FUNDING BY PRIVATE THIRD PARTIES: MAINTENANCE AND CHAMPERTY

The difficulties that existed under common law with respect to funding of wrongful trading proceedings particularly following the decision in *Re MC Bacon Ltd (No 2)* as discussed above entailed that a liquidator had to find ways through which wrongful trading proceedings could be funded other than looking to the company. Several other avenues of funding have therefore been explored.

One of such avenues has been for a liquidator to enter into arrangements with third parties under which some of the proceeds of the wrongful trading proceedings could be assigned to the third party in exchange for the third party's undertaking to fund the proceedings. However, Keay[819] has observed that the problem with such arrangements is that in doing so, the liquidator will be engaging in maintenance and /or champerty which have been considered under common law to be against public policy.

Under the Halsbury's laws of England,[820] maintenance is defined as the giving of assistance or encouragement to one of the parties to litigation by a person who has neither an interest in the litigation nor any motive recognized by the law as justifying

818 Rule 148 3(a) of the Insolvency Rules.

819 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 71.

820 4thEdn, vol.9, p.272, para 400. See also the House of Lords decision in *Giles vs. Thompson* [1994] I AC 142

© University of Pretoria

interference. In *Hickman vs. Kent or Romney Marsh Sheep breeders Assn.*,[821] a champerty was described as a type of maintenance.

Similarly, Keay[822]defines maintenance as an assistance or encouragement of proceedings by someone who has neither an interest in the proceedings nor any motive recognized by the law as justifying interference in the proceedings and, a champerty, as a form of maintenance.[823]

7.4.1 Public policy against champerty and maintenance

Under common law, champerty and maintenance were considered to be against public policy because of the abuses which they occasioned in the justice system.[824] Steyn LJ in *Gilles vs. Thompson*[825]explained the said abuses as follows:

> "…it seems that one of the abuses which afflicted the administration of justice was the practice of assigning doubtful and fraudulent claims to royal officials, nobles and other persons of wealth and influence, who could in those times have expected to receive a very sympathetic hearing in the court proceedings. The agreement was often that the assignee would maintain the action at his own expense and share the proceeds of a favourable outcome with the assignor."

Prior to the *Gilles v Thompson* decision, Lord Denning had summarized the rationale behind the public policy against champerty and maintenance in *Re Trepca Mines Ltd*[826] in the following words:

> "The reason why the common law condemns champerty is because of the abuses to which it may give rise. The common law fears that the champertous maintainer might be tempted, for

821 (1920) 37 TLR 163.

822 Ibid.

823 Referred to as "aggravated maintenance" in *Guy vs. Churchill* (1888) 40Ch D 481, 489.

824 Before 1967 in England, from where Malawi takes much of its common law, champerty and maintenance were criminal offences and there were also civil penalties applicable to them. By the 1967 Criminal Law Act, Parliament in England and Wales abolished the criminal and civil penalties for champerty and maintenance, subject to an important observation, namely, that the said abolition would not affect any rule of that law as to the cases in which a contract is to be treated as contrary to public policy or otherwise illegal.

825 (1993) 3 All ER 321.

826 (1963) Ch 199.

© University of Pretoria

> his own personal gain, to inflame the damages, to suppress evidence, or even to suborn witnesses. These fears may be exaggerated; but, be that so or not, the law for centuries has declared champerty to be unlawful."

Clearly, public policy has, for some time, been against officious intermeddling that characterizes champerty or any kind of maintenance arrangements where the assistance the maintainer provides is without justification or excuse.[827]

In *Groovewood Holdings Plc vs. James Capel & Co. Ltd*,[828] a liquidator sought to carry on with an action for negligence for £38m against a financial advisor. However, the liquidator was unable to get funding for the proceedings from either the creditors or the shareholders and he resorted to enter into "sponsorship" arrangements where the sponsor agreed to provide the necessary funding on condition that he would be entitled to 50% of the money recovered in the action.

An application was made by the defendants for a stay of the action on the basis that the arrangement was champertous and therefore illegal. Although it was conceded by the liquidator that the arrangement was champertous, it was submitted that the court ought not to stay the action for the reason that the liquidator had been acting meritoriously in the interest of the creditors.

In declining the submission and ordering a stay of the action, the court made it clear that the law draws a distinction between what arrangements are champertous and those that are not, and that where there is no statutory exemption for a champertous arrangement, the court ought to set its face against such an arrangement regardless of the fact that the arrangement is made in good faith and in the best interest of the creditors.[829]

---

827 *British Cash and Parcel Conveyors vs. Lamson Store Service Co. Ltd* (1908) 1 KB 1006 per Fletcher Moulton LJ at 1014.

828 [1995] Ch, 80.

829 Ibid per Lightman J at p.88.

© University of Pretoria

There has, however, been a growing expedition in favour of changing the public policy against maintenance and champerty particularly in relation to wrongful trading proceedings. According to Schulte,[830] public policy concerning champerty or other forms of maintenance ought to be relaxed so as to allow the introduction of litigation speculators. The learned commentator argues that this move would allow speculators to achieve benefits for creditors, such as creditor protection, and benefits for the community, such as deterrence and ensuring minimum standards for operating as directors, these being benefits that would otherwise not be achieved if the wrongful trading cases were to fail due to funding.[831]

Schulte argues that the fact that the court's face is currently set against the liquidator achieving these important private law and public law functions due to the formalist barriers against litigation sponsorship does reduce the potency of the wrongful trading remedy to near insignificance as a personal liability mechanism and as a threshold test for minimum commercial morality standard of conduct for directors.[832]

7.4.2 The Insolvency exception to champerty and maintenance

Due to the mounting pressure in favour of the need to change the public policy against maintenance and champerty, the courts at common law did, early enough, recognize an exception to the public policy against champerty and maintenance during insolvency proceedings. This has generally been referred to as the "insolvency exception of public policy against maintenance and champerty." The insolvency exception could be seen in the judgement of Drummond J in *Re Movitor Pty Ltd vs. Sims*[833] who said that:

> The provision by strangers to the litigation of funds to insolvency administrators for the purposes of enabling them to pursue worthwhile claims on behalf of the entity under administration when, without that assistance, good claims might not be able to be prosecuted, will often serve a good public purpose. The purpose of the legislature…will frequently be frustrated because the insolvency administrator will often not have access to the financial

830 Schulte, R "Wrongful Trading: An Impotent Remedy?" (1996) *Journal of Financial Crime*, Vol 4 Issue:1, 45.

831 Ibid.

832 Ibid.

833 (1996)19 ACSR 440.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

> resources necessary to pursue, for the benefit of the administration, claims which have reasonable prospect of success.[834]

Although the *Re Movitor* case related to administration rather than liquidation, the direction taken by the court in that case was soon to be extrapolated to liquidation. In the subsequent decision of *Re Oasis Merchandising Ltd,*[835] the court of appeal held that:

> "As a matter of policy we see much to be said for allowing a liquidator to sell the fruits of action for the reason given by Drummond J [In Re Movitor], provided that it does not give the purchaser the right to influence the course of, or interfere with the liquidator's conduct of the proceedings. The liquidator is an officer of the court exercising a statutory power in pursuing the proceedings and must be free to act accordingly."

Through the insolvency exception discussed above, champerty and maintenance became available under common law to a liquidator and therefore a liquidator could assign any of the bare causes of action of the insolvent that vested in him (being property of the insolvent) to any provider of funding of the proceedings on condition that the liquidator received a share of the proceeds of the said proceedings.[836]

While the foregoing made it clear that under common law, a liquidator has power to sell the company's property which included causes of action, it did not clarify the question of whether at common law, a wrongful trading action is an asset of a company, capable of being sold or assigned in exchange for a promise to pay the liquidator a part of the fruits of the claim.

---

834 On the facts of this case, a liquidator entered into a "debt retrieval agreement" with an insurance company under which the insurer agreed to cover half the costs of an insolvent trading action, including half the defendant's costs if the action failed. If the action succeeded, the insurer would receive a "premium" of 12 percent of the sum recovered. According to the *Australian Financial Review* of 10 October 1997, p.26, the market for such arrangements has grown tremendously following the decision in *Re Movitor*. See Herzberg A "Why are there So Few Insolvent Trading Cases?" (1998) 6 *Insolvency Law Journal*, 77, 94, who argues, in respect of the foregoing that it goes without saying that before a liquidator can obtain funds in such circumstances, the insurer will satisfy itself that evidence of a contravention by directors is particularly strong, and that the directors against whom they contemplate legal action have the means to pay the compensation awarded against them.

835 (1997) 1 BCLC 689.

836 *Seear vs. Lawson* (1880) 15 Ch D 426; *Re Park Gate Waggon Works Co.* (1881) 17 Ch D 234 (CA); *Ramsey vs. Hartley* (1977) I WLR 686; *Stein v Blake* (1996) 2 AC 243; *Norglen Ltd vs. Reeds Rains Prudential* (1998) I AII ER *218.*

© University of Pretoria

Unfortunately, the answer to this question remained in the negative. Making similar observations as were made by the court in *Re MC Bacon Ltd* decision, the court in *Re Oasis Merchandising Services Ltd,*[837] explained why this was the position. Firstly, the court took the view that the power to commence wrongful trading proceedings was granted to a liquidator personally and not to the company and it involved the recovery of moneys to which the company never had any right, for which reason the said moneys could not properly be described as the property of the company.[838]

Secondly, the court took the view that reference to the "company's property," as far as the liquidator's power to realize the same was concerned, referred to the property that existed at the commencement of the liquidation and could not therefore refer to a cause of action under wrongful trading which is property which arises after commencement of liquidation. Due to these reasons, the court took the view that a liquidator has no power to assign the proceeds of wrongful trading litigation.

It would appear from the *Re Oasis Merchandising* decision that the court was focused on ensuring that there is no interference in the conduct of wrongful trading proceedings by third parties as well as that there should be no loss of control in the conduct of such proceedings on the part of the liquidator.[839]

The foregoing notwithstanding, it must be noted that some hope was raised by the court in the *Re Oasis Merchandising* decision when it said that the liquidator's general power of sale could, in certain circumstances, allow him to assign the proceeds of wrongful trading proceedings in cases where no champerty is involved.[840] However, Hirt[841] has argued, in respect of this point, that the circumstances in which the liquidator could rely on this power are limited and, further, that the validity of such an agreement would so

837 (1995) BCC 911.

838 Ibid, at p. 918.

839 Keay, A "Wrongful Trading; Problems and proposals" (2004) *65 N Ir legal Q.63*,71.

840 (1997) I BCLC 689, at pages 703 -704.

841 Hirt, HC "The wrongful Trading Remedy in UK Law; classification, Application and practical significance" (2004) I *ECFR*, 71 at p. 112.

© University of Pretoria

much depend on liquidator's ability to conduct wrongful trading proceedings without any interference from the party providing the funding.

According to Hirt, the success of this arrangement was rather doubtful as it was clear that in many cases, a third party would be reluctant to enter into a funding agreement without having the power to influence the conduct of the proceedings he was funding.[842]

7.4.3 Reforms enabling funding by third parties under English law

In the United Kingdom, where the wrongful trading rule has been in existence for over three decades, the complication of a liquidator being unable to assign wrongful trading causes of actions was felt throughout the years to the extent that law reform became necessary.[843] As a result, the UK Insolvency Act of 1986 introduced a new provision, section 246ZD which came into effect on 1st October 2015 and which is to the effect that liquidators and administrators can now assign wrongful trading causes of action.[844]

The foregoing is very likely to improve the funding problems that have hampered the wrongful trading remedy for many years in England as, through the amendment, the liquidator or administrator, as the case may be, is now at liberty to assign the rights of the actions to persons that are able to fund the wrongful trading actions privately, whether they are creditors or third parties. As it is clear from the provision, where the said proceedings are successful, the liquidator or administrator is also empowered to assign the proceeds of those proceedings to the person who funded the proceedings.[845]

Although it has been argued that the greater benefit in the English reforms as above will be derived by creditors who will have agreed to underwrite the wrongful trading

---

842 Ibid.

843 On 26th March 2016, the Small Business, Enterprise and Employment Act 2015 ("the SBEEA") obtained Royal Assent. The SBEEA introduced a number of amendments to the Insolvency Act of 1986 in the United Kingdom which were predicated on the need to streamline insolvency processes and removing unnecessary administrative hurdles. As it will be discussed in chapter 9 in this study, part of the amendments is that administrators now have standing to institute wrongful trading claims during administration of companies

844 Section 246ZD (2) (b) of the Act.

845 Ibid.

© University of Pretoria

claims from liquidators and administrators,[846] it is expected that the introduction of the power of assignment will create a market for wrongful trading actions for the benefit of the general body of unsecured creditors.

Apart from assignment of causes of actions, the complications that surrounded the question of funding of wrongful trading proceedings in the United Kingdom, particularly the question of priority of payment of the expenses, the treatment of adverse costs as well as the treatment of the liquidator's costs before conclusion of the proceedings similarly necessitated reforms to the UK Winding up Rules.

There has been a recent amendment of the UK Insolvency Rules of 1986. The said rules now define liquidation expenses and set out the general rule as to their priority.[847] With this amendment, rule 4.218 (i) (a) now refers to liquidation expenses or costs as those expenses or costs "**which are properly chargeable or incurred by….the liquidator in preserving or getting in any of the assets of the company** ***or otherwise relating to the conduct of any legal proceedings which he has power to bring or defend***.[848] No doubt, the amendment is now clear that wrongful trading expenses, including adverse costs and the liquidators costs incurred during wrongful trading proceedings, are now payable by the company in priority to all other liquidation expenses. This position is similar to the one currently obtaining in Malawi.

The amendment means that in general, costs incurred by the liquidator in bringing up wrongful trading proceedings should now fall within rule 4.218 of the UK Insolvency Rules of 1986 and, with this amendment, the legislature in the United Kingdom has effectively reversed the decisions in *Re Bacon Ltd (No 2)* and *Re Floor Fourteen Ltd*.[849]

---

846 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015) p 68, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/14682230.12106#accessDenialLayout accessed on 6th May 2018.

847 Insolvency (Amendment) (No 2) Rules 2002 (SI 2002/2712) (applying to companies that went into liquidation after 1 January 2003.

848 Emphasis supplied, in reference to the addition brought to the rule by the said amendment.

849 See the comments by Hirt, HC "The wrongful Trading Remedy in UK Law; classification, Application and practical significance" (2004) I *ECFR*, 71 at 113 who agrees that since the liquidator still has to demonstrate that the costs "properly chargeable or incurred", to be on the safe side, the liquidator

© University of Pretoria

7.5 FUNDING BY CREDITORS

Although not specifically provided for or excluded, a liquidator is at liberty to source funding from creditors in order to finance wrongful trading proceedings in Malawi. However, it is very unlikely that creditors will be incentivized to provide the said funding considering that the proceeds of the said proceedings will go to the general body of creditors and therefore that the creditor who provided the funding does not enjoy priority in recovering his costs from the liquidator.

Secondly, the possibility of a holder of a floating charge benefiting from the proceeds of wrongful trading proceedings in priority to an unsecured creditor who may have financed the proceedings can equally erode the incentive in creditors to finance wrongful trading proceedings.

Funding from a creditor is very likely to be achieved under the wrongful trading rule in the United Kingdom where, due to the recent amendment to the rule, a liquidator is capable of assigning a cause of a wrongful trading action to a third party, including a creditor, and he is also capable of assigning the proceeds of the action to the said third party or creditor without the said proceeds having to be applied for the benefit of the general body of creditors first, and indeed without a holder of a floating charge having to benefit from the said proceeds in priority to the third party or creditor who may have funded the proceedings.

Amending the wrongful trading rule in Malawi in the similar way it was amended in the United Kingdom will unlock funding of wrongful trading actions by creditors as they will be incentivized by the possibility of them recovering their costs in priority to the general body of creditors and to the holder of a floating charge.

7.6 CHAPTER CONCLUSION

In this chapter, it has been established that funding of wrongful trading proceedings presents one of the greatest hurdles in the prosecution of wrongful trading proceedings

might want to apply for a declaration that prospective costs will be treated as liquidation expense once they have been incurred.

© University of Pretoria

by liquidators in Malawi. It has been established that the treatment of a liquidator's costs in the generality of liquidators' claims has been a problem for a long time to the extent that in the past, there has been desperate attempts by the judiciary to strain the constructions of settled legal positions in order to create avenues for funding of liquidators' claims.

This will be seen from the angle that although it had been a well settled position of law that assets subject to a charge, floating or otherwise, did not form part of the assets of the company available for the unsecured creditors in liquidation, in the English case of *Re Barleycorn Enterprises Ltd*, a court of appeal held that a liquidator's expenses were payable out of floating charge assets, and this remained the law for some time until it was overturned by the House of Lords decision in *Buchler vs. Talbot.*

More specifically, it has been established that funding of wrongful trading proceedings creates an even greater challenge for the reason that these are proceedings which will be commenced when a company is undergoing insolvent liquidation, a fact which entails that the company will, at that point, not have enough assets for distribution to creditors and therefore this will create reluctance on the part of risk averse liquidators to apply those already-insufficient assets of the company to fund speculative wrongful trading proceedings.

On the legality of funding of wrongful trading proceedings by the company, it has been established that section 297 of the Insolvency Act in Malawi provides that costs and expenses of the winding-up are paid in priority to all other unsecured debts. Under rule 148 of the Insolvency Rules of 2017, which were made pursuant to the Insolvency Act of 2016 in Malawi, all fees, costs, charges and other expenses incurred in the course of the winding-up of the company are to be treated as expenses of the winding-up. This entails that the costs of the prosecution of the wrongful trading proceedings, which fit in the category of fees and costs under rule 148 of the Insolvency Rules above, are to be paid in priority to all other unsecured debts in accordance with section 297 of the Insolvency Act.

On the question of priority of payment of winding-up expenses *inter se*, which include wrongful trading costs and expenses, taxed costs of the petitioner, the remuneration of

© University of Pretoria

the liquidator or trustee, or costs of any audit carried out under the Insolvency Act, it has been established that under rule 148(3)(a) of the Insolvency Rules 2017, the first priority in the payment of the winding-up expenses are those expenses which are properly chargeable or incurred by the liquidator in preserving, realizing or getting in any of the assets of the company *or otherwise in the preparation or conduct of any legal proceedings, arbitration or other dispute resolution procedures, which the liquidator has power to bring in the liquidator's own name or bring or defend in the name of the company.*

By virtue of the foregoing, it has been established that priority in the payment of winding up expenses is given to the wrongful trading expenses and costs by virtue of the same being expenses incurred in the preparation or conduct of legal proceedings which the liquidator has power to bring in the liquidator's own name or bring or defend in the name of the company.

On the question of funding by third parties through maintenance or champerty arrangements, it has been established that much as the insolvency exception under common law would allow a liquidator to enter into such funding arrangements with third parties, the problem that will arise at the end of it all will be that the liquidator, in Malawi, has no power to assign the cause of action or the proceeds of the wrongful trading proceedings to the provider of the funding. This is unlike the position in the United Kingdom where a liquidator has such powers. In this vein, it has been established that the inability of the liquidator in Malawi to assign the proceeds of the wrongful trading action to the funder of the proceedings disincentivises potential funders of the wrongful trading proceedings.

Similarly, it has been established that as much as the law does not specifically discourage creditors to provide funding of wrongful trading proceedings, the creditors will be disincentivised to provide the funding for the same reason of inability of the liquidator to assign proceeds of the proceedings to a particular creditor who provided the funding. The creditor who provided the funding will, therefore, not be entitled to any sum more than they would ordinarily be entitled to if they did not provide the funding. Further, it has been established that the possibility of a holder of a floating charge scooping all or a greater part of the proceeds of the wrongful trading proceedings

© University of Pretoria

in priority to the unsecured creditor who may have provided the funding for the successful prosecution of the proceedings is also likely to dissuade creditors from providing the funding.

Finally, it has been established that the problems that are associated with a liquidator accessing funding from third parties or creditors can be surmounted by amending the wrongful trading rule in Malawi in the similar way the rule has been amended in the United Kingdom, to the effect that a liquidator is empowered to assign wrongful trading causes of actions and proceeds to the said third parties or creditors who provide funding of the wrongful trading actions in priority to the general body of creditors and to holders of floating charges. It has been submitted that this will incentivize the said third parties and creditors to provide the funding.

© University of Pretoria

CHAPTER 8

RELEVANCE OF THE MALAWIAN WRONGFUL TRADING RULE

SUMMARY

8.1 Introduction……………………………………………………………..258

8.2 The UNCITRAL legislative guide on insolvency law……………………..259

8.3 Compliance of the legal framework of the Malawian wrongful trading rule with the UNCITRAL legislative guide in insolvency law…260

8.4 Chapter Conclusion……….………………………………………………272

8.1 INTRODUCTION

The purpose of this chapter is to interrogate whether or not the legal framework of the wrongful trading rule in Malawi, as discussed in the preceding chapters, complies with the international standards of best practices in insolvency law as recommended by the United Nations Commission on International Trade Law (UNCITRAL). A discussion on this point will be answering the second main research question of this study, namely, " is the Malawian wrongful trading rule in tandem with internationally recommended best practices in insolvency law?" An answer to this research question is pertinent as it shows the extent, if any, to which Malawi, as a member of the United Nations, complies with international standards of best practice in insolvency law as recommended by the said United Nations.

In undertaking this analysis, this chapter will begin by outlining the key issues isolated by UNCITRAL to be found in rules that create personal liability against directors of companies for their conduct during a period approaching insolvency of their companies, such as the wrongful trading rule in Malawi. The study will then provide

© University of Pretoria

an analysis as to whether or not such key issues are embraced in the legal framework of the wrongful trading rule in Malawi as discussed in the preceding chapters.

8.2 THE UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW

The plight of directors of financially distressed companies has increasingly become the subject of extensive debate particularly in the post-global financial crisis period.[850] The divergences of mechanisms for legal treatment of directors of financially troubled companies, coupled with the efficacy of the said mechanisms and the predictability of their application in cross-border insolvencies prompted calls for harmonization of the law in this area.[851]

The United Nations Commission for International Trade law (UNCITRAL) has always been of the conviction that divergences arising from the laws of different states relating to international trade constitute one of the obstacles to the development of world trade.[852] UNCITRAL's position has therefore been that removal of such obstacles through the promulgation of uniform laws, among others, promotes a progressive harmonization and unification of the law relating to international trade-cooperation, a factor which is key in the promotion of friendly relations among states and consequently the maintenance of peace and security.[853]

---

850 van Zwieten, K "Director liability in insolvency and its vicinity: West Mercia Safety wear Ltd v Dodd Revisited" (*Oxford Legal Studies Research Paper* No. 38/2017) 1 available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2970913 (accessed 4th Sept 2018).

851 Ibid. See the following attempts at harmonization made by INSOL Europe: "Harmonization of Insolvency Law at EU Level" (2010 *note prepared for the European Parliament's Committee on Legal Affairs*) PE 419.633, 22; INSOL International, "Proposal by INSOL International: Directors' and Officers' responsibilities and liabilities in insolvency and pre-insolvency cases" (3 April 2010) *Submitted to UNCITRAL Working Group V (Insolvency Law*), A/CN.9/WG.V/WP.93/Add.3.

852 Official Records of the General Assembly, Twenty-First Session, Resolution 2205(XXI), A,/RES/2205(XXI), Dec.17,1966" available online at http://daces.un.org/doc/RESOLUTION/GEN/NRO/005/08/IMG/NR000508.pdf?OpenElement (accessed 16th Aug. 2018).

853 Ibid. See also Block-Leib, S and Halliday, TC "Harmonization and Modernization in UNCITRAL's Global Legislative Guide on Insolvency Law" *Texas International Law Journal of February 2017*, available at http://ssrn.com/abstract=965710 (accessed on 14th July 2018).

© University of Pretoria

With the foregoing view, UNCITRAL has produced guidance that now forms Part Four of its Legislative Guide on Insolvency Law and which deals specifically with directors' obligations in the period approaching insolvency.[854] The guide isolates key elements to be found in the provisions imposing such obligations on directors as follows:*(a)* the nature and extent of the obligations; *(b)* the time at which the obligations arise; *(c)* the persons to whom the obligations would attach; *(d)* liability for breach of the obligations; *(e)* enforcement of the obligations; *(f)* applicable defences; *(g)* remedies; *(h)* the persons who may bring an action to enforce the obligations; and *(i)* how those actions may be funded.

The UNCITRAL *Guide* highlights the desire on the part of the United Nations to create regimes among its nations and all willing nations that safeguard the interests of creditors through the creation of personal liability rules against directors or other officers of companies whose behavior when faced with the financial difficulties of their companies may be found to be indifferent or reckless, even though it may not be fraudulent.

8.3 COMPLIANCE OF THE LEGAL FRAMEWORK OF THE MALAWIAN WRONGFUL TRADING RULE WITH THE KEY ISSUES IN UNCITRAL'S LEGISLATIVE GUIDE IN INSOLVENCY LAW

Considering that the wrongful trading rule in Malawi is one of such rules that creates personal liability against directors of companies for their conduct in the affairs of the company during a period approaching insolvency as intimated by the UNCITRAL *Guide*, this study will assess whether the legal framework of the wrongful trading rule in Malawi, as defined in the preceding chapters in this study, embraces the key issues isolated in the UNCITRAL *Guide* as being the key issues which must exist in the rule such as the wrongful trading rule in Malawi. The aim of this assessment is to establish the extent to which the legal framework for wrongful trading in Malawi conforms with the international standards of best practice in insolvency law. The assessment is undertaken as follows:

[854] United Nations Commission on International Trade Law, Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April2013) 5.

© University of Pretoria

8.3.1 The nature and extent of the obligations and the time at which they arise

This is a combination of the first two key issues isolated in the UNCITRAL *Guide* above. These two key issues suggest that the rule that creates personal liability against directors must first of all spell out *the nature and extent of the obligations* that attach to the said directors and also *the time when such obligations arise*. As it has been discussed in chapter 4 herein, the legal framework for the wrongful trading rule in Malawi provides for obligations that attach to directors of financially troubled corporations. Such obligations are different depending on the time when they arise.

The first set of obligations attaches to directors when their companies, while technically solvent, begin to navigate the vicinity of insolvency. The obligations include monitoring the financial situation of the company, seeking professional advice from independent financial advisors or insolvency practitioners as well as cessation of business and instituting company reorganization on the basis that the company is likely to become unable to pay its debts as they fall due,[855] among others.[856]

---

855 Note that the obligation to institute a company reorganization order arises at two different levels of a company's financial distress. The first one, which arises when a company is navigating the vicinity of insolvency (and not when it is insolvent) is instituted when the directors know, or when they ought to know that the company **is likely to become** unable to pay its debts as they fall due. The second one, which arises when a company is insolvent, (not when it is navigating the vicinity of insolvency) is instituted when the directors know, or when they ought to know, that the company **has become** unable to pay its debts as they fall due. Both of these alternatives are provided for under section 17 (a) of the insolvency Act, 2016.

856 Generally, the obligations that attach to directors of the companies when their companies begin to navigate the vicinity of insolvency emanate from the statutory requirement for the directors to take steps with a view to minimizing the potential loss to the company's creditors right from the point in time, before the commencement of the winding up of the company, when the directors know, or when they ought to know that their company would not avoid going into insolvent liquidation. Precisely, these obligations stem from Sections 187(2)(b) and (3) of the insolvency Act of 2016, which provide that:

> (1) Subject to subsection (3), if in the course of the winding-up of a company it appears that subsection (2) applies in relation to a person who is or has been a director of the company, the Court, on the application of the liquidator, may declare that the person is to be liable to make such contribution to the company's assets as the Court thinks proper.
>
> (2) This section shall apply in relation to a person if –
>
> > (a) the company has gone into insolvent liquidation;
> >
> > **(b) at some time before the commencement of the winding-up of the company, the person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and…** (emphasis supplied)

© University of Pretoria

The second set of obligations arises when the company is insolvent to the extent that insolvent liquidation becomes unavoidable. At this point, the obligations that attach to directors include initiating company reorganization on the basis that the company is unable to pay its debts as they fall due,[857] or to initiate an immediate placement of the company into liquidation if the director is of the view that reorganization will not achieve a better outcome for the company.[858]

8.3.2 The persons to whom such obligations would attach

This is the second key issue isolated in the UNCITRAL *Guide*. By this issue, UNCITRAL suggests that the rule that creates personal liability for failure to fulfil the above obligations should clearly identify *the persons to whom such obligations attach*. As it would be clear, the legal framework for the wrongful trading rule in Malawi makes such obligations to attach only to directors of companies.[859]

> **(3)** **The court shall not make a declaration under this section with respect to any person if it is satisfied that, after the condition specified in subsection (2)(b) was first satisfied in relation to him, the person took every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken.** (emphasis supplied).

857 Section 17(a) of the insolvency Act of 2016. As discussed above, this is the occasion where the company reorganization order is instituted by the director on the basis that the company **has become** unable to pay its debts as they fall due, as opposed to the occasion where the said reorganization order is instituted on the basis that the company **is likely to become** unable to pay its debts as they fall due, the latter of which happens when the company is navigating the vicinity of insolvency, and not when it has become insolvent.

858 Under section 17(a) of the insolvency Act of 2016 in Malawi, a court can make a company reorganization order after a company has become unable to pay its debts only when it is satisfied that placing the company under reorganization will:

a) Rescue the company as a going concern, restoring the company to solvency and thereby preserving the company and its business operations as a going concern, section 14(1)(a) of the Act.

b) Achieve a better result for the company's creditors as a whole than would be likely if the company was to be wound up without first being in company reorganization, which may include a sale or a transfer of any business of the company as a going concern, section 14(1)(b) of the Act.

c) Enable the administrator to realize the company's property in order to make distribution to one or more secured or preferential creditors, section 14(1)(c) of the Act.

859 This is clear from Sections 187(1) and (2)(c) of the Insolvency Act of 2016, which read as follows:

> **(1)** Subject to subsection (3), if in the course of the winding-up of a company it appears that subsection (2) applies in relation to a person **who is or has been a director of the**

© University of Pretoria

It has, however, been established in chapter 3 of this study that the term director is defined broadly to encompass any person who occupies the position of a director regardless of what the position is called. It has been seen that what matters is not the title or reference given to the person, but the substance of his activities in relation to the company. In this vein, it has been established that a person will be found to be a director for purposes of wrongful trading even if he is a manager or a mere officer in the company, and even when he is a complete outsider. On the other hand, it has been established that a person may be found not to be a director of the company even when he is named or referred to as the director, or chief executive of the company.

All types of directors discussed in this study, i.e. *de jure*, *de facto* and shadow directors, can be liable for failure to fulfil their fiduciary obligations to the company. This entails that they can all be found liable for wrongful trading for failure to fulfil their obligations to the company when the company is faced with insolvency, a fiduciary duty.

It has also been established that there are other special categories of persons who can qualify to be referred to as shadow directors or *de facto* directors and therefore become liable for breach of fiduciary duties of directors including wrongful trading if they are found to have exercised directorial powers in relation to the board or the director or directors of a company. Examples of such persons are shareholders; professional advisers such as auditors, public accountants, legal practitioners, insolvency practitioners etc.; independent companies; holding companies with regard to their subsidiaries as well as banks with regard to borrowing companies. The overriding criterion in all situations is whether the person crossed the line from advising to instructing.

---

company, the Court, on the application of the liquidator, may declare that the person is to be liable to make such contribution to the company's assets as the Court thinks proper.

(2) This section shall apply in relation to a person if –

…

(c) the person was a director of the company at the time. (emphases supplied).

© University of Pretoria

8.3.3 Liability for breach of the obligations and how the said obligations may be enforced

This is a combination of the fourth and fifth key issues isolated in the UNCITRAL *Guide*, namely, *liability for breach of the obligations* and *how the said obligations may be enforced*. UNCITRAL leaves it to the regimes to fashion the nature of the liability that must attach to the responsible persons as they find proper, as long as it is clear that the desire is to create personal civil liability as opposed to criminal liability, except where the director-indifference is perpetrated by fraud. With respect to the fourth key issue, it clear that the liability that is created in Malawi is the personal civil liability for wrongful trading.[860] In Australia, for instance, the liability which is created is the personal civil liability for insolvent trading.

With respect to the fifth key issue of *how the said obligations may be enforced*, UNCITRAL suggests the existence of an elaborate enforcement mechanism for breach of the obligations. As it will be seen, the wrongful trading rule embraces the said fourth and fifth key issue from the UNCITRAL *Guide* by providing for personal civil liability for wrongful trading against the directors. The wrongful trading rule itself is an enforcement mechanism for breach of the said obligations.

8.3.4 Applicable defences (during proceedings to enforce such obligations)

This is the sixth key issue isolated in the UNCITRAL *Guide*. By this issue, UNCITRAL suggests that the legal framework of the rule seeking to create liability for these delinquent officers must be clear as to the *applicable defences* that must be available to the respondents during the proceedings for breach of the said obligations. The legal framework for wrongful trading rule in Malawi embraces this suggestion and provides for defences in wrongful trading proceedings.

[860] It must be noted that the phrase "**wrongful trading**" is not used in the main text of section 187 of the insolvency Act of 2016 in Malawi. The phrase is only used as a marginal note of the section. There are ramifications of the use of this phrase in the interpretation of the section, as the word "wrongful" seems to connote that for liability under this section to be established, the conduct of the director in question must be shown to have been "wrong" in the literal sense of the word, while such is not the case. A detailed discussion of the ramifications that come with the use of the phrase "wrongful trading" as a marginal note of the section is undertaken in chapter 9 herein.

© University of Pretoria

Firstly, it is a defence in a wrongful trading claim in Malawi for a director to show that there was no time, before the commencement of the winding-up of the company, when he knew or concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and that for that reason, he took no step with a view to minimizing the potential losses to the company's creditors because according to him, no creditor was going to suffer any loss since the company was going to remain solvent. This has been referred to in this study as a "no step" defence.[861] This, however, is a very risky defence for the reason that the court will not only rely on the subjective standard of knowledge of a particular director, but that an objective standard will also simultaneously be used in deciding whether or not the director's lack of knowledge was reasonable in the circumstances.

This stems from the provision under the rule that in order for a director to rely on the above defences, the facts which the director ought to know or ascertain or the conclusions which he ought to reach are those that could be known or ascertained or reached by a reasonably diligent person having the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions

---

861 The "no step defence" can be inferred from the wording of section 187(2)(b) as read with section 187(3) of the insolvency Act of 2016 in Malawi, which provide that:

> (2) This section shall apply in relation to a person if –
>
> (a)…
>
> **(b) at some time before the commencement of the winding-up of the company, the person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation**…(emphasis supplied).
>
> **(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that, after the condition specified in subsection (2)(b) was first satisfied in relation to him, the person took every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken.** (emphasis supplied).

It is submitted that the inferred combined effect of the above provisions is that a director who can prove that he did not know, and he was never faced with a situation from where to conclude, at any point before the commencement of the winding up of the company that the company would not avoid going into insolvent liquidation, can escape liability for wrongful trading by having taken "no steps" with a view to minimizing the potential loss to the company's creditors. This can be justified on the basis that according to him, no creditor was going to suffer any loss.

© University of Pretoria

as are carried on by that director in relation to the company,[862] and the general knowledge, skill and experience which the particular director has.[863]

Secondly, it has also been established that it is a defence to a wrongful trading claim if it can be shown by a respondent director that at some time before the commencement of winding-up of the company when the he knew or concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, he took every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken.[864] In this study, this defence has been referred to as the "every step" defence.[865]

Just like the "no step" defence, the "every step" defence is similarly not easy to establish. Firstly, this defence raises a question of what is the meaning of *at some time before the commencement of winding up*? The answer to this question lies in the director being able to identify a moment of truth or a crisis point in the financial life of the company at which point he should be able to accept that while it appeared previously

---

862 Section 187 (4) (a) of the Insolvency Act.

863 Section 187 (4) (b) of the Act.

864 Section 187(3) of the Insolvency Act, as read with Section 187 (2)(b) of the Act.

865 The "every step defence" is clear from 187(2)(b) as read with section 187(3) of the insolvency Act of 2016 in Malawi, which provide that:

> (2) This section shall apply in relation to a person if –
>
> (a)…
>
> **(b) at some time before the commencement of the winding-up of the company, the person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation**…(emphasis supplied).
>
> **(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that, after the condition specified in subsection (2)(b) was first satisfied in relation to him, the person took every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken.** (emphasis supplied).

It is submitted that the precise combined effect of these provisions, as opposed to the inferred one that yield the no step defence, is that where a director knew or ought to have concluded, at some point before the commencement of the winding up of the company that the company would not avoid going into insolvent liquidation, he will only escape liability for wrongful trading if he can show that he took " every step" with a view to minimizing the potential loss to the company's creditors as he ought to have taken.

© University of Pretoria

that the company would pull through, the same no longer appears to be a possibility.[866] In *Re CU Fittings Ltd*,[867] the court described this moment of truth as the moment when an honest businessman will recognize that he is now only gambling at the expense of his creditors in the hope that something may turn up.

Secondly, this defence raises the question of what is the meaning of *taking every step*? In this vein, it has been established that the steps which must be taken by the director are dependent on whether the knowledge which the director has acquired or the conclusion which the director has made is that the company is in the vicinity of insolvency or that it is insolvent.[868]

While it is not possible to compile a comprehensive list of all the steps that may satisfy the court in every circumstance, it has been established that there are some steps that are likely to satisfy the court if they are taken when the company is in the vicinity of insolvency, namely, seeking professional advice; resignation where a director's advice is not heeded, as well as cessation of business and instituting company reorganization on the basis that the company is likely to become unable to pay its debts as they fall due.[869]

Where the knowledge that the director has acquired or the conclusion which the director has made is that the company is insolvent, the director will have to initiate company reorganization on the basis that the company is unable to pay its debts as they fall due,[870]

866 Rajak, H. "Wrongful Trading" (1989) *NLJ* 1458, 1459.

867 (1989) BCLC 566 at p. 559.

868 For purposes of the winding-up of a company in Malawi, insolvency, under section 107 (4) (b) of the Insolvency Act, is defined through the company's inability to pay debts as they fall due. The term vicinity of insolvency is not defined under statutory law. However, vicinity of insolvency is defined under common law as a period when a company is nearing insolvency; *Nicholson vs. Permakraft (NZ) Ltd* (1985) 3 A.C.L. 453, or as a period when a company is approaching insolvency; *Geneva Finance Ltd vs. Resource and Industry Ltd* (2002) 20 A.C.L.1427, or a period when a company is on the verge of insolvency; *Colin Gwyervs London Wharf (Limehouse) Ltd* (2002) EWHC 2784. From the common law definition, it can be deduced that at statutory law, vicinity of insolvency is a period of financial difficulty penultimate to the company's inability to pay debts as they fall due.

869 Section 17 (a) of the Insolvency Act

870 Ibid.

© University of Pretoria

or to initiate an immediate placement of the company into liquidation if the director is of the view that reorganization will not achieve a better outcome for the company.

Finally, it has been established that a director can escape liability for wrongful trading by availing himself of general corporate law defences during wrongful trading proceedings. One of such corporate law defences identified in this study is the common law defence under the Business Judgement Rule. It has been established that a director can rely on the defence of a 'business judgement' by showing that his making of the business judgement decision at the point when he knew or concluded that the company would not avoid going into insolvent liquidation was within his duty of "taking every step," and therefore that the business judgement decision he made, even though it may have failed to save the company, must entail that the director took "every step" with the view to minimizing the potential loss to the company's creditors and, therefore, that it must save the director from liability for wrongful trading.

Although it has been shown that this is possible, it has also been shown that the probability of success of this defence is very minimal as it may be viewed by other courts as a deliberate decision by the director to take a coward's way out of the comprehensive directorial obligations to the company which attach to the director whose company is faced with insolvency.

8.3.5 **Remedies** (when such obligations have been breached)

This is the seventh key issue isolated in the UNCITRAL *Guide*. By this issue, the Guide suggests that the legal framework of the rule creating liability for the delinquent directors should provide clearly as to what are the *remedies* available in the proceedings. As it had been discussed in chapter 6 of this study, the legal framework of the wrongful trading rule in Malawi embraces this recommendation by providing that the only remedy in wrongful trading proceeding is that the court may make an order or declaration that the respondent director should contribute to the assets of the company in insolvent liquidation as the court thinks proper.[871] This is referred to in this study as

[871] This is clear from section 187 of the Insolvency Act of 2016 which provides, in subsection 1, that:

(1) Subject to subsection (3), if in the course of the winding-up of a company it appears that subsection (2) applies in relation to a person who is or has been a director of the company, the

© University of Pretoria

the contribution order, and the amount of contribution so ordered is referred to in this study as the contribution sum.

The contribution sum is arrived at by calculating the increase in the net deficiency of the assets of the company during the period of the wrongful trading. This represents the loss suffered by the company by virtue of the wrongful trading. The use of the word "may" in the provision, however, gives the court discretion to award a sum which is less than the increase of the net deficiency of the assets of the company during the wrongful trading period,[872] or no sum at all,[873] where the liquidator has failed to prove the said increase.

It has been established, further, that for the reason that the contribution sum becomes an asset of the company upon the contribution order being made, a holder of a floating charge can benefit from the contribution sum. The contribution sum is also available to pre-wrongful trading creditors of the company in the same way that it is available to post-wrongful trading creditors, the real victims of wrongful trading. This is because the spirit behind the remedy is to benefit the creditors of the company as a whole, and therefore the remedy cannot be available only to a specific class of creditors.

Where liability for wrongful trading has attached to more than one director, it has been established that the court has the discretion whether to hold the said directors jointly or

> Court, on the application of the liquidator, **may declare that the person is to be liable to make such contribution to the company's assets as the Court thinks proper**. (emphasis supplied).

In this study, this remedy has been described as "the contribution order". It has been established in this study that before the court makes a contribution order against a director who is found liable for wrongful trading, it must be proved by the liquidator that the company suffered loss by virtue of the company having continued to trade when it ought not to. This loss is proved when the liquidator shows a net deficiency in the assets of the company during the period of the unwarranted trading. For a detailed discussion of the requirements for the making of the contribution order by a court, see chapter 6 of this study.

872 Although wrongful trading was successfully proved in *Brooks vs Armstrong,* also Known as *The Joint Liquidators of Robin Hood Centre Plc. Vs Armstrong* (2015) EWHC 2289 (Ch), the court nonetheless exercised its discretion to reduce the contribution order to by 50 percent of the increase of the net deficiency of the assets of the company.

873 See *Re Ralls Builders Ltd (In Liquidation)* (2016) EWHC 243 (Ch).

© University of Pretoria

severally liable on the one hand, or severally liable on the other hand.[874] Finally, it has been established that a director who is ordered to pay a contribution sum has no right to have the contribution sum set-off by a payment due to him from the company.[875]

8.3.6 **Who may bring up the action** (to enforce the said obligations)

This is the eighth key issue isolated in the UNCITRAL *Guide*. By this issue, UNCITRAL suggests that the legal framework of the rule creating director liability should provide clearly as to *who may bring up the action to enforce the obligations* that have been breached. In the legal framework for wrongful trading in Malawi, as observed above, it has been identified that only a liquidator of the company has standing to institute wrongful trading proceedings.[876] This position derives from the fact that the wrongful trading mechanism is available in Malawi only when a company has gone into insolvent liquidation and not when it has been placed under any other form of insolvency process such as administration.[877]

---

[874] *Re Brian D Pearson* (1999) BCC 26; *Re Produce Marketing Consortium Ltd* (1999) 5 BCC569; *Re DKG Contractors Ltd* (1990) BCC 903; *Re Continental Assurance Co of England Plc* (2007) BCLC 287.

[875] *Guinness Plc vs Saunders* (1998) 1 WLR 838, affirmed on appeal (1990) 2 WLR 324; Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London and New York*, 108; Odittah, F "Wrongful Trading" (1990) *LMCLQ* 205 at p. 222.

[876] Section 187 of the insolvency Act of 2016 in Malawi provides, in subsections 1, that:

> (2) Subject to subsection (3), if in the course of the winding-up of a company it appears that subsection (2) applies in relation to a person who is or has been a director of the company, the Court, **on the application of the liquidator**, may declare that the person is to be liable to make such contribution to the company's assets as the Court thinks proper. (emphasis supplied).

[877] This stems from subsection 2 of section 187 of the insolvency Act of 2016 in Malawi which provides that:

> **(3)** This section shall apply in relation to a person if –
>
> (a) **the company has gone into insolvent liquidation;** (emphasis supplied)
>
> **…**

In this study, the availability of the wrongful trading mechanism only during insolvent liquidation and only through a liquidator has been labelled as "the liquidation restriction of the rule". This liquidation restriction has been shown in this study to have implications on the vibrance of the rule. For a detailed discussion of the effect of the liquidation restriction on the wrongful trading rule, chapter 9 of this study.

© University of Pretoria

8.3.7 **How the proceedings** (to enforce the said obligations) **may be funded**

This is the ninth and the final key issue isolated in the UNCITRAL *Guide*. By this key issue, UNCITRAL suggests that the legal framework creating personal liability for directors should have clear guidelines as to *how the enforcement proceedings may be funded*. With respect to the wrongful trading rule in Malawi, this final key issue in the UNCITRAL *Guide* requires that the legal framework of the wrongful trading rule in Malawi should be clear as to how the said wrongful trading proceedings may be funded.

In the legal framework of the wrongful trading rule in Malawi, where the proceedings can only be brought up by a liquidator, it has been established, in chapter 7 of this study, that funding of wrongful trading proceedings comes from the assets of the insolvent company as "expenses of the winding-up." This stems from the Insolvency Rules 2018 which are made under the Insolvency Act of 2016 in Malawi. Rule 148(1) of the said Insolvency Rules provides that all fees, costs, charges and other expenses incurred in the course of winding-up are to be treated as expenses of the winding-up. Rule 148(2)(a) of the said Insolvency Rules then provides that the expenses of the winding up of a company are payable out of the "assets of the company available for payment to general creditors, including proceeds of any legal action which the liquidator has power to bring in the liquidator's own name or in the name of the company."

The problem that comes with regard to the funding of wrongful trading claims is the question of priority. Section 197 of the Insolvency Act provides that the costs and expenses of winding-up or bankruptcy, including the taxed costs of a petitioner, the remuneration of the liquidator or trustee and the costs of any audit carried out pursuant to the Act shall be paid in priority to all other unsecured debts.[878] Much as this is clear that the expenses of winding-up do enjoy priority over payment of all other unsecured debts, it nonetheless brings the question of what is the priority of the payments of the expenses of winding-up *inter se*.

According to Rule 148(3)(a) of the Insolvency Rules of 2017 in Malawi, the first priority in payment of winding-up expenses are those expenses which are properly

[878] Section 297(1) as read with section 297 (1)(a) of the Insolvency Act.

© University of Pretoria

chargeable or incurred by the liquidator in preserving, realizing or getting in any of the assets of the company *or otherwise in the preparation or conduct of any legal proceedings, arbitration or other dispute resolution procedures, which the liquidator has power to bring in the liquidator's own name or bring or defend in the name of the company*[879] or in the preparation or conduct of any negotiations intended to lead or leading to a settlement or compromise of any legal action or dispute to which the proceedings or procedures relate.[880] Clearly, the foregoing includes funding for wrongful trading proceedings.[881]

8.4 CHAPTER CONCLUSION

This chapter was dedicated to answering the second main research question of this study, namely, whether the wrongful trading rule in Malawi complies with UNCITRAL's recommended best practices in insolvency law.

---

879 Emphasis supplied. As it will be seen, this is the part that makes wrongful trading expenses rank in priority to other liquidation expenses, and it is the part which has just recently been added to the Insolvency rules in England. It is yet to be seen what effect this inclusion will have on the efficacy of the wrongful trading proceedings.

880 Rule 148 3(a) of the Insolvency Rules.

881 It has been established that much as there is no restriction in a liquidator obtaining funding of wrongful trading proceedings from third parties in Malawi, the third party will not be incentivised to provide the funding knowing that the liquidator cannot assign a portion the proceeds of the proceedings specifically to him as a provider of the funding. This is unlike the position under the English wrongful trading rule where a liquidator has been granted statutory power to assign proceeds of wrongful trading proceedings to third parties who provide funding of the proceedings; section 246ZD of the 1986 UK Insolvency Act. Note that the amendment is recent as it came about on 1st October 2015, arguably after parliament noted the problems which the old provision had with respect of funding of wrongful trading proceedings by third parties. See chapter 7 herein for a detailed discussion of the assignment of the proceeds of wrongful trading proceedings and the ramifications thereof.

Further, with respect to the possibility of funding of wrongful trading proceedings by creditors of the insolvent company, it has been observed that in the absence of the power on the part of a liquidator to assign the proceeds of the wrongful trading action to the creditors who funded the proceedings, the possibility of a holder of a floating charge or any secured lender having to benefit from the proceeds of the wrongful trading action in priority to the creditor is also likely to disincentivize the creditor to provide funding for wrongful trading actions.

The arguments for a holder of a floating charge or any secured lender being able to benefit from the "contribution order" made in wrongful trading proceedings stem from the fact that under section 187(1) of the insolvency Act of 2016 in Malawi, the said "contribution" is made to the assets of the company and therefore upon being made, the said contribution becomes an asset of the company capable of being attached in satisfaction of the debt of a holder of a floating charge or any secured lender. For a detailed discussion on the possibility of a holder of a floating charge or any secured lender being able to benefit from the contribution order in wrongful trading proceedings, see chapter 6.6.1 in chapter 6 of this study.

© University of Pretoria

The chapter has shown that the key issues which have been recommended by UNCITRAL in its Legislative guide in insolvency to be found in the legal frameworks of rules that create personal liability against directors for breach of their obligations towards financially distressed companies, such as the wrongful trading rule, are all embraced in the legal framework of the wrongful trading rule in Malawi.

Precisely, it has been shown in this chapter that the wrongful trading rule in Malawi provides for: *(a)* the nature and extent of the obligations which attach to the directors; *(b)* the time at which the said obligations arise; *(c)* the persons to whom the obligations would attach; *(d)* liability for breach of the obligations; *(e)* enforcement of the obligations; *(f)* applicable defences; *(g)* remedies; *(h)* the persons who may bring an action to enforce the obligations; and *(i)* how those actions may be funded.

In view of the forgoing, it is submitted that the legal framework of the wrongful trading rule in Malawi is in total compliance with the international standards of best practice in insolvency law as recommended by the United Nations Commission on International Trade Law (UNCITRAL).

© University of Pretoria

CHAPTER 9

EFFICACY OF THE WRONGFUL TRADING RULE IN MALAWI

SUMMARY

9.1 Introduction……………………………………………………….…274

9.2 Problems likely to affect the efficacy of the wrongful trading rule in Malawi…………………………….…280

9.2.1 Drafting problems………………………………………………280

9.2.2 The rule being too wide that it fails to serve intended purposes and serves unintended purposes……………..300

9.2.3 The funding problem……………………………………………304

9.2.4 The liquidation restriction of the rule……………………………308

9.2.5 The absence of protection from liability for wrongful trading for directors who do their best…………………………...319

9.2.6 The absence of director disqualification under the rule…………321

9.2.7 The rule presumes solvency of directors…………………….……324

9.2.8 The negative impact of corporate rescue on the vibrance of the rule…………………………………………326

9.2.9 Applicability of the wrongful trading rule in Malawi during the current COVID-19 pandemic……………………….....328

9.3 Chapter conclusion………………………...……………………………330

© University of Pretoria

9.1 INTRODUCTION

Considering the fact that the wrongful trading rule in Malawi is yet to be tested by the Malawian courts, this chapter is aimed at answering the third main research question of this study, namely, " what is the efficacy of the Malawian wrongful trading rule?" A discussion of this question is pertinent as it entails whether the wrongful trading rule in Malawi, in its current statutory form, is capable of achieving the purposes for which it was enacted. The discussion is also pertinent as it may spell the need for reform of the rule in the event that the rule is found, in this chapter, to have significant problems.[882] In undertaking this exercise, this chapter will uncover the problems that are likely to affect the efficacy of the wrongful trading rule in Malawi.

At its inception in the UK Insolvency Act of 1986, from where Malawi copied the rule, the wrongful trading rule was heralded as being 'unquestionably one of the most important developments of company law in the 19th Century.'[883] A few years after its inception, the rule was described using the imagery of a liquidator wielding a "sharp" and "powerful" weapon against wayward directors.[884] However, over the years, the rule has been proved to be fraught with challenges that have hampered its success and, as it was observed by Williams,[885] the impact of the rule has been muted.

---

882 Reforming and redesigning the wrongful trading rule in the ways that may be recommended in this study will positively help to improve the Malawian insolvency system. As it was observed by the vice-president and general counsel of the World Bank Group: *Principles for Effective Insolvency and Creditor/Debtor Regimes* (2016) available and accessed online on 10th July 2020 at http://documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtorregimes "Well-designed legal and regulatory frameworks with respect to insolvency and creditor/debtor rights (ICR) facilitate the extension of credit and enable private sector development. The availability of credit is a key driver of economic activity, innovation and growth. By providing for the restructuring and preservation of distressed yet viable businesses, and providing, alternatively, for the orderly resolution of distressed, non-viable businesses, insolvency laws offer predictability and enhance[s] investor confidence. Overall, the transparency and efficiency of ICR systems have a direct impact on the allocation of credit risk and risk management in the financial sector, and consequently also influence access to credit and its cost."

883 Prentice, D "Creditors' Interests and Directors' Duties" (1990) *10 OJLS* 265, 277.

884 Hicks, A "Advising on Wrongful Trading" (1993)14 *The Company Lawyer* 16.

885 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

© University of Pretoria

A similar observation has been made by Keay.[886] According to Keay, following the enactment of the wrongful trading rule in the United Kingdom, academics and practitioners alike saw the rule as having a bright future in providing the necessary protection for creditors, but that, unfortunately, that optimism has been diminishing with time to the extent that presently, some commentators are more circumspect about the potency of the rule.[887]

Schulte[888] has similarly contended that looking at the problems that surround the wrongful trading rule as it has been discovered over the years, one cannot disagree that a liquidator has been handed a defective weapon, and he has allies that have failed to commit properly to the battle. According to Schulte, the developments surrounding the rule over the years have made it clear that the wrongful trading rule is impotent as it fails to achieve both its private and public law functions because the usage of the rule by liquidators is thwarted both substantively and procedurally.[889]

In support of the arguments that the success of the wrongful trading rule has been diminishing with time, Sealy[890] has put forward results of a research which show that recent studies indicate that there are just a few wrongful trading claims that have been successfully maintained in the courts, a fact which arguably contributes to the scepticism about the efficacy of the rule and which has, possibly, led one commentator to question whether the wrongful trading rule is nothing but a 'paper tiger.'[891]

---

[886] Keay, A "Wrongful Trading; Problems and proposals". (2014) *65 N. Ir Legal Q,* 64, 67. For an optimistic commentary that was made in relation to the rule when it was enacted, see Odittah, F "Wrongful Trading" [1990] *LMCLQ* 205 at 222; Prentice, D "Creditors' interests and Directors' Duties" [1990] *10 OJLS* 265, 277.

[887] Keay, A "Wrongful Trading; Problems and proposals". (2014) *65 N. Ir Legal Q,* 64, 67.

[888] Schulte, R "Wrongful Trading: An Impotent Remedy?" (1996) *Journal of Financial Crime*, Vol 4 Issue: 1, 39.

[889] Ibid.

[890] Sealy, L "Personal liability of directors and officers for debts of Insolvent Corporations: A Jurisdictional perspective (England)" in J. Ziegel (ed), Current developments in international and comparative corporate insolvency law (1994) *Oxford University press*; Mokal, R *Corporate Insolvency law*, (2005) *OUP*.

[891] Cook, C "Wrongful Trading. Is at a Real Threat to directors or a Paper Tiger" (1999) *Insolvency Lawyer*, 99, 100.

© University of Pretoria

However, as Williams[892] has argued, the fact that limited litigation has occurred in relation to the wrongful trading rule since its inception does little to dampen the potency of the rule. Williams argues that not every wrongful trading case, successful or otherwise, will make it to the law reports and therefore that the fact that only a few cases have been reported may not be a determinant of the under-use of the wrongful trading remedy by liquidators.[893] According to the learned author, the remedy may be succeeding when used as a threat of litigation, compelling directors to settle wrongful trading claims which they would not settle without the threat provided by the rule.[894]

While it is accepted that the volume of wrongful trading cases that appear in law reports cannot be used as a yardstick for determining the efficacy of the wrongful trading rule, it cannot be disputed that a large volume of wrongful trading cases in law reports would be a vital element in the achievement of one of the aims for which the rule was designed, namely, deterrence to director-indifference in the running of the affairs of companies.[895]

According to Williams,[896] the very paucity of wrongful trading cases successfully maintained against directors does not assist the rule in achieving deterrence. In the view taken by the learned commentator, the perverse incentives to abuse the protection offered by limited liability can only be effectively countered if directors feel that there is a strong prospect of civil recovery against them through the imposition of liability for wrongful trading.[897] Errant conduct on the part of the directors will, therefore, not be likely to be countered by the fewer instances of actual recovery through wrongful

---

892 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 56 available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

893 Ibid.

894 Ibid.

895 Keay, A "Wrongful Trading; Problems and proposals". (2014) *65 N. Ir Legal Q,* 64, 67.

896 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 63, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

897 Ibid.

© University of Pretoria

trading[898] as, according to Cheffins,[899] effective deterrence of wrongful trading rests on active enforcement of the wrongful trading mechanism.

As much as this study pertains to the wrongful trading rule in Malawi, it must be noted that the rule was only enacted in Malawi under the Insolvency Act of 2016, and that at the time of conducting this research, there was no known decision that had been made by the Malawian courts in relation to the rule. A discussion of the problems associated with the rule will therefore centre on the problems that have been unearthed in relation to the rule under English law since the rule was enacted in the United Kingdom under the UK Insolvency Act of 1986. The relevance of this discussion is that since the wrongful trading rule in Malawi is similar to the UK rule, with the exception of a few recent changes in the UK rule, the same problems that have been discovered under UK rule in relation to the rule will similarly affect the efficacy of the rule in Malawi.

As it has been discussed herein, the purpose of the enactment of the wrongful trading rule in Malawi was the same as it was under English law, namely, to protect the interests of creditors by requiring contribution by errant directors to the assets of the company available for distribution to creditors during insolvent liquidation of the said companies, a fact which would ultimately provide deterrence to director-indifference in the running of the affairs of financially distressed companies.

Based on the foregoing purpose, and apart from the problems that have been unearthed and rectified in relation to the wrongful trading rule in the United Kingdom, it will be shown in many ways that in its current statutory fashion, the wrongful trading rule in Malawi does not provide an effective weapon for the recovery of funds from directors of companies undergoing liquidation for the benefit of the companies' creditors and, based on that reason as well as other reasons as will be discussed in this study, the rule is lacking in its quest to provide deterrence to director-indifference in the running of the affairs of financially distressed companies.

---

[898] Ibid. Note however the concession made by Williams that the fact that the existence of the mechanism sets an expected norm of director behavior will, to a smaller extent, still achieve the deterrence effect.

[899] Cheffins, B *Company law; Theory, Structure and Operation* (1997) Oxford: OUP, 54.

© University of Pretoria

Several problems have been discussed in this study as hurdles that affect the efficacy of the wrongful trading rule leading to the inability of the rule to fulfil its intended purposes of creditor protection and deterrence. Some of the said problems relate to the drafting of the marginal note and some provisions of the rule, while others stem from the unfavorability of the Malawian legal environment of the rule as well as some presumptions inherent in the rule.

Firstly, the chapter discusses problems that emanate from the drafting of the wrongful trading rule. These include the use of the word "*wrongful*" in the marginal note "wrongful trading" which is misleading. Further, the use of the words "*at some time*" in the phrase "at some time before the commencement of the winding up of the company" which is imprecise. Thirdly, the use of the words "*reasonable prospect*" in the phrase "the director knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation" which is elusive. Fourth, the use of the words "*ought to have concluded*" in the phrase "ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation" which is imprecise, and finally, the use of the words "*every step*" in the phrase "the director took every step with a view to minimizing the potential loss to the company's creditors" which are also imprecise.

The chapter then discusses other general problems that surround the wrongful trading rule, such as that the rule is too wide that sometimes it fails to serve its intended purposes and serves purposes which were not intended by parliament when enacting the rule; the problem of funding of wrongful trading actions which stifles the success of the rule; the liquidation exception of the rule whereby the rule only exists when the company has gone into insolvent liquidation, making it unavailable to other insolvency processes such as administration; the absence of protection under the rule for directors who do their best to save the company; the absence of director disqualification under the rule; the fact that the rule presumes a good financial standing on directors when they may actually be insolvent either ordinarily or by virtue of the same insolvency of the company which gives rise to the very wrongful trading claims, and the negative impact of the corporate rescue culture in Malawi on the vibrance of the wrongful trading rule.

© University of Pretoria

Finally, considering the fact the current COVID-19 pandemic has had devastating effects on the solvency of companies in the world, resulting into series of insolvencies of companies not due to director indifference in the management of the affairs of the companies as envisaged by the wrongful trading rule, but due to either the effects of the global COVID-19 pandemic such as lockdowns, immigration restrictions *etc*, or the due to a combination of the said effects and the said director indifference, this chapter will wind up by discussing whether or not the continued application of the wrongful trading rule in Malawi during the current COVID-19 pandemic affects the efficacy of the rule. In undertaking this discussion, the chapter will draw lessons from how the comparable jurisdictions in this study have treated their counterpart rules during the current COVID-19 pandemic.

9.2 PROBLEMS LIKELY TO AFFECT THE EFFICACY OF THE WRONGFUL TRADING RULE IN MALAWI

9.2.1 DRAFTING PROBLEMS

9.2.1.1 Use of the word "Wrongful" in the marginal note of the provision

The use of the word "wrongful" in the marginal note of the rule titled "wrongful trading" is the starting point in analysing problems that hinder the potency of the wrongful trading rule. As it has been observed, the Oxford dictionary definition of the word "**wrongful**" is "***full of wrong***" ***injustice***, or ***injury***; ***marked….by wrong***, ***unfairness*** or ***violation of equity***.[900] According to Keay,[901] this definition gives an impression that in order to make out a wrongful trading case against a director, it is necessary for a liquidator to establish "***wrongdoing***" or "***blameworthiness***" in the conduct of the director prior to the commencement of the insolvent liquidation of a company. This is a factor which was never intended by the Cork Committee when it contemplated enacting the wrongful trading rule.

The use of the word "wrongful," which has the connotations as outlined above, raises an important question of statutory interpretation which cannot be ignored. The question

[900] Simmons, M "Wrongful Trading" (2001) *14 Insolvency Intelligence*, 12.

[901] Keay, A "Wrongful Trading; Problems and proposals". (2014) *65 N. Ir Legal Q,* 64, 67.

© University of Pretoria

that arises is this: *To what extent are words used in the marginal note of a statutory provision to be considered as a legitimate aid to the interpretation of the provision to which the marginal note relates?*

In Malawi, the General Interpretation Act[902] does not provide for the treatment of marginal notes in the interpretation of statutory provisions to which the marginal notes relate. Malawi looks up to common law on this point. The common law position on treatment of marginal notes during interpretation of statutory provisions has not remained static. In *Re Working Urban District Council (Basingstoke Canal) Act 1911*,[903] Phillimore LJ took the view that marginal notes should not be used as aids in the interpretation of provisions to which they relate. The learned judge was very blunt with the basis for his reasoning, saying:

> I am aware of the general rule of law as to marginal notes, at any rate in public general Acts of Parliament; but that rule is founded, as will be seen in reference to the cases, upon the principle that those notes are inserted not by Parliament nor under the authority of Parliament, but by irresponsible persons.[904]

While accepting the position that marginal notes should not be relied on in statutory interpretation, the House of Lords in *Regina vs Montila and Others*[905] rejected the fact that marginal notes are inserted by irresponsible persons, contending that while this was the situation at the time when Phillimore LJ made the remarks in the *Re Working Urban* case, the modern approach is that marginal notes are drafted by Legislative Counsel who are answerable through the cabinet office to the Prime Minister.[906]

Prior to the *Regina vs Montila* decision, Lord Reid in *Chandler vs. DPP*[907] also disagreed with the remarks of Phillimore LJ in *Re Working Urban District Council* decision that marginal notes are inserted by irresponsible persons. Lord Reid stated that:

902 Chapter 101 of the Laws of Malawi.

903 (1914)1 Ch 300.

904 Ibid, at page 322.

905 [2004] UKHL 50.

906 Ibid, para 33.

907 (1964) AC 763.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

> In my view, side notes cannot be used as an aid to construction. They are mere catchwords and I have never heard of it being supposed in recent times that an amendment to alter a side note could be proposed in either House of Parliament. *Side notes in the original Bill are inserted by the draftsman. During the passage of the Bill through its various stages, amendment to it or other reasons may make it desirable to alter a side note. In that event I have reason to believe that alteration is made by the appropriate officer of the House – no doubt in consultation with the draftsman.* So side notes cannot be said to be enacted in the same sense as the long title or any part of the body of the Act.[908] (Emphasis supplied).

Explaining the pressures faced by draftsmen in making marginal notes, a Legislative Counsel in the Cayman Islands, Bilika Simamba,[909] has contended that draftsmen of course try to ensure that once anything is changed in the substantive provision, the label (the marginal note) must be checked to ensure that it is in keeping with the changes.

However, Simamba contends that by their very function,[910] the marginal notes are supposed to be brief and that where the provision is particularly brief, there is an added pressure on the part of draftsmen to make the marginal note correspondingly more brief and that in the end, brevity has the inherent nature of inducing inaccuracy.[911] To this end, Simamba argues, the pressures of drafting coupled with the fact that Parliament does not specifically adopt marginal notes, it is not sensible that marginal notes should be used to determine or assist in determining the meaning of a provision.[912]

There is, however, another school of thought regarding the treatment of marginal notes in the interpretation of provisions to which they relate. While this school of thought does not propose that marginal notes should become an aid to statutory interpretation

---

908 Ibid, at pages 769-790.

909 Simamba, B "Should Marginal Notes be Used in the Interpretation of Legislation?" (2005) *OUP*, 125.

910 Simamba seems to suggest two functions of the marginal notes, namely, to serve as mere labels indicating the subject matter of the provision or serving as a summary of the contents of the provision. See page 126.

911 Ibid, at page 126.

912 Ibid, at pages 126-127.

© University of Pretoria

of the provisions to which they relate, it suggests that marginal notes should not be completely disregarded in the interpretation of the provisions to which they relate.

In *Pickstone vs. Freemans Plc*[913] the court said that an explanatory note attached to a statutory instrument, although it is never part of the instrument, could be used to identify the mischief which the statutory instrument is attempting to remedy.[914] In *Coventry and Solihull Waste Disposal Co Ltd vs. Russel*,[915] the court said that explanatory notes may be referred to as an aid to construction where the statutory instrument to which the note relates is ambiguous.[916]A much clearer position can be seen in *R (Westminster City Council) vs. National Asylum Support Service*[917] where the court said that:

> "In so far as the explanatory notes…accompanied a Bill on its introduction and are updated during the Parliamentary process cast light on the objective setting or contextual sense of the scene of the statute and the mischief at which it is aimed, such materials are always admissible aids to construction.[918]

The height of this school of thought was reached in the *Regina vs. Montila* decision above where, in conceding that the marginal notes are not debated and voted upon in Parliament and therefore that they are not to be given the same weight which is given to the substantial provisions to which they relate, the House of Lords nonetheless said that it is another matter to be required by a rule of law to disregard marginal notes altogether.[919] In the words of the House of Lords:

> One cannot ignore the fact that the headings and side notes are included on the face of the Bill throughout its passage through the Legislature. They are there for guidance. They provide the context for an examination of those parts of the bill that are open for debate. Subject, of course,

913 (1989) AC 66.

914 Ibid, Per Lord Oliver of Aylmerton at p. 127.

915 (1999) 1 WLR 2093.

916 Ibid, page 2103.

917 (2002) 1 WLR 2956.

918 Ibid, at p. 2959.

919 (2004) UKHL, 50, at para. 34.

© University of Pretoria

> to the fact that they are unamendable, they ought to be open to consideration as part of the enactment when it reaches the statute book.[920]

Quoting the reasoning of the court in the *R (Westminster City Council) vs. National Asylum Support Service* decision above with approval, the House of Lords in the *Regina vs. Montila* decision concluded that the headings and marginal notes are as much part of the contextual scene as the explanatory notes and there is no logical reason why they should be treated differently.[921] The court went on to say that this should not be surprising since, as was remarked by Lord Steyn in the *Coventry and Solihull* decision above, language in all legal contexts conveys meaning according to the circumstances in which it is used.[922]

From the foregoing, it will be clear that the connotations that come with the use of the word "**wrongful**" as meaning "**full of wrong**" or "**blameworthy**" as discussed above cannot simply be disregarded by other courts in interpreting the wrongful trading provision. For this reason, in *Re Continental Assurance Co. of London Plc*,[923] some indications can be seen that the court misdirected itself by searching for blameworthiness or wrongdoing in the conduct of the directors and, unsurprisingly, the court was quick to absolve the directors of liability for wrongful trading when it could not see traces of the said blameworthiness or wrongdoing.

In the opinion of Park J in the said case, the fact that the directors were conscientious in what they were doing entailed that no wrong could be apportioned to them.[924] This was despite the fact that the company had incurred a lot of losses to the extent that the company's reserves were depleted and that a quarter of the company's share capital had been dissipated. It is clear, from the view taken by the court in that case, that all this did

---

920 Ibid.

921 Ibid, para 35

922 Ibid, para 36.

923 (2001) BPIR 733.

924 Ibid, at pages 769-70.

© University of Pretoria

not matter as long as there was no element of wrongdoing in the conduct of the directors and, for that reason alone, a wrongful trading case could not be established.[925]

This, it is submitted, is contrary to the spirit of the wrongful trading rule which does not seek to establish blameworthiness or wrongdoing in the conduct of the directors in order for a wrongful trading case to be established by the liquidators, but merely that it must be shown that the directors failed to fulfil their obligations when they were faced with the company's insolvency. Requiring that the liquidators should establish wrongdoing has the effect of making it difficult for liquidators to successfully make out wrongful trading claims, a fact that may lead to the impotency of the wrongful trading rule.[926]

9.2.1.2 Use of the words *"at some time"* in the provision

Section 187(1) of the Insolvency Act in Malawi is clear that liability for wrongful trading will arise with respect to a director if it can be shown that "**at some time**" before the commencement of the winding up, the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and, having so known or concluded, he failed to take every step

---

[925] This must be contrasted with the South African equivalent of the wrongful trading rule, the reckless trading rule under section 424 of the repealed 1973 Companies Act in South Africa which, it has been held, searches for blameworthiness in the conduct of the directors in order for liability under the provision to be established. In *Cronje NO vs. Stone* 1985 (3) SA 597 (T), the court was of the opinion that recklessness may consist blameworthy conduct characterized by a failure to take any due care in the management of a company that is detrimental to both the company and other stakeholders in the company and displays a high degree of disregard for the standards observed by honest and diligent businesspersons. Further, the court said that carelessness may also be demonstrated by a similarly careless failure to attend to the company's business or to prevent a harm which is foreseeable by failing to take reasonable preventive measures against such eventualities. See also *Engelbrecht NO and Others vs. Zuma and Others* [2015] 3 All SA 590 (GP).

[926] It has been observed by one commentator that a proper drafting of the rules that impose personal liability on directors for their failure to fulfil their obligations to companies when the said companies are faced with insolvency promotes deterrence to the said behavior. Commenting on the similarly poor drafting of the insolvent trading provisions in Australia, the equivalent of the wrongful trading provisions in Malawi, Anderson H, "Shelter from the Storm: Phoenix Activity and the Safe Harbour" [2018] 41 *Melbourne University Law Review* 999 at 1000 has observed that:

> Ensuring that bad behaviour is deterred and 'good' behaviour is permitted when creditors are facing significant additional risk requires careful drafting of both the insolvent trading liability provision and its defences.

© University of Pretoria

with a view to minimizing the potential loss to company's creditors as he ought to have taken.

From the above, it is expected that the use of the words **"at some time"** in the provision requires that a liquidator who commences wrongful trading proceedings must pinpoint a time at which he alleges that the director **knew** or **ought to have concluded** that there was no reasonable prospect of the company avoiding going to insolvent liquidation and that the liquidator must plead that exact point of time before the court.

Where the liquidator is unable to locate the said exact point of time, the wrongful trading proceedings will very likely fail. This derives from the position taken by the courts in *Re Sherbone Associates Ltd*[927] and in *Re Continental Assurance Co. of London Plc*[928] that where a liquidator is unable to locate the exact point of time at which he alleges that the director knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation, he is not entitled to argue for wrongful trading in respect of another date which was not pleaded in the claim or to invite the court to select a date subsequent to the one pleaded and make a finding that the director "knew or ought to have concluded" at the particular selected time.

This is problematic and a recipe for failure of many wrongful trading claims for the reason that, as it has been observed by Finch,[929] there will be many instances where it will be difficult for the liquidator to isolate an exact point of time when the director **knew** or **ought to have concluded** that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Finch argues that there would be times when the exact point of time may be revealed by the totality of the evidence given before the court.[930]

---

927 (1995) BCC 40, 42.

928 (2001) BPIR 733, at pages 766-67.

929 Finch, V *Corporate Insolvency Law; Perspectives and Principles,* 2nd edn (2009) *OUP*, 702.

930 Ibid.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

It must be noted, however, that in the *Re Sherborne Associates* decision, the court was wary of its decision being interpreted as a rule precluding deviation based on case-to-case evidence. The court said it would not wish its decision:

> …to be cited hereafter as authority for the proposition that in all [wrongful trading] cases the liquidator must always specify his starting date, and must lose the whole case if he cannot specify to the court that his case is made out by reference to that particular date. Cases vary in detail and complexity.[931]

It is not surprising, therefore, to discover that subsequent to the *Re Sherbone Associates* decision, some courts have adopted a more liberal approach rather than insisting on the liquidator to locate the crucial "point of time" and stick to it.[932] More recently, the courts in *Roberts vs. Frolich*,[933] and *Re Kudos Business Solutions Ltd*,[934] allowed the liquidators to plead the crucial "point of time" in the alternative. In *Roberts vs. Frolich*, in particular, the liquidator pleaded that wrongful trading had occurred around 1st July 2004 (or alternatively on or around 1st September 2004). Although the court found that wrongful trading occurred by 14th September 2004, it nonetheless allowed the liquidator's claim.

Due to the inconsistences appearing in the court decisions regarding the question of the date when liability for wrongful trading crystalized, Keay[935] has argued that a fair degree of uncertainty exists in relation to this question in the sense that while there might be a chance that a court in a particular case may be willing to take a liberal approach and find for a liquidator who pleaded the crucial "point of time" on an estimate or in the alternative, the liquidator himself cannot be certain that in fact this will be the case.

931 (2001) BPIR, 733, at p. 899.

932 See, for instance, *Official Receiver vs. Doshi* (2001) 2 BCLC 235; *Rubin vs. Gunner and Another* (2004) EWHC 316, (2004) BCC 684, (2004) 2 BCLC 110.

933 (2011) EWHC 257.

934 (2011) EWHC 1436.

935 Keay, A "Wrongful Trading; Problems and proposals". (2014) *65 N. Ir Legal Q,* 64, 69.

© University of Pretoria

The unpredictability of the approach which a court faced with a wrongful trading claim may take with respect to the point of time when liability for wrongful trading is alleged to have crystalized entails that there is a risk that the court which any particular liquidator finds himself in with a wrongful trading claim may take a stricter approach and decide that a wrongful trading claim is not made out merely because the liquidator could not pinpoint the said exact "point of time." This uncertainty has the potential of discouraging liquidators from bringing up wrongful trading claims considering that in the event of their claims being unsuccessful, there will be cost implications against the already insolvent estate, and this would be contrary to creditor interest.

9.2.1.3 Use of the phrase " reasonable prospect" in the provision

The use of the phrase "**reasonable prospect**" in Section 187 of the Insolvency Act of 2016 in Malawi equally brings problems of its own. The section materially provides that liability for wrongful trading will arise in respect of a director of a company if, at some time before the commencement of the winding up of the company, the director knew, or ought to have concluded that there was no **"reasonable prospect"** that the company would avoid going into insolvent liquidation, but he nevertheless failed to take every step with a view to minimizing the potential losses to the company's creditors as he ought to have taken.

As it has been rightly observed, the phrase "**reasonable prospect**" in the provision is elusive,[936] and it sometimes depends on the director's rational expectation of what the future may hold.[937] The factors which may be taken into account by the court in determining whether there is a reasonable prospect of the company avoiding going into insolvent liquidation may range from pressure from creditors of the company; withdrawal of support from banks; the loss of contracts; the fact that fresh contracts cannot be obtained as well as failure to pay revenue.[938] The loss of a major supplier has also been considered as one of the factors that may make a director to know or to be

936 Odittah, F "Wrongful Trading" (1990) LMCLQ 205; Payne, J and Prentice, D "Civil Liability of Directors for Company Debts English Law in I Ramsay (Ed) *Company Directors liability for Insolvent Trading* (CCH and University of Melbourne 2001) 206.

937 *Re Kudos Business Solutions Ltd* (2011) EWHC 1436 (Ch).

938 Griffin, S *Personal Liability and disqualification of company directors* (1999) Hart Publishing, 66.

© University of Pretoria

able to conclude that there is no reasonable prospects of a company avoiding going into insolvent liquidation.[939]

As it would be admitted, the decision whether "**reasonable prospects"** of the company avoiding going into insolvent liquidation exists or not will involve both a subjective view taken by the director as well as an objective view which a reasonably diligent director would take in the circumstances. Apart from the above stated pointers and apart from situations where a company will be hopelessly insolvent that the slide into insolvent liquidation is vividly inexorable, there will be many situations where it will be difficult for directors to gaze into the future and determine whether the company is destined for insolvent liquidation.[940]

The problems that stem from use of the phrase "**reasonable prospects**" could well be alleviated if, instead of expecting a director's actions to be based on "reasonable prospects of the company avoiding going into insolvent liquidation," the said action was made to be based on more discernible liability triggers, such as "**insolvency"** and "**incurring a debt,**" as is the case with the Australian counterpart of the wrongful trading rule, the insolvent trading rule. Under the said Australian insolvent trading rule, liability for insolvent trading is triggered by a director's decision to **incur a debt** for the company when he knows or expects the company to be **insolvent**.

It must be noted that even the Australian position above is not without challenges. First, there are challenges encountered with the Australian position above relating to the meaning of the phrase "**incurring a debt**" and also problems relating to "**the time when a debt is said to be incurred**."[941] However, as it has been argued by Keay,[942] while inability to pay debts as they fall due is equally not a precisely defined expression, **insolvency** and **incurring a debt** are more definitive factors than directors being

939 *Re DKG Contractors Ltd* (1990) BCC 903.

940 Mumford, M and Katz, A "Making Creditor Protection effective" (2010) *ICAEW*, 52.

941 For a full discussion on this issue, see generally Mosley, J "Insolvent Trading: What is a debt and when is it incurred?" (1996) *4 Insolvency Law Journal* 156.

942 Keay, A and Walton, P *Insolvency Law; Corporate and Personal* (2012) 3rd Edn, *Jordans*, 16-21.

© University of Pretoria

required to gaze in the future and discern that there are no reasonable prospects of the company avoiding going into insolvent liquidation.

Apart from the challenges in defining incurring a debt and when this occurs, also other concerns which have arisen in Australia regarding these two liability triggers relate to the plight of non-executive directors who will not always be able to know a company's exact financial position as for them to know or to expect a company to be **insolvent** and prevent it from **incurring a debt**. Keay[943] addresses this in three ways:

Firstly, Keay argues that the mere fact of all directors of a company being executive directors does not entail that they will be fully conversant with the financial position of the company as for them not to engage in wrongful trading.[944] In this vein, Keay argues that it is clear from case law that the vast majority of wrongful trading cases are found in small private companies where it is rare to find non-executive directors as almost all the directors will be shareholders or managers of the company.[945]

Secondly, Keay argues that there is an obligation on each director, whether executive or non-executive, to appraise themselves of the financial position of the company,[946] and, thirdly, that the said non-executive directors can extricate themselves from liability for wrongful trading by showing that they did not know and that they did not expect, given the circumstances of their case, that their company was insolvent.[947]

Apart from the foregoing, there are concerns under Australian law with respect to the two liability triggers on the basis that considering, as it has been observed in this study, that companies go in and out of insolvencies during their lives, and therefore that incurring debts is sometimes necessary in order to keep the company afloat, expecting a director to prevent a company from **incurring a debt** each time he knows or expects

943 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 74.

944 Ibid.

945 Ibid.

946 Ibid. see also *Australian Securities and Investments Commission* (ASIC) vs *Healey* (2011) FCA 717.

947 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q. 63*, 74.

© University of Pretoria

the company to be **insolvent** can cause premature insolvent liquidations of companies particularly in cases of some starter-up companies which may in fact need to incur debts in order to grow considering that not every stint of insolvency will be terminal.

In respect of the foregoing, the concern comes in the sense that since a company will often go in and out of insolvency during its life, prohibiting a director from incurring a debt each time they know or expect their companies to be insolvent increases the chances of directors being found liable for insolvent trading, the equivalent of wrongful trading, since there will be many times when the directors will have to prevent the company from incurring debts.

The foregoing concern is, however, not without redress. First, as Keay[948] has argued, when prohibiting the incurring of a debt when a company is insolvent or expected to be insolvent becomes the main liability triggers, the fact that companies go in and out of insolvency every time will not worsen a director's position because it is not every incurring of a debt when a company is insolvent that will lead to liability for insolvent trading (the equivalent of wrongful trading). It is rather the incurring of a debt when a company is insolvent and the company eventually fails to return to solvency and proceeds into insolvent liquidation which will invite liability for wrongful trading.[949]

In this vein, it has been argued that if a company was insolvent, and the director allowed the company to incur a debt knowing fully well that the company was insolvent, but eventually the company trades out of the said insolvency, then certainly no wrongful trading claim would eventuate.[950] Corollary, if the director allowed the company to incur a debt, and the company ends up in insolvent liquidation, then this serves as an indication that the company had serious financial problems which is incompatible with the normal moving in and out of insolvency and therefore that this should have been

948 Ibid.

949 Ibid.

950 Ibid.

© University of Pretoria

known or expected by the director at the time when the debt was incurred so as to make him prevent the company from incurring the debt in question.[951]

On the concern that preventing a company from incurring a debts when the company is known or expected to be insolvent can lead into premature insolvency processes, particularly administration, as directors will be fearful of liability for wrongful trading thereby prompting them to initiate administration every time they know or expect the company to be insolvent and incurring a debt is necessary, Keay[952] counters this concern on the footing that if this was to occur, it would not be a major problem as administration would not only provide the financial boost that would glide the company back to solvency, but rather it would also provide a moratorium to all claims against the company and thereby making the company afford strategic settlement of claims across a period of time, a fact which may enable its successful return to solvency under the guidance of an insolvency practitioner.

In view of the foregoing, it is submitted that while the negative elements of prohibiting a company from incurring a debt are not optimal, namely, that administration may occur when it was not necessary and that it will bring about an extra cost to the company as well as affecting its reputation, the same would be preferable than allowing the company continuing to trade, incurring more and more debts and thereby accelerating losses to creditors.[953] In support of this option, Keay[954] has argued that:

> Intuitively, one would say that creditors would rather see their dividend reduced in a small way in relation to a few companies who did not need to go into administration if they were to see their losses because of wrongful trading reduced significantly.

Further, it is submitted that even if prohibiting directors from allowing companies to incur debts could lead into placement of companies into administration when that was not necessary, when it is considered from the angle that insolvency will have been

---

951 Ibid.

952 Ibid.

953 Ibid.

954 Keay, A *McPherson's Law of Company Liquidation* 3rd Edn. (2013) Sweet and Maxwell, 144.

© University of Pretoria

known or expected by the directors at that time, prohibiting directors from allowing the companies to incur dets when the companies are insolvent seems to accord with the intention of the Cork Committee when it invented the wrongful trading rule in the United Kingdom, namely, that if directors at any time consider the company to be insolvent, they should take immediate steps for the company to be placed in administration or liquidation.[955]

According to Keay, this would not be a novel or radical approach as the same approach is used in France, Belgium and Germany apart from Australia.[956] In case of Australia, where voluntary administration of companies is frequently employed, prohibiting directors from allowing their companies from incurring dets when they know or expect the said companies to be insolvent is touted as a reason for reasonably low number of reported insolvent trading cases,[957] the equivalent of wrongful trading cases.

9.2.1.4 Use of the phrase "ought to have concluded" in the provision

9.2.1.4.1 The phrase is imprecise

Section 187 of the Insolvency Act provides that liability for wrongful trading in respect of a director will arise if, at some time, before the commencement of winding up the company, the director knew, "**or ought to have concluded"** that there was no reasonable prospect that the company would avoid going into insolvent liquidation,[958] and he did not take steps with a view to minimizing the potential loss to the company's creditors as he ought to have taken.[959]

955 Insolvency Law Review Committee, Insolvency Law and Practice (the Cork Report) (Cmnd 858 HMSO 1982).

956 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 75.

957 Herzberg, A "Why are there so few insolvent trading cases?" (1998) *6 Insolvency Law Journal*, 77.

958 Section 187 (2) (b) of the Act.

959 Section 187 (3) of the Act.

© University of Pretoria

Williams,[960] has argued that the words "**ought to have concluded**" are too imprecise and therefore that they bring uncertainty as to the exact point of time when liability for wrongful trading may be incurred as for directors to be deterred and therefore avoid any indifference in the management of the affairs of the company during that point of time. According to the learned commentator, effective deterrence from trading while insolvent could be well achieved by a director being able to predict with a good degree of certainty as to when liability for wrongful trading will arise and therefore be able to know when to cease trading.[961]

The absence of the deterrent-effect in the wrongful trading rule has also been observed by Hicks,[962] who argues that despite the widespread claims of the deterrent effect which the wrongful trading mechanism is said to have on director-indifference, no detailed evidence of the same has been presented, creating doubt if the said deterrent effect actually exists.[963] Lending weight to the foregoing, a study conducted by Baldwin[964] has suggested that generally, personal liability rules such as the wrongful trading rule do not act as effective deterrence measures for director misconduct and that instead, an important driver of directors' conduct is "concern for their company's reputation."[965]

From the foregoing, it would be clear that the words "**ought to have concluded**," as used in section 187 of the Insolvency Act of 2016 in Malawi, do not assist the provision in achieving deterrence as they lack precision as to what time they relate to and, therefore, they are incapable of disincentivizing directors from engaging in a particular "misconduct" at a particular time. Deterrence is more likely to be achieved if the words used in the provision are too exact so as not to leave a doubt in the minds of the directors

---

960 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 63, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

961 Ibid.

962 Hicks, A "Wrongful Trading – has it been a failure?" (1993) 8 *Insolvency Law and Practice*, 134.

963 See e.g. Finch, V *Corporate Insolvency Law; Perspectives and Principles* (2009) CUP 2nd ed, 749.

964 Baldwin, R "The New punitive regulation" (2004) 67 *MLR*, 351.

965 Ibid.

© University of Pretoria

as to what is expected to be done and what time it is expected to be done in order to stay away from liability for wrongful trading.

9.2.1.4.2 The phrase deprives directors of the "every step" defence

As it would be clear, the liability trigger under the wrongful trading rule in Malawi has two limbs. The first limb requires that from the moment a director **"knew"** that there was no reasonable prospect of the company avoiding insolvent liquidation, he should have taken steps with a view to minimizing the potential loss to the company's creditors as he ought to have taken.

The second limb applies to directors who did not know that there was no reasonable prospect that the company would avoid going into insolvent liquidation but who, objectively, "**ought to have known**" so, given the circumstances in which the company was in as well as their knowledge and experience. This limb expects this set of directors, who did not know (but who ought to have known) to have taken steps with a view to minimizing loss to creditors during insolvent liquidation (which only directors who knew would have taken) This is practically impossible.

This second limb of the wrongful trading defence is therefore poorly drafted as it has the potential of inviting liability to all directors who argue that they did not know that the company would avoid going into insolvent liquidation, but who ought to have known so, because with their lack of knowledge that the company would not avoid insolvent liquidation, they will obviously not have taken steps with a view of minimizing the potential loss to the creditors of their companies because according to them, no loss was going to occur to any creditor since the company would remain solvent.[966]

---

[966] As it has been noted in this chapter, It has been observed by one commentator that a proper drafting of the rules that impose personal liability on directors for their failure to fulfil their obligations to companies when the said companies are faced with insolvency promotes deterrence to the said behavior. Commenting on the similarly poor drafting of the insolvent trading provisions in Australia, the equivalent of the wrongful trading provisions in Malawi, Anderson H, "Shelter from the Storm: Phoenix Activity and the Safe Harbour" [2018] 41 *Melbourne University Law Review* 999 at 1000 has observed that:

> Ensuring that bad behaviour is deterred and 'good' behaviour is permitted when creditors are facing significant additional risk requires careful drafting of both the insolvent trading liability provision and its **defences.** (Emphasis supplied).

© University of Pretoria

In this vein, wrongful trading proceedings which are based on the limb that the director ought to have known that there was no reasonable prospect of the company avoiding insolvent liquidation, rather than that the director knew so, are very likely to be challenged on the basis that this limb deprives the director of having a defence in the proceedings. This has the potential of stifling the success of the proceedings, thereby dampening the efficacy of the wrongful trading rule.[967]

In the United Kingdom, this anomaly has been rectified. In effect, the position under the UK Insolvency Act of 1986 presently is that liability for wrongful trading will attach if the director **knew** or **ought to have concluded** that there was no reasonable prospect of the company avoiding insolvent liquidation and that **if he knew** (which does not include **if he ought to have concluded**) he failed to take steps with a view to minimizing the potential loss to the company's creditors.[968] Put simply, under the UK Insolvency Act of 1986, directors who did not know, but who "**ought to have concluded**" that the company would not avoid going into insolvent liquidation, are not expected to have taken steps with a view to minimizing the potential loss to the company's creditors as the case is in Malawi because it is practically impossible to do so.

9.2.1.5 Use of the words "*every step*" in the provision

It has been observed by Sealy[969] that the phrase taking "**every step**" in the defence to a wrongful trading claim, which is to the effect that "*a director will not be liable if he took **every step** with a view to minimizing the potential loss to the company's creditors*" is too broad that it is capable of rendering liability for "incompetence, ignorance and indifference as well as conscious wrongdoing. Although this broadness is vital as it

[967] See also Cheffins, B *Company Law; Theory, Structure and Operation* (1997) 547, who argues that procedural constraints in maintaining insolvent trading provisions (an equivalent of the wrongful trading provisions in Australia) is one of the reasons why the provisions offer limited assistance to creditors of companies.

[968] Section 214 (3) of the Insolvency Act, 1986.

[969] Sealy, L "Personal liability of directors and officers for debts of insolvent corporations: a jurisdictional perspective (England)" in Zeigel, J (ed) *Current Developments in International and Comparative Corporate Insolvency Law,* 1994, Oxford: Clarendon Press, p.492.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

makes the wrongful trading rule intolerant to any director-delinquency in the running of the affairs of a financially distressed company, it is submitted that the defence of taking every step should have been crafted better by at least giving a guidance on the factors that will be taken into account in deciding if a director took every step.

In Australia, some guidelines are given in the defences to "Insolvent Trading," an equivalent of wrongful trading. Insolvent trading in Australia occurs when a director of a company fails to prevent the company from incurring a debt or debts when reasonable grounds exist for suspecting that the company is insolvent or will become insolvent by reason of having incurred the debt or debts in question.[970]

Under section 588H of the Australian Corporations Act of 2001, it is a defence if it is proved that the director took all reasonable steps to prevent the company from incurring the debt.[971] Unlike the wrongful trading provision in Malawi that leaves this defence hanging in balance, the Australian counterpart gives some indication of what the court will take into account in considering whether the director took reasonable steps. Section 588H (6) of the Australian Corporations Act provides that in determining whether the defence of taking all reasonable steps has been proved, the matters to which regard will be had shall include, but not be limited to:

a) Any action the person took with a view to appointing an administrator of the company;[972] and

b) When that action was taken;[973] and

c) The results of that action.[974]

970 Section 588G of the Corporations Act, 2001.

971 Section 588H (5) of the Act.

972 Section 588H (6) (a) of the Act.

973 Section 588H (6) (b) of the Act.

974 Section 588H (6) (c) of the Act.

© University of Pretoria

Apart from the foregoing, the Australian insolvent trading rule also has a mechanism known as the safe harbour[975] which is designed to shield directors from liability for insolvent trading if, upon suspecting that the company is or may be insolvent, the directors begin developing one or more courses of action that are reasonably likely to lead to a better outcome for the company,[976] and the debt is incurred directly or indirectly in connection with any such course of action.[977] The duration for this shield is however not open-ended. A director will benefit from this protection from the time he starts developing any of such courses of action to the earliest of the following:

(a) If the director fails to take any such course or courses of action within a reasonable period of time after he begins to develop the said course or courses of action – the end of that reasonable period.[978]

(b) When the director ceases to take any such course of action.[979]

(c) When any such course of action ceases to be reasonably likely to lead to a better outcome for the company.[980]

(d) When an administrator or a liquidator has been appointed for the company.[981]

It must be noted that the Australian Corporations Act goes further to give guidance on what will be taken into account in deciding if the course of action taken by the director as above is likely to lead to a better outcome for the company. This involves a consideration of whether the director is properly informing himself or herself of the company's financial position;[982] or whether the director is taking appropriate steps to

---

975 Section 588 GA of the Act.

976 Section 588GA (1)(a) of the Act.

977 Section 588GA (1) (a) of the Act.

978 Section 588GA (1) (b) (i) of the Act.

979 Section 588GA (1) (b) (ii) of the Act.

980 Section 588GA (1) (b) (iii) of the Act.

981 Section 588GA (1) (b) (iv) of the Act.

982 Section 588GA (2) (a) of the Act.

© University of Pretoria

prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts;[983] or whether the director is taking appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company;[984] or whether the company is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice;[985] or indeed whether the director is developing or implementing a plan for restructuring the company to improve its financial position.[986]

Away from Australia, the defence to the equivalent of the wrongful trading provision in section 297A of the Companies Act of 1963 in the Republic of Ireland is equally more elaborate than the wrongful trading defence as it slightly opens up on the factors which the court will take into account in considering whether or not the defence is made out, namely, that the officer acted honestly and responsibly in relation to the conduct of the affairs of the company. The court in *Re Heffron Kearns Ltd (No.2)*[987] acknowledged that the Irish provision was more widely drafted than the wrongful trading provision.

The fact that the wrongful trading provision does not give guidance on the steps which will be considered by the court to be sufficient for a director who takes the said steps to escape liability for wrongful trading means that the defence is very imprecise as it is so much dependent on the discretion of each and every court hearing a wrongful trading case to decide which steps are considered to be sufficient to it.

To the extent that the defence is dependent of the discretion of the court, and to the extent that this discretion seems to be at large, there is a chance that directors who can show that they, at least, made an effort will escape liability even though they may not

983 Section 588GA (2) (b) of the Act.

984 Section 588GA (2) (c) of the Act.

985 Section 588GA (2) (d) of the Act.

986 Section 588GA (2) (e) of the Act.

987 Unreported, but available in (1993) JIBL93.

© University of Pretoria

have done their best, as compared to directors who did nothing. The possibility of directors who did not do their best being extricated from liability for wrongful trading dampens the potency of the wrongful trading rule.

9.2.2 THE RULE IS TOO WIDE THAT IT FAILS TO SERVE INTENDED PURPOSES AND SERVES UNINTENDED PURPOSES

As it would be readily accepted, Parliament will always have a mischief that it desires to remedy when it enacts a particular rule of law. In order to undertake a meaningful analysis of whether the wrongful trading rule is working out well, one would need to understand the mischief which the rule was designed to remedy. As it has been rightly observed by Williams[988] the case that was presented by the Cork Committee for the introduction of the wrongful trading rule was predicated on the concern that the principle of limited liability has the potential of breeding a certain degree of indifference and lack of concern on the part of corporate managers with regard to the level of indebtedness of financially distressed companies.[989]

For this reason, the Cork report was clear that the intention for the introduction of the wrongful trading rule was the radical extension of civil liability to directors who recklessly continued to trade financially troubled companies beyond the point where there was no hope of recovery for the company.[990] It was hoped that personal liability would remove the protective cloak of limited liability from the wrongdoing directors, thereby allowing creditors affected by the wrongdoing to be compensated, a situation which would also act as a deterrence of such an abuse of the limited liability status to other present or future directors.[991] For these reasons, the need to combat perverse

---

[988] Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 58, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

[989] Insolvency law and practice: Report of the Review Committee (Chairman, Sir Kenneth Cork) Cmnd 8558 (1982), Cork Report, para 1741.

[990] Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 58, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

[991] See generally "Insolvency law and practice: Report of the Review Committee" (Chairman, Sir Kenneth Cork) Cmnd 8558 (1982), also known as the Cork Report.

© University of Pretoria

incentives created by the principle of limited liability remains the central justification and the intention for the creation of the wrongful trading rule.[992]

Unfortunately, while the concern for indifference and lack of concern amongst company officers for the corporate liabilities was the trigger for the introduction of the wrongful trading rule, the drafting of the rule itself went beyond this central intention to the extent that the wrongful trading rule currently serves other purposes which were not envisaged by the Cork Committee, leaving the desired intention unsatisfied.

As has been observed by Williams,[993] the fact that the key to liability under the wrongful trading rule is to show that the company was allowed to carry on trading at a time when the directors "knew" or "ought to have concluded" that the company was of doubtful solvency means that any such "insolvent trading" may be caught by the rule whether it was borne out of director-indifference to creditors' plight (which was the only aim of the rule envisaged by the Cork Committee) or for any other reason, which was never contemplated by the Cork Committee, for instance, the desire to confer a preference payment on a creditor.[994]

Put simply, it would appear that as long as the test of trading while insolvent is met, the reason behind it does not matter and, as a result, there will be times when the order that will be made by the court will fail to have any effect on the plight of creditors thereby being unable to serve the purpose for which the wrongful trading rule was intended by the Cork Committee and by parliament.

A classic example of this problem occurred in *Re DKG contractors Ltd*.[995] In this case, the liquidator sought to recover £417, 763 from the respondent directors which it was alleged had been transferred from DKG, the insolvent company, to one of its directors,

992 Keay, A "Wrongful Trading and the liability of Company directors: A theoretical perspective" (1996) *Legal Studies*, 431, at p. 434.

993 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 59, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

994 Ibid.

995 [1990] BCC 903.

© University of Pretoria

who was also a significant creditor of DKG. It was alleged that this transfer had been done 10 months prior to DKG's insolvency. The liquidator alleged that the transfer in question amounted to (a) breach of duty by the directors under the relevant statutory law as the payment was made at a time when the company could not meet its debts as they fell due; (b) transaction at a preference in as much as the payment preferred one of the company's creditors; (c) wrongful trading on the basis that throughout the period in which the payments were made, the respondent directors knew or ought to have concluded that the company could not avoid insolvent liquidation but it was allowed to continue trading.

The court found that the liquidator made out all the three allegations and held the respondent directors liable to repay the £417, 763 under the said three heads of claims and, interestingly, the court held, further, that satisfaction of liability under breach of duty in the case discharged the other two claims of transaction at a preference and wrongful trading.

As it would be clear from the above case, the wrongful trading claim was not based on the fact that the respondent directors had traded with indifference while DKG was insolvent because they felt that they were protected by the principle of limited liability. Rather, the claim emanated from a series of self-interested transactions that were intended to prefer a director–creditor over the general body of creditors, the basis of the claim being that the relevant transactions took place at a time when the directors "ought to have concluded" that the company could not avoid insolvent liquidation. Further, as it would be seen from the decision of the court, liability for wrongful trading provided no benefit to the creditors of DKG in that it added nothing to the sums which were recoverable under the breach of duty and the transaction at a preference claims, which were in fact recovered under the breach of duty claim only. The wrongful trading claim was simply regarded as any other monetary claim, with no attention paid to the rationale of the claim.

The *Re DKG* decision is an example of a situation where the wide drafting of the wrongful trading provisions resulted into a decision that failed to achieve the intended purpose of the wrongful trading rule, which is to curb indifference in directors' conduct in the running of the affairs of the company while providing a benefit to the company's

© University of Pretoria

creditors which could otherwise not be provided under other legal claims, such as the claim for breach of duty or the claim for transaction conferring preferential payments, taking the *DGK* decision as an example.

Similarly, in *Re Idessa (UK) Ltd*,[996] the conduct complained of by the liquidator in respect of the respondent director had its roots in self-interest behavior rather than trading with indifference to the plight of creditors. In this case, the liquidator of Idessa similarly brought claims against the respondent directors for breach of duty; transaction at a preference and wrongful trading in respect of payments made by the insolvent company (Idessa) for the benefit of the respondent directors at a time when Idessa was insolvent.

The court found most of the allegations under breach of duty and wrongful trading made out (making it unnecessary to consider the claim for transaction at a preference) and ordered the directors to pay a total of £ 1, 438, 518.23 in respect of liabilities under the said breach of duty and wrongful trading. Out of this sum, £340, 411 was assigned by the judge to a claim for breach of duty on the basis that this sum was transferred by the directors at a time before it could be established that the company had no reasonable prospect of avoiding insolvent liquidation, while the difference of £ 1, 098, 102 was assigned to the wrongful trading claim.

While this shows that a significant sum was received under the wrongful trading claim, there is no indication that the sums could not be recovered through claims other than wrongful trading, particularly the breach of duty claim. In actual fact, the court acknowledged[997] that the £ 1, 098, 102 assigned to the wrongful trading claim included a tax liability of £ 274, 966.11, which could obviously have been recovered under breach of duty. According to Williams,[998] the decision to allocate the £ 1, 098, 102 was therefore a matter of convenience rather than a matter of law.

---

996 (2011) EWHC 804 (Ch).

997 Ibid, at paras 133 and 135.

998 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 81, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

© University of Pretoria

9.2.3 THE FUNDING PROBLEM

As already discussed in chapter 7 herein, funding of wrongful trading proceedings poses one of the greatest hurdles in the success of the rule. To begin with, funding of wrongful trading proceedings becomes a problem in Malawi owing to the fact that these are proceedings that are commenced when a company is already on its financial 'death bed,' due to the insolvent liquidation that will be in progress.

As a matter of fact, except in rare cases, if at all, where a liquidator would institute wrongful trading proceedings merely to achieve deterrence to director indifference in the running of the affairs of the company, in the majority, if not in all cases, the wrongful trading claims are instituted by liquidators in order to achieve an increase in the pool of assets of the company available for distribution to creditors, with deterrence to director indifference being an incidental benefit of the said proceedings.

The foregoing entails that at the time when wrongful trading proceedings will be contemplated by a liquidator, the company will ordinarily be in a position where its assets are insufficient for distribution to all creditors together with payment of liquidation expenses. In this financial situation, many liquidators would not want to apply the already insufficient assets of the company in funding wrongful trading claims particularly where the success of the said claims is not guaranteed or where, if the proceedings were to be successful, it is not guaranteed that the respondent directors, particularly where they are natural persons, will be solvent enough to comply with the order of the court relating to contribution to the assets of the company for distribution to creditors.

The inability by a liquidator to access public funding is another hurdle that hampers the success of the wrongful trading rule. This results in the rule being unable to serve the functions for which it was designed. As observed by Schulte,[999] the wrongful trading rule was designed to serve both private law functions as well as public law functions.

---

999 Schulte, R "Wrongful Trading; an impotent remedy? (1996) *Journal of financial crime*, Vol 4, issue 1, pages 38 and 39.

© University of Pretoria

First, the learned commentator argues that the private law function is served in the sense that, for the benefit of creditors, wrongful trading imposes personal liability on those responsible and this takes away the incentive on the part of persons responsible for the management of corporations to keep on incurring debts for the corporation when there is no possibility of the corporations being able to repay the said debts.[1000]

Second, Schulte argues that the deterrence of abuses of the privilege of limited liability that is achieved by imposition of personal liability on the controllers of a company serves a public law function of ensuring that directors of companies comply with minimum standards for serving as directors of companies, failure which entitles the court to remove the privilege of limited liability by creating personal liability for the responsible directors.[1001]

In view of the foregoing, Schulte argues that as a result of the inability by the liquidator to have access to public funding, the situation that remains at hand is that parliament has enabled and expects the liquidator to pursue an action that serves a public law function with no assistance or incentive to do so from the public.[1002]

While access to public funding would eradicate the funding problems that have stifled the success of the wrongful trading mechanism, it would be seen that access to public funding would also enable the public law function of the wrongful trading mechanism to be fulfilled.[1003]

One of the ways through which a liquidator may have access to public funding is to extend standing to commence wrongful trading proceedings to a public officer. Although Government may not spend enormous sums of money in prosecuting wrongful trading claims, the Government officer will, nonetheless, have a lot of resources at his disposal to conduct investigations than a private liquidator or

[1000] Ibid.

[1001] Ibid.

[1002] Schulte, R "Wrongful Trading: An Impotent Remedy?" (1996) *Journal of Financial Crime*, Vol 4 Issue: 1, 40.

[1003] Ibid.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

administrator.[1004] A proper investigation conducted by a Government official with the aid of Government resources will certainly raise the prospects of successful wrongful trading proceedings thereby enhancing the efficacy of the wrongful trading rule.

Further, having a Government official whose interests are purely to enforce minimum standards for those serving as directors, as opposed to private interests of ensuring that creditors should end up receiving a dividend, entails that the said Government official would take up the wrongful trading proceedings in situations where the liquidator does not see a better yield resulting from the wrongful trading proceedings as this will not be the concern of the Government officer whose interest will be to ensure public order.[1005] In *Woodgate vs Davis*[1006] Barrett J of the Supreme Court of New South Wales remarked that actions under the insolvent trading rule, the equivalent of the wrongful trading rule in Australia, serve a social purpose.

Extending standing to a public officer would not be a radical stance as it will be seen that the approach is embraced in other jurisdictions. In Ireland, an equivalent of a wrongful trading proceeding is brought up by the Director of Corporate Investment, among other claimants. This is done under the Company Law Enforcement Act of 2001. In Australia, the equivalent of a wrongful trading proceedings is brought by the Australian Securities and Investment Commission (ASIC) among other claimants.

Apart from public funding, given the fact that during insolvent liquidation of companies, there will usually be insufficient assets to satisfy all proved debts together with the expenses of winding up, and that in such situations, a liquidator would be hesitant to deplete the already meagre assets of the company to fund speculative claims, and given the fact that liquidators have no access to public funding, alternative sources of funding emanating from the liquidator's ability to assign rights or causes of action in wrongful trading claims through maintenance or champerty arrangements with third

---

1004 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 77.

1005 Ibid.

1006 (2002) 42 ACSR 268.

© University of Pretoria

parties or creditors would emerge to be an alternative way through which the problem of funding in wrongful trading claims would be mitigated.

This view is supported by Schulte,[1007] who concludes that until private third-party sources of funding as above are enabled, the wrongful trading mechanism will remain of no interest to liquidators and of no benefit to creditors, but simply an impotent progeny of a fine legal theory to wrongdoing controllers of companies.

However, assignment of causes of action and proceeds thereof through maintenance or champerty arrangements is currently not possible under the Insolvency Act in Malawi, and therefore private funding in wrongful trading proceedings which could easily be accessible through assignment of causes of action by a liquidator to third parties in return for a share of the proceeds cannot be done in Malawi. The inability of the liquidator to assign the causes of action in wrongful trading entails that the only source of funding available to a liquidator to bring up wrongful trading actions is from the already meagre assets of the company and this has the potential of stifling wrongful trading proceedings thereby affecting the potency of the wrongful trading rule.

In the United Kingdom, the wrongful trading provision has been amended to allow for alternative sources of funding rather than having to rely on liquidators who usually have insufficient assets as to fund the proceedings. Presently, section 246ZD has been added to the UK Insolvency Act of 1986 empowering an office holder, (liquidator or administrator)[1008] to be able to assign a right of an action, including the proceeds of an action[1009] for wrongful trading.[1010] This amendment unlocks funding for prosecution of wrongful trading proceedings from third parties, including creditors who may choose to pursue the proceedings themselves and in the end, the UK position enhances the potency of the wrongful trading rule which was otherwise dampened by the problem of funding of the wrongful trading proceedings.

1007 Ibid.

1008 See the proviso to section 246ZD of the Act.

1009 Section 246ZD (2) of the Act.

1010 Section 246ZB (2) (b) of the Act.

© University of Pretoria

9.2.4 THE LIQUIDATION RESTRICTION OF THE WRONGFUL TRADING RULE

The wrongful trading rule has been criticized for having a "liquidation restriction."[1011] This restriction manifests itself in two ways. First, the wrongful trading mechanism is only available during insolvent liquidation of companies.[1012] Secondly, which obviously flows from the first one, the wrongful trading proceedings in Malawi can only be instituted by liquidators during the said insolvent liquidation of companies.[1013] This liquidation restriction has ramifications that stifle the potency of the wrongful trading rule. For clarity, these two limbs of the liquidation restriction will be discussed separately.

9.2.4.1 Availability of the remedy only during insolvent liquidation of companies

The wrongful trading rule in Malawi can be blamed for being unavailable to companies that undergo other forms of insolvency processes such as administration.[1014] It must be noted that the liquidation restriction had not been part of the proposal by the Cork Committee for the introduction of the wrongful trading rule. The proposal that was made by the Cork Committee had been that the wrongful trading remedy should be available even during administration of companies through an administrator or a creditor of the company, and that in case of liquidation, a creditor must equally have standing to bring up wrongful trading proceedings.[1015]

1011 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 64, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

1012 Section 187 of the Insolvency Act in Malawi.

1013 Ibid.

1014 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 64, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

1015 Insolvency law and practice: Report of the Review Committee (Chairman, Sir Kenneth Cork) Cmnd 8558 (1982), also known as the Cork Report, para 1086.

© University of Pretoria

However, upon being enacted in 1986 in the United Kingdom, from where Malawi copied the rule, the then Government of the day took the view that such a broad power of civil recovery would deter genuine entrepreneurs from taking risks in the operation of their businesses[1016] and, instead, the said Government took a decision to restrict wrongful trading to directors of companies that entered into insolvent liquidation.

It must be noted that no evidence as to the advantage of restricting the wrongful trading remedy only to companies that have gone into insolvent liquidation was given by the then British Government and, as it has been observed by Williams,[1017] subsequent developments in the rules of directors' duties suggest that the concerns which had been expressed by the British government about a broader liability rule deterring entrepreneurs were rather exaggerated.

It has been argued that the decision of the court in *Liquidator of West Mercia Safety wear vs. Dodd*,[1018] which is to the effect that when a solvent company is navigating the vicinity of insolvency, the interests of the company become identifiable with the interests of the company's creditors created a possibility of directorial liability for insolvent trading which is not connected with a formal insolvency process, and that there has been no arguments as to how, if at all, this has deterred or can deter genuine entrepreneurs from taking business risks as suggested by the British Government back then.[1019]

As Williams[1020] has argued, the *Liquidator of West Mercia* decision creates a possibility of an action by or on behalf of a company against a director who, through insolvent trading, breaches their duty to heed creditors' interests in the pre-insolvency context whether the company ends up in liquidation as was the case in *Re DKG*

1016 A Revised Framework for Insolvency Law, (Cmnd 9175 (1984), para 52.

1017 Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 64, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

1018 (1988) 4 BCC 30.

1019 Ibid.

1020 Ibid, at p. 66.

© University of Pretoria

Contractors Ltd,[1021] or where the company ends up in administration as was the case in *Facia Footware Ltd. (In Administration) vs. Hinchcliffe*[1022] in which a claim was successfully made in respect of a directors' breach of the modified duty to have regard to the interests of creditors in promoting the interests of the company, or indeed whether no insolvency process has commenced at all.

Based on the effect of the *Liquidator of West Mercia* decision, it has been argued that the need for wrongful trading to apply only in cases of insolvent liquidation of companies is an unnecessary restriction on the remedy and a significant contributor to the impotency of the wrongful trading rule.[1023] Extending the rule to apply to other forms of insolvency processes can be seen to be ideal and feasible. For instance, if wrongful trading proceedings were to be available during administration of companies, the funding problems would reduce tremendously considering that during administration, the financial position of a company will not have deteriorated more than it would be during insolvent liquidation, and that although there would be administration expenses, there would be no liquidation expenses, which are comparatively greater, to be paid and therefore the company will more likely be in a better financial position to fund the wrongful trading proceedings.

In the United Kingdom, the consequences of the wrongful trading remedy being available only during insolvent liquidation of companies have been felt throughout the years prompting the need for law reform.[1024] Presently, the UK Insolvency Act of 1986 has been amended to extend the availability of the wrongful trading remedy during administration of companies.

The amendment was made by adding section 246ZB to the Insolvency Act of 1986. The new section 246ZB ('Wrongful Trading: Companies in Administration) mirrors

1021 (1990) B.C.C 903.

1022 (1998) 1 BCLC 218.

1023 See e.g. Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York*.

1024 Small Business, Enterprise and Employment HC Bill (2014-2015) Cl 105 (proposing the insertion of a new section 246ZB into the Insolvency Act 1986.

© University of Pretoria

Section 214 (Wrongful Trading) exactly in setting the standard of liability and defences generally, except the language but most importantly, it modifies the wrongful trading provision in its current form to refer to "administration" and "administrators" in place of "liquidation" and "liquidators. The provision makes the following material modifications:

(a) That the wrongful trading remedy will from, 1st October 2015, the date of effect of the amendment,[1025] be available to companies that enter into insolvent administration on or from that date.[1026]

(b) That a company goes into insolvent administration if it enters into administration at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the administration.[1027]

By granting administrators powers to commence wrongful trading proceedings, the amendment under the UK Insolvency Act has enabled administrators to investigate and redress allegations of director-indifference in the running of the affairs of companies during administration rather than having to delay such investigation and redress until a company enters insolvent liquidation.

Further, given that where wrongful trading proceedings by an administrator have been successful the court may order a respondent director to contribute to the company's assets,[1028] the said contribution, where it is meaningful, may increase the assets of the company and possibly be vital in steering the company back to solvency rather than having it proceed to insolvent liquidation.

Apart from the foregoing, the possibility of an administrator being able to maintain wrongful trading claims against directors has the potential of having the said claims brought up much quicker and for the effective benefit of the creditors of the company

1025 Note that the amendment is not to be applied retrospectively, but only to those companies that entered insolvent administration on or from the 1st October 2015 going forward.

1026 Section 246ZB (2)(1) of the Act.

1027 Section 246ZB (6)(a) of the Act. Note that this provision is repeated under section 214(6A) which is a new provision to section 214, the main wrongful trading provision.

1028 Section 246ZB (1) of the Act.

© University of Pretoria

than would be the case if the company had to proceed into insolvent liquidation first. Further, it has been contended that the amendment under the UK wrongful trading rule brings about a beneficial increase in the deterrent effect of the wrongful trading remedy as it may encourage greater care of corporate assets in circumstances where administration is more probable, and not just where insolvent liquidation is probable.[1029]

9.2.4.2 Availability of the remedy only through a liquidator

While this flows from the fact of the wrongful trading remedy being available only during insolvent liquidation, it is nevertheless a contributor to the lack of success of the wrongful trading rule on its own. Even where wrongful trading proceedings are only available during insolvent liquidation as the case is in Malawi, standing to maintain such claims could equally have been given to creditors or to third parties through maintenance and champerty arrangements. According to Prentice,[1030] the fact of the liquidator being the only proper party to maintain wrongful trading proceedings is the key cause of an apparent insufficiency of enforcement of the wrongful trading rule.

As discussed herein, the fact that the proceedings can only be commenced by the liquidator who will obviously be risk averse in terms of applying the already insufficient assets of the company to fund speculative wrongful trading claims has the risk of having some overly cautious liquidators choosing not to commence the proceedings in fear of depleting the assets available for distribution to creditors in the event that the wrongful trading proceedings are not successful and adverse costs have been ordered against the insolvent estate as was the case in *Re MC Bacon Ltd.*[1031] Extending standing to institute the wrongful trading claims to creditors or third parties would entail that the

[1029] Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), at page 65, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/1468-2230.12106#accessDenialLayout accessed on 6th May 2018.

[1030] Prentice D, "Corporate personality, Limited liability and the protection of creditors" in Grantham, R and Rickett, C (Eds) *Corporate Personality in the 20th Century* (1998) Oxford, Hart Publishing.

[1031] (1991) Ch 127. In this case, the liquidator was ordered to pay the costs of an unsuccessful wrongful trading action which he had instituted against directors of the company. Apart from this order, the court refused to allow the liquidator to recover these costs from the company's assets. for this reason, the claim for costs by the liquidator ranked with unsecured creditors.

© University of Pretoria

proceedings would not be hampered by a liquidator's unwillingness or inability to commence the proceedings due to funding.[1032]

It must be noted, however, that in order to enable creditors or third parties to fund wrongful trading proceedings, the wrongful trading rule in Malawi would have to be amended to allow assignment of the wrongful trading causes of actions as well as the proceeds thereof to the said creditors or third parties. With the present statutory fashion of the rule in Malawi, even if the liquidator was to receive the said funding from a creditor or a third party, there is no law that would justify him paying a portion of the proceeds of the action to the said creditor or third party in priority to the general body of unsecured creditors.

In the United Kingdom, the wrongful trading rule was amended on 1st October 2015 whereby standing to commence wrongful trading proceedings has now been extended to administrators during administration of companies.[1033] Coupled with the fact that the liquidators and the administrators have been given the power to assign rights of wrongful trading causes of action including the proceeds thereof,[1034] it is expected that liquidators or administrators may assign the said rights and proceeds to creditors as well as third parties in order to beat the problem of funding of wrongful trading claims by the insolvent estate. This has the potential of creating a market for wrongful trading claims, a fact which will surmount the funding problems that hamper the potency of the rule.[1035]

1032 It must be noted that in in the present statutory fashion of the wrongful trading rule in Malawi, the possibility of creditors funding the proceedings is not restricted, save the fact that they would have to do this through indemnifying the liquidator. However, this is hampered by the fact that although one creditor may have funded the proceedings, the proceeds thereof may not be enjoyed by him alone as they have to benefit all unsecured creditors, a fact which will remove an incentive on creditors to fund the proceedings currently.

1033 See generally section 246ZB of the UK Insolvency Act of 1986.

1034 Ibid.

1035 The proposed inclusion of an administrator as one of the possible claimants in the reformed wrongful trading provision would not be a radical and unprecedented change. In the United Kingdom, from where the Malawian wrongful trading provision was copied, the rule has been recently reformed to include an administrator as one of the possible claimants in the wrongful trading claims and, as it has been discussed above, the inclusion has removed the liquidation restriction which required that only a liquidator during liquidation of a company should have standing to bring up wrongful trading proceedings. The UK Insolvency Act of 1986 now has a new provision, Section 246 ZD which

© University of Pretoria

The inclusion of an administrator to be one of the possible claimants under the wrongful trading rule brings the rule in conformity with the initial recommendations of the Cork committee when the wrongful trading rule was conceived before it was enacted.[1036] The Cork Committee had recommended that the wrongful trading mechanism should equally be available through administrators of companies during administration. Unfortunately the then British Government did not take the inclusion of the administrator into account when enacting the wrongful trading provision under the UK Insolvency Act 1986.

In support of the proposal to give standing to administrators to bring up wrongful trading proceedings, Keay[1037] has outlined three possible setbacks of not having administrators as part of the claimants. According to the learned commentator, where an administrator believes that directors have engaged in wrongful trading, he or she would have to recommend that the company moves from administration to insolvent liquidation from where the wrongful trading proceedings may be maintained by a liquidator and this may be time-consuming as well as costly.[1038] It would also mean the end of the company and definitely losses to creditors making the wrongful trading rule to fail in its intended role as a creditor protection mechanism.

Further, for an administrator to opt to convert the administration into an insolvent liquidation, he or she would have formed a view that the wrongful trading proceedings against the directors would bring a better yield to the company than administration would. For this reason, having wrongful trading claims undertaken during administration of companies might be helpful as the proceeds of the wrongful trading proceedings undertaken during a company's administration may tremendously

came into effective on 1st October 2015 which, *inter alia*, makes wrongful trading proceeding available during administration of a company and thus making an administrator a claimant in that regard.

1036 Insolvency Law Review Committee, Insolvency Law and Practice (the Cork Report) (Cmnd 858 HMSO 1982) [1791], [1792]

1037 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 75.

1038 Ibid.

© University of Pretoria

increase the assets of the company in administration enabling the company to return to solvency, thereby avoiding the insolvent liquidation.

Another set-back of not having wrongful trading claims during administration of companies, as isolated by Keay,[1039] is that a creditor who believes that a director of the company has engaged in wrongful trading may push for an insolvent administration of the company knowing fully well that he stands a change of receiving a share from the proceeds of the wrongful trading proceedings over and above what he would ordinarily be entitled to during the said liquidation. This would not be the case if the wrongful trading mechanism was available during administration for the reason that a moratorium that will crystalize on the company during the administration will entail that the creditor will not claim or be entitled to receive his debt until the company returns to solvency or proceeds into insolvent liquidation.

Thirdly, Keay argues that considering that a company can go from administration to dissolution without having to go into insolvent liquidation from where wrongful trading proceedings can be maintained, it is possible for directorial conduct which would amount to wrongful trading to disappear without investigation because the company never went through insolvent liquidation from where such investigation could occur.[1040]

However, it must be noted that there are also some setbacks in making wrongful trading proceedings available during administration of companies. The first of them, as it was observed by Davis,[1041] is that directors will be reluctant to initiate administration of the company knowing fully well that they stand to be prosecuted for wrongful trading.

This concern is dispelled by Keay[1042] who argues that if directors swiftly place an insolvent company into administration and wrongful trading claims are successfully maintained against them, there will still be a benefit in the sense that the directors

1039 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 75.

1040 Ibid.

1041 Davis, P "Directors' creditor- regarding duties in respect of trading decisions taken in the vicinity of insolvency" (2006) *EBOR* 302, at p. 319.

1042 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 76.

© University of Pretoria

would have avoided engaging in the said wrongful trading for a significant period of time, so that the loss that would have occurred to the company at the time when the liability crystallizes on the directors would be very minimal than it would be if the directors had chosen to continue trading without promptly placing the company into administration.

Further, Keay expresses scepticism against the fact the directors would be reluctant to initiate administration for fear of being found liable for wrongful trading during the said administration as, according to the learned commentator, many directors will not have even contemplated the wrongful trading rule at the time of contemplating initiating administration of the company.[1043]

From the foregoing, it is submitted that there are more benefits in extending standing to commence wrongful trading claims to administrators during administration of companies than there are in maintaining the liquidation restriction of the wrongful trading rule where the rule only exists during insolvent liquidation and only through a liquidator as it is presently the case under the rule in Malawi.

In Australia, a rule similar to the wrongful trading rule is referred to as the insolvent trading rule. Under the insolvent trading rule, a director will be liable if he allows a company to incur debts at a time when he knew or ought to have known that the company was insolvent. The Australian rule is however wider when it comes to the question of standing to bring insolvent trading proceedings in that it allows creditors, criminal prosecution authorities, corporate regulatory agencies, such as the Australian Securities and Investments Commission (ASIC) and liquidators to institute insolvent trading proceedings.[1044]

Further, insolvent trading in Australia is not limited to companies that enter into insolvent liquidation. The rule is also available in cases of any company that incurs a debt when it is not cash flow solvent,[1045] provided that the directors have reason for

---

[1043] Ibid.

[1044] See generally section 588G of the Australian Corporations Act of 2001.

[1045] Section 588 GA of the Act.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

suspecting the insolvency of the company. Liquidation is however a prerequisite for proceedings by a creditor[1046] and also (obviously) by a liquidator.

The South African equivalent of the wrongful trading rule, loosely referred to as the reckless trading rule, equally does away with the liquidation restriction. Section 424 of the 1973 companies Act provides that:

> Where it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was, or is being carried on recklessly or with the intention to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the master, the liquidator, the judicial manager, any creditor or member or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.[1047]

As it would be clear from the foregoing, the South African position makes the reckless trading rule applicable in all forms of insolvency processes, not only during insolvent liquidation as is the case in Malawi. Corollary, the South African position gives standing to commence reckless trading proceedings not only to a liquidator, but also to other persons such as the Master, a judicial manager, a creditor, a member/ shareholder of the company and indeed a contributory of the company. The fact that standing is given to many persons, and the fact that reckless trading rule is not only available during insolvent liquidation entails that the reckless trading remedy in South Africa is

---

1046 Section 588R of the Act.

1047 In *Kalinko vs. Nisbet and Others* 2002 (5) SA 766 (W) at 774B-D, Claassen J said the following with regard to this section:

> It has been held that this section supplements and does not replace remedies which may be available at common law to any person…The section also enables the Court to impose liability on a person where at common law such liability might not exist at all. The section comes to the aid of a claimant in circumstances where a claim under the common law may be difficult to prove. In particular, it relieves the claimant of proof of any causal connection between the fraudulent or reckless conduct of the business of the company and the debts or liabilities for which the wrongdoer may be declared liable.

It must be noted , however, that in 2006, the Supreme Court of South Africa changed the law in *Ciancic and others vs. Industro-Clean (Pty) Ltd and another* [2006] JOL 17559 (SCA) and held that a causal link between the reckless conduct and the debts is a factor to be taken into account when applying for a claim under section 424(1).

© University of Pretoria

likely to be utilized by the many interested players and this may enhance the potency of the remedy, unlike the likely underutilization of the rule in Malawi stemming from the liquidation restriction.

Further, wrongful trading is a remedy that emanates from director-indifference towards the interests of creditors during a period approaching insolvent liquidation of companies. As Rajak[1048] has argued, if the focus of the duties of directors shifts to creditors when the company enters the zone of insolvency, then the creditors should be able to enforce that duty before the formal declaration of insolvency. Further, as it has been vehemently argued by some commentators, making the wrongful trading rule to be applicable only during insolvent liquidation of companies goes against the notion of creditors protection at which the rule is aimed.[1049]

Going by the same analysis, wrongful trading being a remedy that seeks to address director-indifference to the plight of creditors, standing ought to have been given to creditors to be able to institute wrongful trading proceedings for the loss directly suffered by them by virtue of the said director errancy, rather than waiting for liquidators to enforce that duty for them when it is possible that the liquidators may elect not to pursue the claims for other reasons, particularly funding.

1048 Rajak HH "Director and officer liability in the zone of insolvency: a comparative analysis" *PER* vol 11,2.

1049 For instance, Mokal R "An agency cost analysis of the wrongful trading provisions: Redistribution, perverse incentives and the creditors' bargain" (2000) 59 *Cambridge Law Journal* 335 at 343, has argued, in respect to the wrongful trading rule in the United Kingdom, which is similar to the rule in Malawi, that the rule fails to protect creditors as the duty to minimize the potential loss to the said creditors under the rule arises once it is clear that the company is beyond redemption. This view is shared by Lombard, S "Claims Against Negligent of Fraudulent Directors: Proposes Amendments to South African Legislation" (2007) 16 *INT'L Insolvency REV* 75, 91, who argues that the English wrongful trading rule takes any conduct by directors prior to the point when the company is beyond redemption to be irrelevant. According to Lombard, the directors may very well have caused the company to reach the point of no redemption and in that situation, creditors will not have redress for the conduct of the directors that led to the demise of the company. The view is further shared by Arsalidou, S "The Impact of Section 214(4) of the Insolvency Act 1986 on Directors' Duties" (2000) 22 *The Company Lawyer* 19, who argues that the wrongful trading rule only catches a 'limited span of negligent directorial conduct' and does not provide directors with an incentive to act with care when the company is solvent, but only when it has become clear to them that the company is going to fail.

© University of Pretoria

9.2.5 ABSENCE OF PROTECTION FROM WRONGFUL TRADING FOR DIRECTORS WHO DO THEIR BEST

While liability for wrongful trading should attach on directors who fail to fulfil their obligations to their company when the company is faced with insolvency, there are times when the conduct of the directors in the circumstances is found to have been reasonable so as not to invite liability for wrongful trading. Unfortunately, no matter how reasonable the said conduct can be, the directors who took the said actions will still risk liability for wrongful trading if the court finds the said reasonable action to fall short of "taking every step with a view to minimizing the potential loss to the company's creditors" as required by the wrongful trading rule.

The absence of protection for directors who show that they did their best, even though they may not have taken every step with the view to minimizing the potential loss to the company's creditors increases chances of liability for wrongful trading in directors. The same also discourages innovative thinking on the part of directors of financially distressed companies as their eyes are always cast of doing what may be regarded as "taking every step with a view to minimizing the potential losses to the company's creditors" and not necessarily what will practically save the company from plunging into insolvent liquidation.

If the wrongful trading rule had a provision which excluded liability for wrongful trading on the part of the directors who, upon learning that their company was financially distressed, put in place a comprehensive and innovative plan which they hoped, in good faith, would save the company – although in the end it fails to – the rule would have encouraged practical innovation which would, in certain cases, save companies from plunging into insolvent liquidation.

An example of such protection from liability is such as the Australian safe harbour carve-out principle under the Australian counterpart of the wrongful trading rule, the insolvent trading rule. The safe harbour principle protects directors of Australian companies from insolvent trading if they can show that from the moment they knew that their company was financially distressed, they embarked on a comprehensive plan which they honestly and reasonably believed would save the company and they

© University of Pretoria

continued to trade or to allow the company to incur debts even though it was insolvent in order to fund the said plan. [1050]

The need for protection from wrongful trading would be important on the basis that in the current form of the wrongful trading rule in Malawi, the rule simply requires that **at some time time** when directors know or ought to have known that the company would not avoid going into insolvent liquidation, they should take **every step** with a view to minimizing the potential loss to creditors as they ought to have taken. As discussed herein, apart from the difficulty in pin-pointing what this exact point of time is, the rule does not give an insight of what those steps should be, unlike the Australian insolvent trading rule which expressly states that the steps which should be taken may include the action taken with a view to appointing an administrator;[1051] when that action was taken,[1052] and the results of that action.[1053]

Further, it would be admitted that the steps which may be taken by the directors under the current wrongful trading rule in Malawi, or the good business judgement decisions

[1050] For a detailed discussion of the safe harbor principle, see para 9.2.1.5 above. Suffice to say at this point that a safe harbour carve out allows directors, in appropriate circumstances, to engage in informal work-outs with creditors rather than placing the company into liquidation or voluntary administration but yet remain under a threat of personal liability where debts that the company cannot repay are incurred during the work out period; Anderson H, "Shelter from the Storm: Phoenix Activity and the Safe Harbour" [2018] 41 *Melbourne University Law Review* 999 at 1001. It must be noted, however, that this commentator makes the foregoing favourable observation of the safe harbour carve out, she remains critical of the aggregate benefits of the safe harbour and submits, as an opening statement of her article, at 1000, that:

> A more significant objection is that a safe harbour could lead to a great prevalence of illegal phoenix activity, sheltering under the appearance of business rescue. The benefit of the liability carve out to the 'big end of town' is not worth the risk.

A phoenix activity involves the corporate failure of one company (Old Company) and a second company (New Company) arising from the Old Company's ashes where the New Company's controllers and business are essentially the same as the Old Company's; Anderson, H *et al*, "Profiling Phoenix Activity" (2015) 33 *Company and Securities Law Journal*, 133, 133. According to this learned commentator, at 133, phoenix activity can be legal where the previous controllers start another similar company in order to genuinely rescue the failed company's business, and an illegal phoenix activity is procedurally similar to the legal phoenix activity but is distinguished by an intention to exploit the corporate form at the expense of unsecured creditors usually through a speedy liquidation of the Old Company, with its assets sold at an under value to the New Company.

[1051] Section 588 H (6) (a) of the Corporations Act 2001.

[1052] Section 588 H (6) (b) of the Corporations Act 2001.

[1053] Section 588 H (6) (c) of the Corporations Act 2001.

© University of Pretoria

that they will make in the circumstances, may not always result into a successful recovery of the company and therefore that even with those steps taken, or those decisions made, some companies will still plunge into insolvent liquidation. Although the directors who will have taken "every step" (which includes making good business judgement decisions in the circumstances) will be protected from liability for wrongful trading, the protection will come only as a defence in wrongful trading proceedings and not as a bar to wrongful trading proceedings against the directors.

In view of the foregoing, it would be ideal that rather than having to wait until wrongful trading proceedings are taken against the directors and they have to extricate themselves from liability on the defence of having taken "every step" or under the Business Judgement Rule, the wrongful trading rule should outrightly bar wrongful trading proceedings against directors who, upon knowing or expecting their companies to be insolvent, they develop a comprehensive plan which may lead to a better outcome for the company.

9.2.6 ABSENCE OF DIRECTOR DISQUALIFICATION UNDER THE WRONGFUL TRADING RULE

In the current form of the wrongful trading rule in Malawi, a director who has been found liable for wrongful trading may continue to serve as a director in other companies regardless of his record of wrongful trading liability. This is because the wrongful trading provision, section 187 of the Insolvency Act of 2016 in Malawi, does not provide for director disqualification on the basis of the director having been previously adjudged liable for wrongful trading.

The only possibility of prohibiting persons who have previously been adjudged liable for wrongful trading to serve as directors of other companies is when the constitution of the company that seeks to appoint that person expressly prohibits appointment of persons who have been previously found liable for wrongful trading to serve as directors of the company. This prohibition will have to be considered in light of section 146 of the Companies Act of 2013 in Malawi which provides that a person may not be

© University of Pretoria

eligible for appointment as a director if he or she is prohibited from being a director of a company.[1054]

Another possibility through which a person who has previously been found liable for wrongful trading in Malawi may be ineligible to serve as a director of other companies is where the said person has failed to comply with a contribution order in wrongful trading proceedings and is, by reason thereof, adjudged to be bankrupt and remains undischarged from the bankruptcy. The person will, under Section 146 (2) (c) of the Companies Act of 2013 in Malawi, not be eligible for appointment as a director of a company for being an undischarged bankrupt.

Form the foregoing, it would be clear that the courts in Malawi do not have the powers to disqualify a person from serving as a director in other companies upon that person being found liable for wrongful trading. The absence of director disqualification on the basis of liability for wrongful trading has the potential to bring a proliferation of wrongful trading in Malawian companies. This is because the directors who have been found liable for wrongful trading may resurface in another company and continue serving as directors in that other company with the same indifference which led to their liability for wrongful trading in the previous companies.

Personal liability on such directors may, in certain instances, not have achieved the deterrence it is meant to achieve for the reason that some of these directors may not have had enough personal assets for a liquidator to pursue a recovery from them after securing an order for contribution against them.

As it would be admitted, the directors who engage in wrongful trading will have caused losses to creditors and, bearing in mind that the wrongful trading rule ensures compliance by the directors with minimum standards for serving as a director, it is clear that persons with a record of wrongful trading liability will be a hazard to the society not only for having caused losses to traders indifferently, but also for having previously failed to comply with the minimum standards for serving as directors.

[1054] Section 146 (2) of the Act.

© University of Pretoria

Further, it is not in the interests of the public in general to permit directors who have engaged in wrongful trading to continue serving as directors of other companies with the same indifference, causing losses to creditors. Keay[1055] has argued that this has wide-ranging consequences such as the creditors of the company not being able to pay their creditors and so on, therefore causing a chain reaction of insolvencies.

In the United Kingdom, from where the Malawian wrongful trading rule was copied, the court has been given specific powers to disqualify persons for being eligible to serve as directors of other companies once they have been found liable for wrongful trading. Admirably, the United Kingdom has a whole Company Director's Disqualification Act of 1986 designed to disqualify persons as directors of companies for various reasons.

Section 10 of the said Company Directors Disqualification Act in the UK provides that where the court makes a declaration under Section 214 of the Insolvency Act of 1986 (the wrongful trading provision) that a person is liable to make a contribution to a company's assets, then, whether or not an application for such an order is made by any person, the court may, if it thinks fit, also make a disqualification order against the person to whom the declaration relates.[1056] Further, the Act provides that the maximum period for disqualification under the above provision is 15 years.[1057]

In view of the foregoing, it is submitted that providing for director disqualification powers under the wrongful trading rule in Malawi may enhance the efficacy of the rule by, firstly, enhancing deterrence as a lot of reputable directors would not want the disrepute that comes with a disqualification from serving as directors of other companies. Secondly, director disqualification may serve to ensure that persons who fail to satisfy the minimum standards for serving as directors of companies are prevented from serving as such for several years or at all and this may reduce the scale of director indifference in the running of the affairs of Malawian companies. Director

1055 Keay, A "Wrongful Trading; Problems and proposals (2014) *65 N Ir legal Q.63*, 78.

1056 Section 10 (1) of the Company Director's Disqualification Act.

1057 Section 10 (2) of the Company Director's Disqualification Act.

© University of Pretoria

disqualification will, therefore, ensure that the wrongful trading rule in Malawi is able to serve both the private law as well as the public law functions for which it was designed.

9.2.7 THE RULE PRESUMES SOLVENCY OF DIRECTORS

As it would be seen, the wrongful trading mechanism is predicated on the presumptions that upon being ordered to contribute to the assets of the company, the contribution by the respondent director will increase the assets of the company available for distribution to creditors, and that this personal liability order will bring personal financial hardship to the respondent director. These presumptions lie at the heart of the aims of the wrongful trading rule, namely, to provide creditor protection through the maximization of assets available for distribution to creditors, and to provide deterrence to director-indifference in the management of the affairs of the company for fear of personal liability.

Unfortunately, the first presumption is predicated on another presumption which is not guaranteed, namely, that upon being so ordered to contribute to the assets of the company, the respondent director will comply with the said order of the court immediately or at all. There are many times when this will not be the case.[1058] Several eventualities will be found to be possible occurrences once the court pronounces the contribution order.

To begin with, the presumption seems to take for granted the fact that the respondent director will be solvent and therefore able to comply with the order of the court. As it may be generally accepted, it is not unusual to find that many directors who are natural persons are appointed to a board based on their expertise and experience and seldom due to their solvency, and hence it will be too speculative and unrealistic to expect that the fact that a person has been a director of a company automatically means that he is

[1058] Cheffins, B *Company Law; Theory, Structure and Operation* (1997) 547, argues that there are a number of reasons why insolvent trading provisions (an equivalent of the wrongful trading provisions in Australia) may offer limited assistance to creditors of companies. One of the reasons isolated by the learned commentator is that the defendant director may have few personal assets as to pay the compensation to the creditors.

© University of Pretoria

solvent enough to contribute meaningfully to the assets of the company during insolvent liquidation.

The presumption does not take into account the fact that there may be other directors, particularly directors of small companies, who, although they may have been previously solvent, the same insolvent liquidation giving rise to the wrongful trading claims will have occasioned great financial losses to them making them unable to comply with the court's order for contribution.[1059] There is a good body of evidence suggesting that directors of small companies are significantly exposed to financial risk from the failure of their companies either due to the fact that they may have been providing personal guarantees to corporate debt,[1060] or indeed the fact that they may have been self-financing the company business through provision of loans.[1061] It is in such cases where the insolvency of the corporation would have significant financial setbacks in the said directors, making them unable to comply with the order of the court to contribute to the company's assets.[1062]

1059 Under wrongful trading, banks, other companies, professional advisors, holding companies and shareholders are all eligible to be found liable as directors of the insolvent company.

1060 Fredman and Goldwin, "Incorporating the Micro Business: Perceptions and Misperceptions" in A. Hughes, A and Story, D *Finance and Small Firm* 1994 London; Routledge.

1061 Hughes, A "Finance for SMEs: A UK Perspective" (1997) *A Small Business Economics*, 151. See also Avery *et al*, "The Role of Personal Wealth in Small Business Finance" (1998) 22 *Journal of Banking and Finance* 1019.

1062 See an argument by Anderson H, "Shelter from the Storm: Phoenix Activity and the Safe Harbour"[2018] 41 *Melbourne University Law Review* 999 at 104 who takes the view that insolvent trading, the Australian equivalent of the wrongful trading rule, is actually more likely to occur with respect to directors of small companies as compared with directors of larger companies. According to the learned commentator, a director of a small company might be willing to take the risk of trading insolvently in a last-ditch attempt to save their investment and livelihood, hoping to sail under the regulatory radar while this may not be the case with directors of larger companies, for the reason, among others, that insolvency itself may be hard to ascertain in an extensive and complex business.

This view seems to tally with a view taken earlier by Haris J, "Director Liability for Insolvent Trading: Is the Curse Worse than the Disease?" (2009) *Australian Journal of Corporate Law* 266, 274-275 that directors of larger companies may have no further incentive to save their positions or to maintain enterprise value for the company's shareholders and therefore they are likely to act cautiously. This also lends weight to the view taken much earlier by Byrne M, "An Economic Analysis of Directors' Duties in Favour of Creditors" (1994) 4 *Australian Journal of Corporate Law* 275, 286 that even before solvency looms, directors of large companies may concentrate on strategies to minimize the risk of possible liability, rather than on the growth and prosperity of the company for the benefit of its shareholders.

© University of Pretoria

Further, apart from directors of small companies being unable to comply with the order for contribution, in a company law regime like Malawi where it has been shown, in Chapter 5 above, that shareholders are also prone to wrongful trading claims, it is equally expected, where the liability for wrongful trading has attached to a shareholder, that payment of the contribution sum will not be guaranteed as the same shareholder may have already suffered financial loss due to the ensuing insolvent liquidation of his company.

9.2.8 THE NEGATIVE IMPACT OF CORPORATE RESCUE ON THE VIBRANCE OF THE WRONGFUL TRADING RULE IN MALAWI

The advent of the corporate rescue process under the same Insolvency Act of 2016 which brought about the wrongful trading rule in Malawi entails that directors of financially distressed companies will be incentivised to place their companies under a corporate rescue process,[1063] knowing that in so doing, they stand not to be prosecuted for wrongful trading. Where this happens, it means, firstly, a significant number of financially distressed companies may not be placed under insolvent liquidation, which is a pre-requisite for inception of the wrongful trading proceedings against directors, as the companies may be rescued and return to solvency.

[1063] Referred to as administration in Malawi. See chapter 4 herein for a detailed discussion of administration under the Insolvency Act in Malawi. In South Africa, the process of compromise with creditors has been shown to have an effect of dampening the vibrance of the reckless trading rule by depriving creditors of their *locus standi* to institute reckless trading proceedings. See Stegman J in *Ex Parte De Villiers; In re MSL Publications (Pty)Ltd* (1990) 4 SA 59 (W) 87 who is of the opinion that any compromise or arrangement with creditors will have the effect of 'averting the danger' of personal liability for reckless trading. The learned Judge repeated his view in *Ex Parte De Villiers; In re Carbon Developments* 1992 2 SA 95(W) 107-108 saying that section 311 of the 1973 Companies Act which provides for extinction of all the companies debts and liabilities has the effect of making the reckless trading rule under section 424 of the said Act non-functional as:

> a debt or other liability of the company is the very foundation upon which any declaration of personal liability on the part of a wrongdoing company representative must stand…and that when that foundation ceases to exist…the wrongdoing company representative who might otherwise have been declared personally responsible in terms of s 424 cease to be amenable to any such declaration.

A contrary approach was taken in *Pressma Services (Pty) Ltd vs Schuttler* 1990 2 SA 411 (C) 418, where the court held that "creditor of the company" in section 424 of the Companies Act 1973 must not be construed so as to include a person in respect of whom there was an existing indebtedness at the time when the compromise was sanctioned. Lombard S, "Claims against negligent and fraudulent directors: proposed amendments to South African legislation" (2007) *16 INT'L Insolvency REV* 75, 78 has argued that should this interpretation be followed, the sanctioning and implementation of a compromise in terms of section 311 of the 1973 Companies Act in South Africa will not have the effect of depriving creditors of *locus standi* to bring claims for reckless trading.

© University of Pretoria

Secondly, this will mean that even for those companies that will not be rescued through the administration and will eventually be placed under insolvent liquidation, the directors, who will have placed the company under administration, will likely survive liability for wrongful trading on the defence that they took every step with a view to minimizing the potential loss to the companies' creditors as they ought to have taken.[1064] The foregoing entails that the corporate rescue process, referred to as administration of companies, impacts negatively on the efficacy of the wrongful trading rule in Malawi.

Making a similar observation with regard to the Australian insolvent trading rule, an equivalent of the wrongful trading rule in Malawi, Herzberg[1065] has argued that the most important reason for the paucity of insolvent trading proceedings in Australia is the increasing use of the voluntary administration scheme under the Corporations Act.[1066]

Further, Herzberg argues, and rightly so, a practical consequence of the use of the corporate rescue process is that those companies that will not be rescued and will proceed to insolvent liquidation will be such that were hopelessly insolvent with little or no meaningful assets as for a liquidator to use the same to fund speculative insolvent trading proceedings.[1067]

In view of the foregoing, it is submitted that there ought to be a reform of the wrongful trading rule to the effect that company administration should not have a negative impact on the vibrance of the wrongful trading rule as both administration of companies as well as the wrongful trading rule are vital mechanisms that serve the same purpose of creditor protection in respect of financially distressed companies.

1064 For a detailed discussion of the defence of taking every step with a view to minimizing the potential loss to the company's creditors, see Chapter 5 Paragraph 5.3.

1065 Herzberg A, "Why are there So Few Insolvent Trading Cases?" (1998) 6 *Insolvency Law Journal*, 77.

1066 Act No. 50 of 2001

1067 Ibid.

© University of Pretoria

9.2.9 THE APLICABILITY OF THE WRONGFUL TRADING RULE IN MALAWI DURING THE CURRENT COVID-19 PANDEMIC *VIZ A VIZ* THE EFFICACY OF THE RULE

This question has been necessitated by the advent of the global COVID-19 pandemic which has had adverse effects on the businesses of companies. Due to the pandemic, it has been evident that companies have been collapsing not because of director-indifference in the running of the affairs of a financially distressed company, which is the liability trigger under the wrongful trading rule, but due to the effects of the COVID-19 pandemic, particularly the lock downs and immigration restrictions in many countries in the world, including Malawi.[1068] While director indifference in the management of the affairs of financially distressed companies continues to occur during the current COVID-19 pandemic and that corporate insolvencies have continued to happen on that basis, it has become impossible to rule out the effects of the pandemic as having contributed to the corporate insolvencies that have occurred since the pandemic started.

In view of the foregoing, it has been necessary to consider whether directors of companies that have plunged into insolvent liquidation in Malawi during the COVID-19 pandemic should be amenable to wrongful trading proceedings for their failure to keep the company solvent during the pandemic if, other than the effects of the pandemic, director indifference is found to have, even to a slightest extent, played a role in causing or failure to prevent the insolvent liquidation.

Although Malawi has not considered this question, there is merit in having this important question addressed as it is clear that it is not possible to rule out the effects of the COVID-19 pandemic as a contributory factor in the corporate insolvencies that have occurred since the pandemic started, even though there may be evidence of director-indifference in the management of the affairs of the company during the same

[1068] It has been observed that the international spread of the 2019 novel coronavirus pandemic does not only has widespread consequences from a social and health perspective, but that it also crippled the global economy and as a result, governments globally are responding with a combination of legal, economic and financial adjustments in order to navigate this difficult time: Gurrea-Martínez, A "Insolvency law in times of Covid-19" (17-04-2020) Ibero-American Institute for Law and Finance, Working Paper 2/2020 accessed online on the 17th of January 2021 at https://ssrn.com/abstract=3562685 and also available and accessible at http://dx.doi.org.uplib.idm.oclc.org/10.2139/ssrn.3562685 (10-07-2020).

© University of Pretoria

time. It is submitted, therefore, that during the currency of the present COVID-19 pandemic, the wrongful trading rule in Malawi is difficult or impossible to make use of. Malawi would wish to learn from the following comparable jurisdictions which have swiftly addressed this question:[1069]

In Australia, the Coronavirus Economic Response Omnibus Act of 2020, enacted on 24th of March 2020, suspends the insolvent trading rule during the COVID-19 pandemic. The Act introduces section 588GAAA (1) after section 588GA(1) which is titled "Safe Harbour-Temporary Relief in Response to the Corona Virus." The provision is to the effect that the insolvent trading provisions under the Corporations Act of 2001 will not apply in relation to a person and a debt incurred by a company if the debt is incurred during the six months period starting from the date of the enactment, namely, 24th March 2020 or any period as would be extended.

Similarly, in the United Kingdom, the Corporate Insolvency and Governance Act of 2020 which was enacted on 26th June 2020 suspends the operation of the wrongful trading provision under section 214 of the UK Insolvency Act of 1986 due to the COVID-19 pandemic. Chapter 12 of the said Act is to the effect that a director is not responsible for the worsening of the financial position of the company or its creditors if the same occurs between 1st March 2020 and 30th September 2020.

In South Africa, the reckless trading rule has also been suspended due to the coronavirus pandemic.[1070] Unlike Australia and the United Kingdom where the said suspensions

---

[1069] As it has been observed by Calitz, J, "Insolvency law adjustment in response to the economic impact of the COVID-19 pandemic : the South African experience" (2020) *Journal of South African Law, volume 2020, issue 4,* 763, the current global financial crisis brought about by the COVID-19 pandemic "is confronting emerging market economies with a double blow as it has brought along a sudden halt in capital inflows as a result of the global deleveraging process, as well as a dramatic decline in export demand associated with the global slump."

[1070] It must be noted that when the COVID-19 pandemic hit South Africa, a national state of disaster was declared on 15th March 2020 under section 3 of the Disaster Management Act 57 of 2002. This was followed by an announcement by President Cyrill Ramaphosa that a nationwide lockdown was to be effected on 26th March 2020. The national lockdown in South Africa had serious economic repercussions in retail and customer-focused businesses particularly in the tourism, hospitality and aviation industries. For instance, On 29 April 2020 Edcon, one of South Africa's largest retail companies, was placed under a business rescue process following the filing on 28th April 2020 of a resolution in terms of s 129(1) of the Companies Act 71 of 2008. On the other hand, the Johannesburg

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

have come by way of statute, the South African suspension has come through a practice notice issued by the Companies and Intellectual Property Commission (CIPC) in terms of paragraph 4(1)(b) of the Companies Regulation (GNR 351 of 26 April 2011)[1071] advising that in light of the COVID-19 pandemic and the national state of disaster, the Commission would not be invoking its powers under section 22 of the Companies Act 71 of 2008 in relation to reckless trading.[1072]

9.3 CHAPTER CONCLUSION

This chapter was aimed at interrogating the efficacy of the wrongful trading rule in Malawi, bearing in mind that the rule is new and untested by the Malawian courts. In undertaking this exercise, the chapter identified and discussed the problems that are associated with the wrongful trading rule and which are likely to affect the efficacy of the rule in Malawi. The identification has been achieved by looking at the statutory

---

high court on 28th April 2020 granted an order for the provisional liquidation of SA Express, after the state-owned airline had been placed under a business rescue process on 6th February 2020.

1071 The notice was issued on the 24th of March 2020 and was accessed online on 17th April 2020 at http://www.cipc.co.za/files/1015/8504/6745/practice_note_1_of_2020.pdf

1072 Note that the Companies and Intellectual Property Commission is mandated, where it has reasonable grounds to believe that a company is engaging in reckless trading, among other offences, to issue a notice to the company for it to show cause why it should be permitted to continue carrying on its business or to trade, as the case may be. There are several other jurisdictions beyond the comparable jurisdictions herein which have had to adjust their insolvency laws in order to mitigate the effects which the Covid-19 pandemic has had in their economies. In Indian Government, for instance, has introduced the Insolvency and Bankruptcy Code (Amendment) Ordinance 2020 (Insolvency Ordinance) which became effective on 5th June 2020. The said Insolvency Ordinance has inserted a new s 10A (Suspension of Initiation of Corporate Insolvency Resolution Process) into the Insolvency Code and modified s 66 (Fraudulent Trading or Wrongful Trading) of the Insolvency Code. Similarly, the German Government has reacted to the pandemic by introducing a law that suspends the duty to file and to limit the directors' and managers' liability in case of an insolvency caused by the Covid-19 pandemic: *Gesetz zur vorübergehenden Aussetzung der Insolvenzantragspflicht und zur Begrenzung der Organhaftung bei einer durch die Covid-19-Pandemie bedingten Insolvenz* ("Act to temporarily suspend the duty to file and to limit the directors' and managers' liability in case of an insolvency caused by the Covid-19 pandemic"), abbreviated to "COVInsAG" and enacted as par 1 of the *Gesetz zur Abmilderung der Folgen der Covid-19-Pandemie im Zivil-, Insolvenz- und Strafverfahrensrecht* ("Act to mitigate the consequences of the Covid-19 pandemic in the fields of civil law, insolvency law and criminal procedure"), *BGBl* I 2020 569. See *INSOL International – World Bank Group Global Guide* www.insol.org (10-07-2020). Calitz, J, "Insolvency law adjustment in response to the economic impact of the Covid-19 pandemic : the South African experience" (2020) *Journal of South African Law, volume 2020, issue 4,* 763, has submitted, in view of these reactions by various jurisdictions, that the effectiveness of these rushed measures will, no doubt, be under the spotlight soon enough. With respect to South Africa, the submission by Calitz should be particularly true when regard is had to the observation made by the same learned commentator, (ibid) that the current South African legislation and institutional framework dealing with corporate insolvency is outdated and inadequate to deal with the disruption of businesses of companies caused by the COVID-19 pandemic, and therefore that the South African insolvency system lacks capacity to cope with the COVID-19 pandemic without an extraordinary Government intervention.

© University of Pretoria

frame and the presumptions inherent in the wrongful trading rule in Malawi and also by looking at the problems that affect the counterpart rules in the comparable jurisdictions in this study, namely the United Kingdom, Australia and South Africa. The problems have been identified as follows:

9.3.1 Drafting problems

9.3.1.1 Use of the word "wrongful" in the marginal note of the wrongful trading provision

It has been established that the use of the word "**wrongful**" in the phrase "wrongful trading" in the marginal note of the wrongful trading rule as provided in section 187 of the Insolvency Act of 2016 in Malawi is misleading as it gives the impression that it is a requirement for liquidators to prove blameworthiness or wrongdoing in the conduct of the director in order for the director to be found liable for wrongful trading when that is not a requirement under the rule. In *Re Continental Assurance Co. of London Plc*, the court misdirected itself by searching for blameworthiness or wrongdoing in the conduct of the directors and absolved the directors from liability for wrongful trading when it could not see traces of the said blameworthiness or wrong doing.

9.3.1.2 Use of the phrase "at some time" in the provision

As it is clear from the wrongful trading provision, liability will crystalize on a director if it is shown that "***at some time***" before the commencement of the winding-up of the company, the director knew or ought to have concluded that there is no reasonable prospect that the company would avoid going into insolvent liquidation.

It has been established that the phrase "at some time" is too imprecise and it makes liquidators fail to locate the exact time when wrongful trading commenced and plead it in wrongful trading proceedings as being the time meant by the provision. As it has been shown, failure to plead the exact point of time when a liquidator alleges that wrongful trading commenced is fatal to the success of the claim; *Re Sherbone Associates Ltd* and *Re Continental Assurance.*

© University of Pretoria

Although in *Roberts vs. Frolich* and in *Re Kudos Business Solutions Ltd* the court seemed to take a liberal approach by allowing liquidators to plead this crucial point of time in the alternative, the existence of two approaches by the court, a strict approach as in *Re Sherbone Associates Ltd* and *Re Continental Assurance* decisions and a liberal approach as in *Roberts vs. Frolich* and *Re Kudos Business Solutions Ltd* decisions mean that the liquidator will be unsure of which approach the court he goes to will adopt and this may dissuade some risk averse liquidators from pursuing wrongful trading proceedings where they are unsure of the exact dates when wrongful trading may have commenced. This may dampen the potency of the wrongful trading rule.

9.3.1.3 Use of the phrase "reasonable prospect" in the provision

Under section 187 of the Insolvency Act of 2016 in Malawi, liability for wrongful trading will attach to a director of a company if it can be shown that at some time before the commencement of the winding up of the company, when the said director knew or ought to have concluded that there was no **reasonable prospect** that the company would avoid going into insolvent liquidation, he failed to take every step with a view to minimizing the potential loss to the company's creditors as he ought to have taken.

As it has been established in this chapter, the meaning of the phrase "reasonable prospect" is elusive and it requires a director to gaze in the future and discern whether the said prospect exists. This is a near impossible undertaking. As it has been shown in this chapter, the fact that the meaning of this phrase is elusive, coupled with other words or phrases in the provision which are imprecise, entails that the totality of the liability elements of the wrongful trading rule are vague and difficult for a liquidator to establish, and this has been shown to have the potential of dampening the efficacy of the wrongful trading rule.

9.3.1.4 Use of the phrase "ought to have concluded" in the provision

Liability for wrongful trading is triggered if, at some point before the commencement of winding up, the director knew or **ought to have concluded** that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

© University of Pretoria

It has been established that the phrase "ought to have concluded" as used in the provision is too imprecise that it brings uncertainty as to when the liability for wrongful trading may be incurred and that this affects the deterrent effect of the rule for the reason that the uncertainty as to when liability may be incurred fails to model a behaviour in directors which is geared towards avoiding incurring the said liability.

Further, it has been established that the phrase "ought to have concluded" deprives directors of the defence of taking every step, by requiring a director who did not know (that the company would not avoid proceeding into insolvent liquidation) to have taken steps which only a director who knew (that the company would not avoid proceeding into insolvent liquidation) could have taken. This is practically impossible. It has been established that the phrase is likely to invite legal challenges for depriving a respondent director of a defence of taking every step and this may stifle the success of the wrongful trading rule. The wrongful trading provision in the United Kingdom has been specifically amended to remove this impracticality.

9.3.1.5 Use of the phrase "every step" in the provision

It is a defence to a wrongful trading claim if a director can show that having known or having concluded that the company would not avoid proceeding into insolvent liquidation, he took **every step** with the view to minimizing the potential loss to the company's creditors." It has been established that the phrase is too broad that it can trigger liability for incompetence, ignorance, indifference as well as conscious wrongdoing on the part of the director. This is against the intention for which the wrongful trading rule was invented, namely, to create liability only for director-indifference in the running of the affairs of a company. It has been established that the fact that the use of the words "every step" creates liability for other reasons other than director-indifference in the running of the affairs of the company means that the use of the words "every step" make the wrongful trading rule to fail to achieve its intended purpose at times.

Further, it has been established that the phrase "every step" is too imprecise and it gives a wide discretion to every court to decide which steps are satisfactory in each individual case. It has been established that the fact that other courts may take a liberal approach

© University of Pretoria

and absolve from liability directors who can show that they tried, even though they may not have done their best, has the potential of stifling the potency of the rule.

9.3.2 The rule being too broad that it sometimes fails to serve its intended purpose

It has been established that the wrongful trading rule is too broad so that there are times where it fails to serve its intended purpose of compensating the company for the loss suffered by the company's creditors during the wrongful trading period. In *Re DKG contractors Ltd*, the court found that the liquidator successfully made out a wrongful trading clam, but surprisingly held that the satisfaction of liability under a breach of duty claim in the case also discharged the other two claims of transaction at a preference and wrongful trading. Clearly, the court failed to appreciate the essence of the wrongful trading remedy and took it to be nothing more than payment of money which could equally be satisfied under a different head of claim.

Similarly, in *Re Idessa (UK) Ltd*, after finding that most of the allegations under breach of duty and wrongful trading were made out (making it unnecessary to consider the claim for transaction at a preference) the court ordered the directors to pay a total of £ 1, 438, 518.23 in respect of liabilities under the said breach of duty and wrongful trading. Out of this sum, £340, 411 was assigned by the judge to a claim for breach of duty on the basis that this sum was transferred by the directors at a time before it could be established that the company had no reasonable prospect of avoiding insolvent liquidation, while the difference of £ 1, 098, 102 was assigned to the wrongful trading claim.

It has been established that there is no indication of the relationship of the sum assigned by the judge for wrongful trading with the increase in the net deficiency of the assets of the company during the period of wrongful trading in the case (which is the measure of the compensation to the company). This has prompted Williams to conclude that the assignment of the wrongful trading sum in the case was merely a matter of convenience than law,[1073] as it did not serve the intention for which the wrongful trading rule was invented.

1073 See paragraph 9.2.2 above.

© University of Pretoria

9.3.3 The funding problem

It has been established that funding of wrongful trading proceedings is the greatest hindrance to the success of the wrongful trading rule. This problem is compounded by the fact that the liquidator has no access to public funding and also the fact that although there is nothing prohibiting the liquidator to have recourse to private funding through maintenance or champerty arrangements with third parties or to have funding arrangements with creditors, the liquidator is unable under the law in Malawi to assign the proceeds of the wrongful trading proceedings to the said third party or to the said creditors in return for their provision of funding.

This entails that where the liquidator does not have enough assets, as will always be the case in Malawi for the reason that wrongful trading proceedings in Malawi can only be instituted during insolvent liquidation of a company, and thus when the company already has insufficient assets, he will not institute the proceedings at all. In the United Kingdom, the wrongful trading rule has been specifically amended to allow a liquidator to assign proceeds of the wrongful trading action to third parties who provide funding for the proceedings, and this has addressed the problem of funding and enhanced the success of the wrongful trading rule.

9.3.4 The liquidation restriction

The liquidation restriction of the wrongful trading rule pertains to the situation where the wrongful trading proceedings in Malawi can only be instituted during liquidation of a company and only through a liquidator. It has been established that this has an effect on the funding of the proceedings for the reason that during insolvent liquidation, the liquidator will usually not have enough assets to fund speculative claims and this is likely to influence a lot of liquidators not to commence wrongful trading proceedings at all. Further, it has been established that the unavailability of the rule in other forms

© University of Pretoria

of insolvency processes such as administration also affects the funding of wrongful trading proceedings.

This is because during administration of a company, the company's assets will not have been tremendously dissipated, and that although there would be administration expenses, the absence of the liquidation expenses at that stage, which are greater than administration expenses, means that the company in administration will have enough assets to fund wrongful trading proceedings. The wrongful trading rule in in the United Kingdom has been specifically amended to remove the liquidation restriction, making the rule available during administration through an administrator.

9.3.5 Absence of protection from wrongful trading for directors who do their best

It has been established in this chapter that the absence of protection for directors who, upon learning the precarious financial position which their company is found in, embark on a comprehensive plan to achieve a better out come for the company does not incentivise directors to put in place an innovative plan which may save the company from plunging into insolvent liquidation.

As it has been discussed in this chapter, it would have been ideal if the wrongful trading rule in Malawi had adopted the Australian safe harbour principle which protects directors of Australian companies from liability for insolvent trading, the Australian equivalent of wrongful trading, if they can show that from the time they knew or expected their company to be insolvent, they devised and started implementing a comprehensive plan aimed at achieving a better outcome for the company.

9.3.6 Absence of director disqualification under the rule

It has been established in this chapter that the absence of director disqualification powers under the wrongful trading provision in Malawi equally dampens the efficacy of the wrongful trading rule. The reason for this analysis has been shown in this chapter to be the fact that directors who have been previously found liable for wrongful trading are able to continue serving as directors of other companies even with the same indifference for which they may have been previously found liable for wrongful trading.

© University of Pretoria

As it has been shown in this chapter, while this has the potential to increase the scale of wrongful trading in Malawian companies on the basis that it allows persons who have previously failed to live up to the minimum standards for serving as directors of companies to continue serving as directors. It has also been shown that the absence of director disqualification fails to achieve deterrence to indifference in the management of the affairs of companies by reputable directors who may not want the disrepute that comes with director disqualification.

9.3.7 The rule presumes solvency on directors

It has been established that the wrongful trading rule is based on an unfounded presumption that directors of companies will be solvent enough as to comply with the contribution order thereby increasing the assets of the company available for distribution to creditors. It has been established that apart from artificial persons whom the court will find to have been directors of the company for purposes of wrongful trading and who will usually be solvent enough, a lot of human directors will be appointed as directors due to their expertise and experience and not due to their solvency and their ability to comply with the contribution order cannot be guaranteed.

Arguably, wrongful trading is more likely to occur against human directors than the said artificial directors. In this vein, the expectation that human directors will contribute meaningfully to the assets of the company is likely to lead to frustrations as many of them may not be able to do so. This is likely to affect the potency of the wrongful trading rule.

9.3.8 The negative impact of corporate rescue on the vibrance of the wrongful trading rule in Malawi

It has been established in this chapter that while the corporate rescue culture which has been enacted under the Insolvency Act of 2016 in Malawi is very important for the survival of many financially distressed companies in Malawi, corporate rescue, known as company administration under the Malawian Insolvency Act, has a negative effect on the efficacy of the wrongful trading rule in Malawi.

© University of Pretoria

This, it has been established in this chapter, is due to the fact that directors of financially distressed companies will rush to place their said companies under administration knowing that through that, they stand not to be prosecuted for wrongful trading either because the company will avoid going into insolvent liquidation (where wrongful trading proceedings may be instituted) or because even if the company goes into insolvent liquidation, the directors will survive liability for wrongful trading on the basis that by initiating administration of the company, they would be found to have taken every step with a view to minimizing the potential loss to the company's creditors, which is a defence to wrongful trading.

In view of the foregoing, it has been observed that there ought to be a reconsideration of the framing of the rule so that corporate rescue, which is as important as the rule itself, does not affect the vibrance of the wrongful trading rule in Malawi.

9.3.9 Applicability of the wrongful trading rule during the current COVID-19 pandemic in Malawi

It has been established in this chapter that the wrongful trading rule in Malawi continues to apply during the current COVID-19 pandemic. In this vein, it has been established that the continued applicability of the rule during the said pandemic dampens the efficacy and the vibrance of the rule as the rule is difficult or impossible to make use of during the currency of the pandemic. This is because director-indifference in the management of the affairs of financially distressed companies, which the rule was designed to combat, is currently subdued by the effects of the COVID-19 pandemic to the extent that it is almost impossible to rule out the effects of the pandemic as being a great contributing factor to corporate insolvencies that have occurred since the pandemic started, also director-indifference may partially exist.

Finally, apart from the foregoing, it has also been established that the continued applicability of the wrongful trading rule during the current COVID-19 pandemic in Malawi entails that Malawi is failing to adjust and embrace the recent trends in insolvency law necessitated by the pandemic which the comparable jurisdictions in this study have embraced.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

CHAPTER 10

RECOMMENDATION OF REFORMS TO ENHANCE THE EFICACY OF THE WRONGFUL TRADING RULE IN MALAWI AND THE EXPECTED GAINS OF THE REFORMS

SUMMARY

10.1 Introduction……………………………..……………………………340

10.2 Recommendations of reforms to enhance the efficacy of the wrongful trading rule in Malawi…………………………………344

10.3 Other problems of the current wrongful trading rule which will be rectified by the proposed reforms………………………….355

10.4 An inherent problem of the wrongful trading rule which cannot be rectified by the proposed reforms…………………………………...….358

10.5 Summary of recommended reforms………………………………………359

10.6 Outlook of the recommended reformed wrongful trading rule…………360

10.7 The expected gains of reforming the wrongful trading rule in Malawi in the recommended ways………………………………………..364

10.8 Recommendation on the applicability of the wrongful trading rule in Malawi during the current COVID-19 pandemic……………………366

© University of Pretoria

10.1 INTRODUCTION

The preceding chapter having exposed a litany of problems that are likely to affect the efficacy of the wrongful trading rule in Malawi, this chapter, which is the last chapter in this study, answers the last main research question of this study, namely, "is there need for further law reform to enhance the efficacy of the wrongful trading rule in Malawi?" This chapter answers this question in the affirmative and provides a number of recommendations for reform that may help to enhance such efficacy of the wrongful trading rule in Malawi.

The first reform that is recommended is to change the liability triggers of the rule as they are in section 187 of the Insolvency Act of 2016 in Malawi, which are to the effect that a director will be liable for wrongful trading if it is proved that "***at some time before the commencement of the winding up, the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation***, and then he ***failed to take every step with the view to minimizing the potential loss to the company's creditors***."

These liability triggers, as highlighted above, will have to be replaced with an active duty placed on directors **to prevent the company from incurring a debt when they know or expect the company to be insolvent**. This reform will have to be coupled with the replacement of the misleading marginal note titled "*wrongful trading*" with a new one titled "*insolvent trading*." Further, the section will need to have a heading, titled, "**Director's duty to prevent insolvent trading by the company**."

These reforms will do away with the drafting problems that have been shown to be likely to hamper the efficacy of the rule, such as:

(a) The use of the word "**wrongful**" in the marginal note of the rule which has been shown in chapter 9 herein to be capable of misleading the court into searching for wrongdoing or blameworthiness in the conduct of the directors in order to find them liable for wrongful trading.

© University of Pretoria

(b) The use of the phrase "**at some time"** before the commencement of the winding up" which has been shown in chapter 9 herein to be imprecise.

(c) The use of the phrase "**reasonable prospect"** that the company would avoid going into insolvent liquidation" has been shown in chapter 9 herein to be elusive.

(d) The use of the phrase "**ought to have concluded"** that there was no reasonable prospect of the company avoiding insolvent liquidation" which, apart from being imprecise, it also deprives the directors of the defence of taking "every step" as it has been shown in chapter 9 herein.

The proposed reform above will have to be coupled with a reform to the defences to wrongful trading provided under the rule. Currently, it is a defence to a wrongful trading claim if a director, having known or concluded, at some time before the commencement of the winding-up, that the company would not avoid going into insolvent liquidation, **took every step with the view to minimizing the potential loss to the company's creditors as he ought to have taken**.

It is recommended that this defence, which is not clear as to which steps the directors must take, should be replaced with a more elaborate set of alternative defences all of which are geared towards the director preventing the company from incurring a debt when the company is insolvent or when he expects it to be insolvent.

Another recommendation for reform of the rule involves removing the liquidation restriction of the rule, making the rule available during administration of companies. This will ensure that wrongful trading claims are not stifled for the mere reason that the liquidator is unwilling to commence the proceedings either due to funding or for any other reason.

Apart from the automatic addition of the administrator as an applicant if the rule is made available during administration of companies, it is recommended that another reform should be done to extend the scope of permissible applicants to third parties, creditors and to the Director of Insolvency in Malawi.

© University of Pretoria

If the rule is amended to include third parties and creditors as claimants, it is recommended that a further reform be done to allow the liquidator to assign rights of causes of wrongful trading actions as well as proceeds thereof to the said third parties and creditors. This will incentivize the said third parties and creditors to provide funding for the prosecution of wrongful trading claims with an assurance that they will receive a share of the proceeds of the actions in return for their funding in priority to the general body of unsecured creditors.

Further, the inclusion of the Director of Insolvency as an applicant is aimed at unlocking public funding for the prosecution of the wrongful trading claims, and therefore ending the funding problem which hampers the efficacy of the rule as it has been shown in chapter 9 herein.

Another recommended reform pertains to introducing a safe harbor carve out in the wrongful trading rule, whereby directors are spared from liability for wrongful trading if they can show that from the time they knew or expected their companies to be insolvent, they put in place a recovery plan for the company which they honestly believed it would lead to a better outcome for the company than would an immediate administration or liquidation, and that they allowed the company to incur the debt or debts in question in order to fund the implementation of that recovery plan.

It is also recommended that the amendments should include introducing director disqualification within the rule where the court should be given the powers to automatically disqualify a natural person from being appointed a director for a period up to 10 years immediately after finding the person liable for wrongful trading.

If the reforms recommended herein were to be implemented, the reformed rule will automatically do away with some of problems which hamper the efficacy of the rule as identified in chapter 9 herein. Firstly, the rule will automatically do away with the problem of it being too wide that it fails to serve its intended purposes and serves unintended purposes as the liability elements of the rule will have been significantly narrowed. Secondly, the reformed rule will automatically do away with the practical impossibility in the rule which requires director who do not know that their companies

© University of Pretoria

are destined for insolvent liquidation to, nevertheless, take steps to save the company, a thing which can only be done by directors who know that their companies are headed for insolvent liquidation. Finally, with the recommended reforms, the rule will be available during administration of companies and therefore the reform will have automatically done away with the negative impact of corporate rescue on the vibrance of the rule.

However, the proposed reforms will not, and cannot, do away with the problem that the rule presumes solvency in directors. This is an inherent problem of the rule and therefore it will remain, although its effect on the efficacy of the rule will significantly dwindle with the reforms proposed herein.

After outlining the recommended reforms, the chapter gives an outlook of the reformed "wrongful trading" rule if the recommendations herein were to be actualized. The chapter then addresses an ancillary question to the proposed reforms, namely, " what are the expected gains of reforming the wrongful trading rule in the ways recommended in the study?" This is the fifth research question of this study.

On the expected gains, it is submitted in this chapter that while the efficacy of the wrongful trading rule will be enhanced by the proposed reforms, the vibrance of the rule will remain average because the need for the rule was exaggerated when the rule was contemplated, as there is not a large scale of wrongful trading by directors in companies as it was concluded by the Cork Committee in the United Kingdom when inventing the rule.

Finally, it having been submitted at the end of chapter 9 herein that the effects of the current COVID-19 pandemic have hampered the efficacy of the wrongful trading rule by making it impossible to isolate which collapses of companies are not due to the effects of the pandemic and but due to director indifference in the running of the affairs of companies as for the wrongful trading rule to apply only in respect of the latter case, the chapter winds up by making a proposal on the applicability of the wrongful trading rule in Malawi during the currency of the COVID-19 pandemic to ensure that the vibrance of the rule is preserved.

© University of Pretoria

10.2 RECOMMENDATIONS OF REFORMS TO ENHANCE THE EFICACY OF THE WRONGFUL TRADING RULE IN MALAWI

10.2.1 Prohibiting multiplicity of debts when the company is insolvent.

The first recommendation for reform of the wrongful trading rule in Malawi as it is in section 187 of the Insolvency Act of 2016 is to change the vague liability triggers that are compacted in section 187(2)(b) of the said provision. The said triggers would have to be replaced with two liability triggers which aim at prohibiting a director from allowing the company to **incur debts** when it is **insolvent**.

Section 187(1) of the Insolvency Act of 2016 in Malawi, as read with section 187(2)(b) provides that liability for wrongful trading will attach on a director of the company after the company goes into insolvent liquidation when it is shown that:

> **"at some time before the commencement of the winding-up of the company,** the director knew or **ought to have concluded** that there was no **reasonable prospect** that the company would avoid going into insolvent liquidation, and he failed to take **every step** with a view to minimizing the potential loss to the company's creditors as he ought to have taken. (emphasis supplied on the four liability triggers)."

It is recommended that section 187 (2)(b) of the Insolvency Act of 2016, as quoted above, be amended by completely overhauling the entire section in order to do away with the four vague liability triggers highlighted in the provision. Instead, it is recommended that the provision be replaced with liability triggers that simply require the director to prevent a company from **incurring a debt** when he knows or expects his company to be **insolvent**. In this vein, the four vague liability triggers in section 187(2)(b) of the Insolvency Act will be replaced with two definitive liability triggers, namely, **insolvency** and **incurring a debt**.

© University of Pretoria

The reform recommended above will undoubtedly do away with the problems that are created by the present liability triggers under the rule. With respect to the removal of the phrase "**at some time before the commencement of the winding up**" the reform recommended above will remove the problem faced by a liquidator in a wrongful trading claim in establishing the exact point of time when it is alleged that wrongful trading commenced. As it has been observed, where a liquidator fails to prove this exact point of time, the claim for wrongful trading will fail.[1074]

Further, as it has also been observed in this study, where the evidence adduced in the proceedings show that wrongful trading may have commenced on a different date other than the date pleaded, the liquidator is not at liberty to argue for wrongful trading in respect of that other date, and he or she is not at liberty to invite the court to select a date, based on the evidence adduced, when wrongful trading must have commenced.[1075] As it has been observed by Finch, [1076] there will be several times when liquidators will not be precise in locating the exact time when wrongful trading commenced and, Finch has added, sometimes this exact point of time may become clear through the evidence given in court rather than what is contained in the wrongful trading pleadings.[1077]

Although the courts in the cases of *Roberts vs. Frolich* and *Re Kudos Busines Solutions Ltd* took a relaxed approach by allowing the liquidators to plead the crucial "point of time" in the alternative, it is submitted that these two cases present an unjustified exception and therefore that the Applicant in a wrongful trading claim cannot be completely certain that subsequent courts will follow this relaxed approach.[1078]

Even taking the approach in *Roberts vs. Frolich* and *Re Kudos Business Solutions Ltd* above to be the current approach, it will be noted that these two cases did not outlaw

---

[1074] For a detailed discussion of the problems that emanate from use of the phrase "at some time before the commencement of the winding up" in section 187 of the Insolvency Act of 2016 in Malawi, see chapter 9 para 9.2.1.2 herein.

[1075] Ibid.

[1076] Ibid.

[1077] Ibid.

[1078] Ibid.

© University of Pretoria

the approach taken by the courts in *Re Sherbone Associates* and *Re Continental Assurance*. The existence of two conflicting approaches, therefore, only highlights the confusion that is created by the two liability triggers in the current wrongful trading rule.[1079]

With respect to the removal of the phrase "**ought to have concluded**" in the provision, it is clear that the provision will no longer have an imprecise liability trigger which also had the effect of depriving directors of the defence of taking every step.[1080] With respect to the removal of the phrase **"reasonable prospect"** in the provision, the provision will not have an elusive liability trigger which requires directors to gaze into the future in order to discern what amounts to a reasonable prospect in each individual situation. Instead, the provision will have definitive liability triggers which simply require them to prevent the company from **incurring a debt** when they know or expect it to be **insolvent**.[1081]

10.2.2 Replacement of the "every step" defence with elaborate alternative defences

If the reforms proposed above were to be effected, removing the "every step" defence among the other four vague liability triggers in section 187(2)(b) of the Insolvency Act of 2016 in Malawi and making **insolvency** and **incurring a debt** to be the only liability triggers of the wrongful trading rule, it is recommended that a set of alternative defences be introduced under the rule for directors who allow the company to incur a debt when it is insolvent. In this vein, it is recommended that it should be a defence to a director who allows a company to incur a debt when it is insolvent if it can be shown:

(a) That the director had reasonable grounds to expect, and did expect, that the company was solvent when the debt was incurred, or

1079 Ibid.

1080 For a detailed discussion of the problems which emanate from use of the phrase "ought to have concluded" in the provision, see chapter 9, para 9.2.1.4 herein.

1081 For a detailed discussion of the problems that emanate from use of the phrase "reasonable prospect" in the provision, see chapter 9 para 9.2.1.3 herein.

© University of Pretoria

(b) That the director took all reasonable steps (not just "every step" as it is in section 187 (3) above) to prevent the incurring of the debt by the company;[1082] or

(c) That the director had reasonable grounds to believe that any debt incurred would be able to be repaid.[1083]

As it would be clear, the defence proposed in paragraph (c) above addresses a concern that the proposed reform prohibits any kind of incurring of a debt when a company is insolvent. As it is clear from the said proposed alternative defence, a director will escape liability for the reformed wrongful trading rule even after having allowed the company to incur a debt which was eventually not repaid and the company went into administration or insolvent liquidation as long as he can show that at the time when the debt was incurred, he had reasonable grounds to believe that the debt incurred would be repaid.[1084]

10.2.3 Renaming the rule the "Insolvent Trading Rule"

With the above recommendations for reform, it is further recommended that the word "**wrongful**" in the marginal note of the rule (section 187 of the Insolvency Act of 2016 in Malawi) be replaced with the word "**insolvent**" thereby having the rule renamed the **Insolvent Trading Rule**, making it clear that the rule is aimed at preventing insolvent trading of companies. Further, removal of the word "**wrongful**" from the marginal note of the rule will also address the problem that affects the efficacy of the rule stemming from the use of that word, namely, the misconception by some courts in expecting a director's conduct to be shown to have been "**wrong**" or "**blameworthy**" based on

1082 This will absolve from liability a director who, for instance, votes against incurring the debt at a meeting although he may have been voted out in the end.

1083 Note that some of the alternative defences proposed above are similar to the defences under the Australian equivalent of wrongful trading in the Corporations Act 2001, S.588 H.

1084 For a detailed discussion of the concerns that may arise with the recommended defences herein and how the said concerns are allayed, see chapter 9, para 9.2.1.5 herein.

© University of Pretoria

the English definition of the word "**wrongful**" as was the case in *Re Continental Assurance Co. of London Plc*.[1085]

Further, it is recommended that the rule (section 187 of the Insolvency Act of 2016 in Malawi) should have a heading which must be clear as to what is expected of the rule and the persons from whom this is expected. In this vein, it is proposed that the said heading should read: "**Director's duty to prevent insolvent trading by the company.**" This will enable focus to be on the two main liability triggers of the rule, namely "**insolvency** and **incurring a debt**."

10.2.4 Extending the scope of permissible claimants to administrators, creditors, third parties and a public officer

Another recommendation which may improve the efficacy of the wrongful trading rule is to extend the scope of permissible applicants in the wrongful trading proceedings. In the current form of the rule, only liquidators are given standing to commence wrongful trading proceedings. The fact that only liquidators have standing to commence wrongful trading proceedings brings some challenges relating to funding.

These challenges arise firstly because the liquidator has no access to public funding and considering that the company will usually have insufficient assets at the time when wrongful trading proceedings are contemplated, the liquidator will be reluctant to use the said meagre assets to fund speculative wrongful trading claims.

The fact that a liquidator is the only claimant permitted under the wrongful trading rule also entails that the rule will only operate when a company has gone into insolvent liquidation. This is what has been described as the liquidation restriction in this study.[1086]

[1085] For a detailed discussion of the problems that emanate from use of the word "wrongful" in the marginal note of the provision, see chapter 9 para 9.2.1.1 herein.

[1086] For a detailed discussion of the problems which emanate from the liquidation restriction of the wrongful trading rule, see chapter 9, para 9.2.4 herein.

© University of Pretoria

It is recommended that the first step in extending the scope of claimants in the wrongful trading rule should be to remove the liquidation restriction so that the rule exists not only when a company has gone into insolvent liquidation, but also before the inception of the said liquidation whenever the conduct of the director in the management of the affairs of the company is subject to examination.

One such opportune times is when the company has been placed under administration. As it would be accepted, an administrator is mandated to investigate the immediate past conduct of the directors in order to make a report as to how a company can be properly driven back to solvency. It is recommended that in the process of conducting the said investigation, the administrator should also investigate whether the director **allowed a company to incur a debt when he knew or expected the company to be insolvent**, and be able to commence proceedings based on the director's inability to prevent the company from incurring the debt in such circumstances.

Making the wrongful trading rule available during administration of companies will address the concerns, as have been raised by some commentators, that the fact that the wrongful trading rule is available when the company is financially beyond redemption goes against the notion of creditor protection which the rule was designed to ensure.[1087]

Further, unlike a liquidator who will have liquidation costs to pay, over and above the need to fund wrongful trading claims from the already insufficient assets of the company during the insolvent liquidation, an administrator will only have the lesser administration costs to pay as opposed to the greater liquidation costs, and hence this will, in principle, entail that the administrator will have enough assets to fund wrongful trading claims as opposed to the liquidator. Making an administrator to be one of the claimants in wrongful trading claims therefore has the potential of eradicating one of the greatest impediments to the efficacy of the wrongful trading rule, namely, funding of the proceedings.

[1087] Ibid.

© University of Pretoria

Again, unlike in the case of liquidation where the creditors will be awaiting payment by the liquidator, the creditors under administration will not be waiting for immediate payment as the primary purpose of an administrator is not to pay creditors, and the presence of a moratorium against the creditors' claims against the company during administration will help to preserve the assets of the company thereby making them available for funding of wrongful trading claims.

Having removed the liquidation restriction, it is further recommended that standing to commence wrongful trading proceedings in Malawi be extended to creditors of the company as well as third parties. Apart from the fact that that the extension of possible applicants in wrongful trading actions has the potential of having the proceedings commenced by one of the said applicants in instances where a liquidator or an administrator is unable to commence the proceedings, a fact which may result in the vibrance of the rule, extending standing to creditors and third parties also has the potential of unlocking funding for wrongful trading proceedings and therefore do away with the major set-back in the prosecution of wrongful trading proceedings.[1088]

With respect to extending standing to a public officer, it is recommended that standing to bring up wrongful trading proceedings should be extended to the Director of Insolvency. In Malawi, the Registrar General, who is the Registrar of Companies by virtue thereof is also the Director of Insolvency. There are several reasons why standing to commence wrongful trading proceedings should be extended to a public officer.

First, the wrongful trading rule does not only serve a private law function of creditor protection. The rule also serves a public law function of ensuring minimum standards for directorial conduct in the management of the affairs of a company. For this reason, it is necessary that a public officer be given standing to commence wrongful trading proceedings under the rule in order to safeguard the public interests served under the rule in the event that a liquidator or an administrator is, for some reason, unwilling or unable to commence the proceedings.[1089]

[1088] For a detailed discussion on the benefits of extending standing to commence wrongful trading proceedings to creditors and third parties, see chapter 9, para 9.2.4.2 herein.

[1089] For a detailed discussion on the private law and public law functions served by the wrongful trading rule, see chapter 9, para 9.2.3 herein.

© University of Pretoria

This is not to propose that the public officer should only be allowed to commence the wrongful trading proceedings where the same are not commenced by a liquidator or an administrator. This would be absurd as it would entail the elevation of private law interests over public interests in the rule. It is proposed that the three proposed claimants should have an equal opportunity to commence the said proceedings, although practically it is expected that the public official will not be interested to be the one maintaining the proceedings where a liquidator or administrator is keen to commence the proceedings.

The second reason for the proposal to include a public official to be one of the claimants in wrongful trading proceedings is to increase the avenues of funding of wrongful trading proceedings. As it has been observed herein, one of the greatest setbacks in the prosecution of wrongful trading proceedings is the issue of funding. A liquidator, who will already be having insufficient assets for distribution to creditors during an insolvent liquidation of a company, will be very reluctant to apply his meagre assets to fund speculative wrongful trading proceedings, particularly knowing that, in the current form of the wrongful trading rule in Malawi, a liquidator has no access to public funding.[1090]

10.2.5 Introducing a safe harbor carve-out under the rule

Having recommended herein that the wrongful trading rule should be reformed to the extent that directors of insolvent companies should prevent the said companies from incurring debts, it is necessary that the reform must equally encompass what the said directors should be doing from the moment they know or expect their companies to be insolvent. As it would be readily admitted, it is not feasible to expect that every time directors know or expect their companies to be insolvent, they should cause the company to cease trading and place the company under a form of an insolvency process.

[1090] For a detailed discussion on how extending standing to commence wrongful trading proceedings to a public officer may address the funding problem that hampers the success of wrongful trading proceedings, see chapter 9 para 9.3 herein.

© University of Pretoria

Although one of the possible concerns of the proposed reform of the wrongful trading rule as above is that placing a company under an insolvency process is the very likely option for directors who would want to avoid the slightest possibility of being found liable for wrongful trading, it is submitted that this ought not to be the first option for directors considering that a company will, in its lifetime, move in and out of insolvency, a fact which entails that not every stint of insolvency is fatal for the company and therefore that there is no necessity for the directors to cause the company to cease trading each time they know or expect their company to be insolvent.

On the other hand, it must be noted that directors have the responsibility to make business judgement decisions for the betterment of the company and that they are protected from liability that flows from their business judgement decisions that go wrong. This entails that even where the directors know or expect their companies to be insolvent, their first priority must remain to make business judgement decisions that may glide the company back to solvency rather than placing companies in an insolvency processes each time the companies are financially distressed.

In this vein, the greatest question becomes "**what if taking steps that may glide the company back to solvency requires that the company should incur a debt or debts**?" To this question, it is recommended that there should be an exception to the extent that the directors should be at liberty to allow the company to incur a debt or debts when they know or expect their companies to be insolvent only if the debt or debts in question are incurred in respect of a comprehensive plan to glide the company back to solvency.

For this to be possible, it is recommended that the reformed wrongful trading rule in Malawi must embrace the Australian principle of safe harbor which protects the directors from liability under the Australian counterpart of wrongful trading if, upon knowing or expecting their companies to be insolvent, the directors begin to develop one or more courses of action that will lead to a better outcome for the company.[1091]

1091 For a detailed discussion of the safe harbor principle, see chapter 9, para 9.2.5 herein.

© University of Pretoria

It is hoped that the protection from prosecution for wrongful trading afforded by the recommended introduction of a safe harbor into the wrongful trading rule, coupled with the possibility of another protection from liability based on the common law principle of the Business Judgement rule, will provide the necessary incentives to directors to be focused on bringing their companies back to solvency when they know or expect their companies to be insolvent rather than taking the coward's way out of simply placing their companies under an insolvency processes each time they know or expect the companies to be insolvent with a view of avoiding eventual liability for wrongful trading.

10.2.6 Introducing director disqualification under the rule

As it has been discussed in chapter 9 herein, the absence of director disqualification powers under the wrongful trading rule in Malawi entails that persons who have previously been found liable for wrongful trading may continue to serve as directors in other companies with the same indifference that invited their initial liability for wrongful trading. This has the effect of increasing the scale of wrongful trading in companies as well as increasing the number of directors who fail to satisfy the minimum standards for serving as directors in Malawian companies. As it has been observed in chapter 9 herein, the foregoing has the potential of dampening the efficacy of the wrongful trading rule in Malawi.[1092]

Considering that under both the Companies Act and the Insolvency Act in Malawi the court has no specific powers to disqualify persons who have previously been found liable for wrongful trading, it is recommended that the wrongful trading provision under section 187 of the Insolvency Act should be reformed by adding a subsection that empowers the court, upon making a finding of liability for wrongful trading against a director, to further make a disqualification order against the director, prohibiting the director from serving as a director for a period up to 10 years.

Considering, as discussed above, that liability for wrongful trading in respect of a director emanates from failure by the director to comply with the minimum standards

1092 For a detailed discussion on the importance and impact of director disqualification powers under the wrongful trading rule in Malawi, see chapter 9, para 9.2.6 herein.

© University of Pretoria

for serving as a director, and also considering the need to protect creditors of other companies from losses emanating from similar conduct by the same persons, and the desire to promote deterrence to conduct displayed by the said persons, it is recommended that unlike the disqualification under the Company Directors Disqualification Act in the United Kingdom which is discretional, the disqualification of directors in Malawi should be automatic upon the court establishing liability against directors. However, considering that that the disqualification will be automatic, it is recommended that the disqualification should range between 5 years to 10 years depending on the magnitude of the loss suffered by the company by virtue of the wrongful trading.

10.2.7 Enabling assignment of wrongful trading causes of actions and proceeds

The funding challenges that hamper the success of the wrongful trading rule may be partly surmounted by reforming the wrongful trading rule in such a way that the rule becomes available even during administration of companies and also that both the administrator and the liquidator should be at liberty to assign both the wrongful trading causes of actions as well as the proceeds thereof to third parties or creditors who may be willing to provide funding of the proceedings in return for a share of the proceeds of the said proceedings.[1093]

In this vein, it is recommended that the reforms to section 187 of the Insolvency Act of 2016 in Malawi should include inserting a provision that enables a liquidator or an administrator to assign wrongful trading causes of action and proceeds thereof to third parties or creditors who may be willing to fund the proceedings in return for a share of the proceeds of the proceedings.

[1093] For a detailed discussion on how assignment of wrongful trading causes of action and proceeds thereof may address the funding problem which hampers the success of the wrongful trading rule, see chapter 9, para 9.2.3 herein. See also Chapter 7, paras 7.4.3 and 7.5 herein.

© University of Pretoria

10.3 OTHER PROBLEMS OF THE CURRENT WRONGFUL TRADING RULE WHICH WILL BE AUTOMATICALLY RECTIFIED BY THE RECOMMENDED REFORMS

If effected, the reforms to the wrongful trading rule proposed herein will also rectify other problems identified in the rule that affect its efficacy as follows:

10.3.1 Problem of the rule not serving its intended purpose

One of the problems associated with the wrongful trading rule as identified in chapter 9 above is that the rule was drafted too widely that it serves other purposes which were not intended, while failing to serve its intended purpose. As Williams observed, the fact that the main liability element under the current wrongful trading rule is for a liquidator to show that the director allowed a company to continue to trade when he knew or ought to have known that there was no reasonable prospect of the company avoiding going into insolvent liquidation means that as long as this liability element exists, a court will likely find a claim for wrongful trading to have been made out whether or not the said continuing to trade was borne out of the director's indifference in the management of the affairs of the company.[1094]

Williams argues that this is contrary to the original intention of the rule as it was conceived by the Cork Committee, namely that the main liability trigger of the rule as above must be shown to have descended from director-indifference in the management of the affairs of the company, and not anything else.[1095]

As it has been discussed herein, in *Re DKG Contractors Ltd* the court found a claim for wrongful trading to have been made out by the liquidator, but surprisingly instead of proceeding to make a contribution order, the court concluded that the contribution order was satisfied by a payment which was ordered under a claim for breach of duty in the case. Similarly, in *Re Idessa (UK) Ltd*, the court found claims for breach of duty

1094 For a detailed discussion of the problem of the wrongful trading rule having been drafted too widely that it fails to serve its intended purpose and sometimes serves unintended purposes, see chapter 9 para 9.2.2 herein.

1095 Ibid.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

and wrongful trading to have been made out by the liquidator and, while the court awarded different sums for the said two claims, there was no indication why the sum awarded under the wrongful trading claim could not have been recovered under the breach of duty claim, and the inclusion of a tax liability sum under the wrongful trading award made it clear that the whole wrongful trading award could have been awarded under the breach of duty claim.[1096]

The foregoing confusion which clearly stems from the wide drafting of the wrongful trading rule will surely disappear with the reform of the rule recommended herein for the reason that the reform will do away with the wide main liability triggers of the rule, namely, that **"at some time before the commencement of the winding-up of the company, the director knew or ought to have concluded that there were no reasonable prospects of the company avoiding going into insolvent liquidation."**

Instead, the recommended reform simply seeks to make **insolvency**, in the sense of the company being unable to pay its debts as they fall due, to be the main liability element of the rule. As it would be clear, this main liability element is too narrow and it is coupled with another narrow second liability element which is that **the director allowed the company to incur a debt** in that state, as opposed to the vague second liability element in the current wrongful trading rule of "**the director having failed to take steps with a view to minimizing potential losses to the creditors of the company as he ought to have taken**" when the first liability element above was satisfied. It is hoped that with the reforms proposed herein, the problem of the rule failing to serve its intended purpose or serving a purpose not intended in the rule will be eradicated.

10.3.2 Doing away with the practical impossibility inherent in the rule

As it has been observed in chapter 9 herein, section 187(1) of the Insolvency Act of 2016 in Malawi is to the effect that *if a director knew or **ought to have concluded** that the company would not avoid going into insolvent liquidation,* then it is a defence if he took *every step with a view to minimizing the potential losses to the company's creditors as he ought to have taken*. The use of the words "**ought to have concluded**" in the

1096 Ibid.

© University of Pretoria

provision deprives a respondent director of the defence of "**taking every step**" by expecting a director who "*did not conclude*" to have taken "*every step*" a fact which is practically possible only if the director "*had concluded*."[1097]

This can be a reason for directors to successfully challenge the wrongful trading proceedings on the basis that the limb of the defence that expects them to have taken steps if they "*ought to have concluded that the company would not avoid going into insolvent liquidation*" deprives them of the said defence if they did not so conclude. This challenge has been shown in chapter 9 herein to have the potential of affecting the efficacy of the rule. It is submitted that this problem will be eradicated by the reforms proposed above as the words "ought to have concluded" will be removed from the provision.

10.3.3 Doing away with the negative impact of corporate rescue on the wrongful trading rule

As it has been observed in chapter 9 of this study, the corporate rescue mechanism under the Insolvency Act of 2016 in Malawi impacts negatively on the vibrance of the wrongful trading rule in Malawi. This stems from the fact that due to the liquidation restriction of the wrongful trading rule (where the rule only operates when a company has gone into insolvent liquidation) there is a potential for many directors to choose to place their companies under corporate rescue, referred to as administration in Malawi, with a view to preventing the company from going into insolvent liquidation where they may stand to be prosecuted for wrongful trading.[1098]

One of the reforms to the wrongful trading rule recommended in this study has the potential of eradicating the problem of the wrongful trading rule being affected by the administration of companies in Malawi. This is the removal of the liquidation restriction of the wrongful trading rule. As it has been recommended that the wrongful trading rule should also be available during administration of companies through administrators of

[1097] For a detailed discussion of the problems that emanate from use of the phrase "ought to have concluded" under the rule, see chapter 9, para 9.2.1.4 herein.

[1098] For a detailed discussion of the negative impact of corporate rescue on the wrongful trading rule in Malawi, see chapter 9, para 9.2.8 herein.

© University of Pretoria

the said companies, it is expected that directors of financially distressed companies will still be amenable to liability for wrongful trading even during administration of the companies. Once this reform is undertaken, placement of a company into administration will cease to be an escape route from wrongful trading for errant directors as is the case in Malawi currently.

10.4 AN INHERENT PROBLEM OF THE RULE WHICH CANNOT BE RECTIFIED BY THE RECOMMENDED REFORMS

There is one problem associated with the wrongful trading rule which, it is submitted, cannot be rectified by the reforms proposed herein for the reason that the problem is inherent in the spirit of the rule. This is the fact that the wrongful trading rule, be it in the current form or after it is reformed in the manner proposed herein, presupposes that the directors of companies are solvent enough to pay the ordered contribution sum to the assets of the company for the benefit of the creditors of the company.

The wrongful trading rule fails to get to grips with the reality that many human directors will not be appointed to the position of a director based on their personal solvency but rather due to their qualifications, expertise or experience. To expect such persons to suddenly be able to comply with an order of the court requiring payment from them, meaningful enough to redress the losses suffered by all creditors of a company during its insolvent liquidation is therefore to expect the near impossible situation.[1099]

As much as creditor protection through compensation for the loss suffered by creditors remains the primary aim of the wrongful trading rule, there will be many instances where this may not be achieved due to inability of the directors to comply with the contribution order because of their own personal insolvency, which in cases of shareholder-directors, it will have been a chain reaction of the very insolvency of the company giving rise to the said wrongful trading claims.

However, this should not be interpreted to mean that the wrongful trading rule is incapable of achieving its intended purpose because it is borne out of a wrong

[1099] For a detailed discussion of the problem that emanates from the presumption of solvency in directors which is inherent in the wrongful trading rule, see chapter 9, para 9.2.7 herein.

© University of Pretoria

supposition of solvency of directors of companies. To begin with, not all directors will be insolvent and unable to comply with the contribution order by the court. Secondly, as it has been made clear in Chapter 3 herein in relation to the meaning of the term director for purposes of wrongful trading, a wide range of artificial persons are eligible to be found by the court to have been directors of the company for purposes of wrongful trading.

These include banks, holding companies, public accountancy firms, auditing firms, stand-alone companies, insolvency practice firms, law firms *etc*. It is submitted that unlike human directors some of whom may be insolvent and unable to comply with the contribution order, the artificial directors mentioned herein will usually be solvent enough to make contributions to the insolvent companies for the benefit of the creditors.

10.5 SUMMARY OF RECOMMENDED REFORMS

It has been recommended in this study that the following proposals for reform of the wrongful trading rule in Malawi will remove or reduce the problems that have been identified in Chapter 9 of this study as hindrances to the efficacy of the rule:

(a) Replacing the word "**wrongful**" in the marginal note of section 187 of the Insolvency Act of 2016 in Malawi with the word "**insolvent**" so that the marginal note of the section reads "**insolvent trading**" as opposed to "**wrongful trading**." The rule will be referred to as the " insolvent trading" rule, and this will make it clear that the rule is geared towards preventing insolvent trading of companies.

(b) Inserting a heading of section 187 of the Insolvency Act in Malawi titled "**Director's duty to prevent insolvent trading by the company.**" This will make it clear that it is the directors of the company that have the duty to prevent insolvent trading of their companies and therefore that they are liable for the said insolvent trading if they do not prevent it.

(c) Narrowing the main liability elements of the rule to be "**allowing the company to incur a debt when it is, or it is expected to be, insolvent**" instead of the current liability elements under the rule which are as wide and as imprecise as "**failure by the director to take reasonable steps with the view to minimizing the potential**

© University of Pretoria

losses to the company's creditors from some time before the commencement of the winding up of the company when the director knew or ought to have concluded that the company would not avoid going into insolvent liquidation."

(d) Expressly outlining three major alternative defences available during insolvent trading proceedings, unlike merely stating a general defence of the director "**taking steps with a view to minimizing the potential loss to the company's creditors as he or she ought to have taken**" as is the case presently.

(e) Making the insolvent trading rule to be applicable during administration of companies, and not only during liquidation of companies.

(f) Extending the range of applicants in insolvent trading proceedings by adding an administrator, a public officer and a creditor over and above the liquidator.

(g) Introducing an automatic power for the court to disqualify directors who have been found liable for insolvent trading from serving as directors for a period up to 10 years.

(h) Introducing a safe harbour carve-out under the rule where directors who know or expect that their company is insolvent are allowed to develop a plan to save the company from administration or liquidation and incur a debt or debts for the implementation of the said plan without having to be liable for insolvent trading when the plan eventually fails.

(i) Enabling the liquidator in the proceedings to assign the rights of the insolvent trading causes of action and the proceeds thereof to third parties or creditors who are willing to fund the proceedings in return for a share of the proceeds.

10.6 OUTLOOK OF THE RECOMMENDED REFORMED WRONGFUL TRADING RULE

With the foregoing proposed reforms to the wrongful trading rule, the new section 187 of the Insolvency Act of 2016 in Malawi will appear and read as follows:

© University of Pretoria

Director's duty to prevent insolvent trading by the company. **Insolvent trading.**

187 (1) Subject to subsection (3), if in the course of administration or winding-up of the company it appears that subsection (2) applies in relation to a person who is or has been a director of a company, the Court, on the application of an administrator, a liquidator, a creditor or the Director of Insolvency, or any other person may declare that the person is to be liable to make such contribution to the company's assets as the Court thinks proper.

(2) This subsection shall apply in relation to a person if-

(a) The person is a director of the company at the time when the company incurs a debt; and

(b) The company is insolvent at that time or becomes insolvent by incurring that debt or by incurring at that time debts including that debt; and

(c) At the time when the debt is incurred, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and

(d) The company goes into administration or insolvent liquidation; and

(e) In case of the company having been insolvent when the debt is incurred, the debt remains unpaid at the time when the company goes into administration or insolvent liquidation.

(3) (1) The court shall not make a declaration under this section with respect to any person if it is satisfied -

© University of Pretoria

(a) that the director had reasonable grounds to expect, and did expect, that the company was solvent at that time and that it would remain solvent even if it incurred that debt; or

(b) That the director took all reasonable steps to prevent the incurring of the debt by the company; or

(c) That the director had reasonable grounds to believe, and did believe, that any debt incurred would be able to be repaid.

(2) In determining whether the defence under section (3) (1) (a) above has been proved, the matters to which regard will be had shall include, but not be limited to;

(a) any action the person took with a view to appointing an administrator of the company; and

(b) when that action was taken; and

(c) the results of that action.

(3) Section (1) and (2) shall not apply if-

(a) upon knowing or expecting that the company is or may become insolvent, the person starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company than the immediate appointment of an administrator or a liquidator of the company; and

(b) the debt is incurred in connection with such course of action during the period starting at that time and ending at the earliest of any of the following times:

(i) if the person fails to take any such course of action within a reasonable period after that time – the end of that reasonable period;

(ii) when the person ceases to take any such course of action;

© University of Pretoria

(iii) when any such course of action ceases to be reasonably likely to lead to a better outcome for the company;

(iv) the appointment of an administrator or liquidator of the company.

(4) For the purposes of subsection (2) and (3) and (4), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having –

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

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

(5) The reference in subsection (4) to the functions carried out in relation to the company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

(6) For the purposes of this section, a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for payment of its debts and other liabilities and the expenses of the winding-up.

(7) The administrator or liquidator shall, where he thinks fit, assign the cause of action under this section as well as the proceeds of the same to a third party or a creditor of the company.

(8) Where the court makes a declaration under subsection (1) herein, then, whether or not an application for such an order is made by any person, the court may also make a disqualification order against the

© University of Pretoria

person to whom the declaration relates for a maximum period of 10 years.

(9) In this section, "director" includes a shadow director.

(10) This section shall apply without prejudice to section 186.

10.7 THE EXPECTED GAINS OF REFORMING THE WRONGFUL TRADING RULE IN MALAWI IN THE RECOMMENDED WAYS

In his article titled "What Can We Expect to Gain from Reforming the Insolvent Trading Remedy?" Williams[1100] has argued that there is not much to be expected to be gained from reforming the wrongful trading rule. According to the learned commentator, the dismal performance of the rule as evident in the smaller number of successful wrongful trading cases in the courts so far is not only founded on the statutory defects inherent in the rule but on the fact that the potential impact of the wrongful trading rule when it was enacted was based on unfounded claims about the scale of wrongful trading in companies as it was claimed in the Cork Report.

Williams argues that there is no evidence that the call made in the Cork Report for a "radical" extension in civil liability through the introduction of the wrongful trading rule was ever likely to be realized in the sense of a large number of liability orders, and, as such, there is no basis upon which to conclude that the dismal number of reported successful wrongful trading cases is not consistent with the dismal scale of wrongful trading in companies.[1101]

Williams argues that while the wrongful trading rule is important in some cases, reforming the statutory frame of the rule will bring limited gains because the greatest

[1100] Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015), 83, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/14682230.12106#accessDenialLayout accessed on 6th May 2018.

[1101] Ibid.

© University of Pretoria

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

setback in the rule is the unfounded assumption of prevalence of wrongful trading cases in companies made by the Cork Committee which led to the inception of the rule.[1102]

Concurring with the observations made by Williams, it is submitted that the expectations on the potency of the wrongful trading rule were exaggerated by the Cork Committee, and that the underperformance of the rule since its inception in the United Kingdom does not stem from lack of usefulness of the rule, but largely from the fact that the usefulness of the rule was overrated by the Cork Committee resulting in the rule being presently measured by a high standard.

However, unlike the view taken by Williams that reforming the statutory frame of the rule will bring limited gains, it is submitted that the reforms proposed herein have high prospects of enhancing the efficacy of the rule. As it has been seen in Chapter 9 herein, the statutory frame of the rule plays a greater role in hindering the efficacy of the rule. Although the inherent problem of the rule, the presumption of solvency of directors, will continue to affect the efficacy of the rule, it is submitted that reforming the statutory frame of the wrongful trading rule in the ways proposed above will meaningfully enhance the efficacy of the rule.

It is further submitted that the success of the wrongful trading rule should not only be measured by the number of successful prosecutions achieved under the rule. The success should also be measured with respect to the role which the rule plays in reducing or eradicating wrongful trading in companies through deterrence to directors from engaging in wrongful trading for fear of personal liability under the rule. To this end, the paucity of wrongful trading cases in the courts several years after the rule was enacted must also be taken as an indication of the success of the rule through deterring wrongful trading in companies.

Further, a reform to the rule, such as the introduction of a safe harbour carve-out which offers protection from liability to directors who develop and implement a plan aimed at achieving a better outcome for the company when the company becomes insolvent, is very likely to prevent insolvent liquidation of companies. Prevention of insolvent

[1102] Ibid

© University of Pretoria

liquidation of companies should, it is submitted, also count as the success of the reformed wrongful trading rule, and this conforms with the wishes of the Cork Committee when it envisaged the wrongful trading rule.

In view of the foregoing, it is submitted that while it should not be expected that the reforms proposed herein will increase the efficacy of the wrongful trading rule to the extent that was touted by the Cork Committee when the rule was contemplated, the reforms will nevertheless significantly enhance the efficacy of the rule beyond what the rule is capable of achieving in its current statutory frame.

10.8 RECOMMENDATION ON THE APPLICABILITY OF THE WRONGFUL TRADING RULE IN MALAWI DURING THE CURRENT COVID 19 PANDEMIC

The wrongful trading rule was invented as a tool for the protection of creditors of companies through the minimization or eradication of director indifference in the management of the affairs of financially distressed companies, a factor which may result in the prevention of avoidable insolvencies of companies. Having the rule to remain applicable during the current COVID-19 pandemic when it has become impossible to isolate which corporate insolvencies stem from director-indifference as opposed to the effects of the pandemic, as for the wrongful trading rule to apply only in respect of the former cases, means that the efficacy and the vibrance rule is, during the currency of the COVID-19 pandemic, muted.

In view of this scenario, it is recommended that Malawi passes a law temporarily suspending the operation of the wrongful trading provisions in section 187 of the Insolvency Act of 2016 until such a time when the COVID-19 pandemic is over. Failure to do so currently entails possible liability for wrongful trading on directors of companies for factors heavily influenced by the effects of the COVID-19 pandemic rather than pure director-indifference in the management of the affairs of financially distressed companies, which the rule was designed to combat.

The suspension of the wrongful trading rule in Malawi during the current COVID-19 pandemic will entail that the rule is shelved for operation at the time when its efficacy

© University of Pretoria

and vibrance (in combating director errancy or indifference in the running of the affairs of financially distressed companies) can be felt, unlike the present time where the difficulty or impossibility of making use of the rule has muted the said efficacy and vibrance of the rule.

It is submitted that the suspension of the wrongful trading rule in Malawi being recommended herein will be in tandem with the recent trends in insolvency law, such as those prevailing in the comparable jurisdictions in this study, where all their counterpart rules have been suspended during the current COVID-19 pandemic for predominantly the same reason being advocated herein.

© University of Pretoria

BIBLIOGRAPHY

BOOKS

Arrow, KJ *The Limits of Organization*, (George J. McLeod Limited 1974).

Austin, P and Ramsey, I *Ford, Austin & Ramsay's Principles of Corporations law* (Butterworths 2008).

Bailey, E et al *Corporate Insolvency law practice* (Butterworths 2001).

Boxell, T (Consultant Editor) *A Practitioner's guide to Directors' Duties and Responsibilities* (Sweet & Maxwell 2010).

Brown, SR *Company directors: A concise treatise on the duties, powers, rights and liabilities of company directors in Australia* (Sweet & Maxwell 1965).

Butcher, BS *Directors' duties: A new millennium, a new approach?* (The Hague; Boston: Kluwer Law International 2000).

Cassim, FH (ed) et al *Contemporary Company Law* (Juta Law 2012).

Cassim, FH (Managing Editor) et al *The Law of Business Structures* (Juta 2012).

Cheffins, B *Company Law: Theory, Structure and Operation* (Oxford University Press 1997).

Davies, P and Worthington, S *Gower and Davies Principles of Modern Company Law* (Sweet & Maxwell 2012).

Davies, P *Introduction to Company Law* (Oxford University Press 2002).

Delport, P et al *Henochsberg on the Companies Act, 2008,* Vol 2, Issue 14, Appx 1.

Farrar, JH et al *Farrar's Company Law* (Butterworth 1991).

Finch, V *Corporate Insolvency Law; Perspectives and Principles* (Cambridge University Press 2009).

Finn, PD *Fiduciary Obligations* (The Law Book Company Ltd 1977).

Ford, H Austin, R and Ramsey, I *Ford's Principles of Corporations Law* (Reed International Books Australia Pty Ltd 1999).

© University of Pretoria

Goode, R *Principles of Corporate Insolvency law* (Sweet & Maxwell 1997).

Griffin S, *Personal liability and disqualification of Company directors* (Hart Publishing Co. 1999).

Hannigan, B *Company Law* (Oxford University Press 2009).

Jackson, T *The logic and limits of bankruptcy law* (Harvard University Press 1986).

Keay, A *Insolvency: Personal and Corporate law Practice* (Melbourne: Longmann Business & Professional 1998) 3rd ed.

Keay, A *McPherson: The law of Company Liquidation* (Law Book Co. of Australia 1999).

Keay, A *McPherson's Law of Company Liquidation* (Sweet & Maxwell 2013).

Keay, A and Walton, P *Insolvency Law; Corporate and Personal* (Jordans 2012).

Meskin, PM, Kunst, JA Galgut, B, Deport, P, Vorster, Q, and Burdette, D *Henochsberg on the Companies Act 71 of 2008* (Lexis Nexis 2011, Loose-leaf edition).

Millard JA, QC *The Responsible Director* (The Carswell Company Ltd 1989).

Mokal, R *Corporate Insolvency; Theory and application* (Oxford University Press 2005).

Paolini, A (ed) *Research handbook on Directors' Duties* (Edward Elgar Publishing 2016).

Ramsay, IM (ed) *Company director's liability for insolvent trading* (Melbourne: Centre for Corporate Law and Securities Regulation and CCH Australia 2000).

Sarra, J and Davis, R *Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations* (Butterworths Canada Ltd 2002).

Sharrock, R et al *Hockly's Insolvency law* (Juta 2012).

Tolmie, F *Corporate and Personal Insolvency Law*, (Cavendish Publishing 2003).

Zeigel, J (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press 1994).

ARTICLES

Anderson, H "Shelter from the Storm: Phoenix Activity and the Safe Harbour" (2018) 41 *Melbourne University Law Review* 999.

© University of Pretoria

Armour, J and Walters, A "Funding Liquidation: A Functional Review" (2006) *Law Quarterly Review* 1.

Arsalidou, D "The Impact of Section 214(4) of the Insolvency Act 1986 on Directors' Duties" (2000) 22 *The Company Lawyer* 19.

Avery, RB et al "The Role of Personal Wealth in Small Business Finance" (1998) 22 *Journal of Banking and Finance* 1019.

Bachner, T "Wrongful trading - A new European model for creditor Protection?' (2004) 5 *European Business Organization Review* 293.

Bainbridge, S "Much ado about little? Directors' fiduciary duties in the vicinity of insolvency" (2005) *Law & Economics Research paper series* 38 accessed online at http://ssrn.com/abstract=832504 on 17th December 2018.

Bainbridge, S "The Business Judgement rule as Abstention Doctrine" *UCLA Law and Econ Research paper no. 03-18* p.112 available at SRN: http://ssrn.com/abstract...429260 accessed on 18th August 2019.

Baldwin, R "The New punitive regulation" (2004) 67 *Modern Law Review* 351.

Berle, AA "For Whom Corporate Managers Are Trustees: A Note" (1932) 45 *Harvard Law Review* 1365.

Block, DJ et al "The Business Judgement rule: Fiduciary duties of corporate directors and officers" (1987) *The Business Lawyer* Vol 42, No. 3 pp. 995-997.

Block-Leib, S & Halliday, TC "Harmonization and Modernization in UNCITRAL's Global Legislative Guide on Insolvency Law" (2017) *Texas International Law Journal of February* available at http://ssrn.com/abstract=965710 accessed on 14th July 2018.

Boraine, A and van Wyk, J "The application of the 'repealed' Companies Act 61 of 1973 to liquidation proceedings of insolvent companies" (2013) *De Jure* v46 644-683 available at https://UnivofPretoria.on.worldcat.org/oclc/8598486759 accessed on 23rd November 2020.

Boraine A and van Wyk J "Various Aspects to Consider with Regard to Special Insolvency Rules for Small and Medium-Sized Enterprises in South Africa" (2016) *International Insolvency Review*, v25 3-35, available at, https://UnivofPretoria.on.worldcat.org/oclc/5982844292 accessed on 13th of May 2017.

Botha, D "Directors' Fiduciary Duties to Bondholders? Some Relationship Between Corporate Financial Management and Fiduciary Law" (1993) *SA Merc LJ* 287.

© University of Pretoria

Bratton, WW "Corporate Debt Relationships, Legal Theory in a Time of Restructuring" (1989) *Duke Law Journal* 92.

Brudney, V "Corporate Bondholders and Debtor Opportunism: In Bad Times and Good" (1992) *Havard Law Review* 105.

Brusser, RA "Actions against Delinquent Directors" (1985) *SA Company LJ* 33.

Bruni, G "Corporate Officers' Liability in The Event of Insolvency or Winding Up in Italy" (2006) 6 *Journal of International Banking and Finance Law* 219.

Byers, M "Directors duties in the vicinity of insolvency; why a fiduciary duty to creditors should not be triggered" (2011). Pages 4-5, available at https://www.insolvency.ca/en/whatwedo/resources/3-2011lawaward_byers_m_directors_duties_vicinity_insolvency.pdf#page=1 accessed on 16th September 2018.

Byrne M, "An Economic Analysis of Directors' Duties in Favour of Creditors" (1994) 4 *Australian Journal of Corporate Law* 275.

Calitz, J "Insolvency law adjustment in response to the economic impact of the Covid- 19 pandemic : the South African experience" (2020) *Journal of South African Law* Volume 2020, issue 4.

Chimpango, B "The Insolvency Act 2016: Towards Embracing Corporate Rescue Culture in Malawi." (2017) *Chase Cambria* Vol 14, Issue 2.

Cieri, RM and Riela, MJ "Protecting directors and officers of corporations that are insolvent or in the vicinity of insolvency: Important considerations, Practical solutions" (2004) *De Paul Business & Commercial law Journal* Volume 2: 295.

Cieri, RM et al, "Breaking up is easy to do: Avoiding the solvency related pitfalls in Spinoff Transactions (1999) *54 Business Law Review* 560.

Coffee, JC & Klein, WA "Bondholder Coercion: The Problem Constrained Choice in Debt Tender Offers and Recapitalizations" *58 U. Chi. L. Rev.* 1207.

Cook, C "Wrongful Trading – is it a real threat to Directors of a paper Tiger" (1999) *Insolv L* 99.

Cooke, TE and Hicks, A "Wrongful trading; predicting insolvency" (1993) *BL* 338.

Dabner, J "Directors' Duties – The Schizoid Company" (1988) 6 *CSLJ* 105.

© University of Pretoria

Davies, P "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency." (2006) 7 *European Business Organization Law Review* 329.

de Lacy, J "The concept of a company director: Time for a new expanded and unified statutory concept" (2006) *Journal of Business Law* 267.

Dooley, MP and Veasy, EN "The role of the board in derivative litigation; Delaware law and the current AU proposals compared, (1989) 44 *Business Lawyer*, 503 -542.

Eidenmuller, H "Trading in times of crisis: Formal insolvency proceedings, workouts and the incentives for shareholders/managers (2006) *7 European Business Organization Law Review* 239.

Farrar, JH "The Responsibility of Directors and Shareholders for a Company's debts" (1989) 4 *Canta LR* 12.

Finch, V "Directors' duties: Insolvency and the unsecured creditor" in Clarke, A (ed) current issues in insolvency law, (London: Stevens 1991).

Finch, V "The measures of Insolvency law" (1997) 17 *O.J.L.S.* 227.

Fredman and Goldwin, *Incorporating the Micro Business: Perceptions and Misperceptions*' in A. Hughes and D. Story, "Finance and Small Firm" (London; Routledge 1994).

Gerner-Beuerle, C and Schuster, E "The Evolving structure of Directors' duties in Europe" (2014) *European Business Organization Law Review* 15: 191-223.

Grantham, RB "The Judicial Extension of Directors' Duties to Creditors" (1991) *JBL* 1.

Gurrea-Martínez, A "Insolvency law in times of Covid-19" (17-04-2020) Ibero-American Institute for Law and Finance, Working Paper 2/2020 accessed online on the 17th of January 2021 at https://ssrn.com/abstract=3562685 and also available at http://dx.doi.org.uplib.idm.oclc.org/10.2139/ssrn.3562685 accessed on 10th July 2020.

Haris J, "Director Liability for Insolvent Trading: Is the Curse Worse than the Disease?" (2009) *Australian Journal of Corporate Law* 266.

Havenga, M "Creditors, Directors and Personal Liability under section 424 of the Companies Act" 1992 *SA Merc LJ* 63 - 69.

© University of Pretoria

Havenga, M "Breach of directors' fiduciary duties; Liability on what basis?" (1996) *SA Merc LJ* 366.

Havenga, M "Fiduciary duties of company directors with specific regard to corporate opportunities" (1998) *University of Free State, South Africa* 309.

Herzberg, A "Why are there so few insolvent trading cases? (1998) 6 *Insolvency Law Journal* 77.

Hicks, A "Advising on wrongful trading: Part 1" (1993) 14 *Co law* 16.

Hicks, A "Wrongful Trading: Has it been a failure?" (1993) 8 *Insolvency Law and Practice* 134.

Hirt, HC "The wrongful trading remedy in UK law classification, Application and practical significance" (2004) 1 *ECFR* 71.

Ho, LC "On Deepening Insolvency and Wrongful Trading" (2005) 20 *Journal of International Banking Law and Regulation* 9, available at https://ssrn.com/abstract=741024 accessed on 17th December 2018.

Hughes, A "Finance for SMEs: A UK Perspective" (1997) *A Small Business Economics* 151.

Iacobucci, E "Directors Duties in Insolvency: Clarifying What Is at Stake" (2004) 39 *Canadian Business Law Journal* 398.

Kandestin, CD "The duty to creditors in near-insolvent firms: Eliminating the near insolvency distinction" (2007) 60 *Vanderbilt Law Review* 1261.

Jones, D "The Phantom Director: A Comic Character" (1997) *Paper for Joint Conference of Law Society for Accountants* [recommending a repeal of the shadow director provisions].

Keay, A "Company directors' responsibilities to creditors" (2007) *Routledge; Cavendish, London & New York* 5.

Keay, A "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 *Modern Law Review* 665.

Keay, A 'The shifting of director's duties in the vicinity of insolvency' (2015) *International Insolvency Review* 4(2) 140-164 at 154 available at https://doi.org/org/10.1002/iir.1236 or http://eprints.whiterose.ac.uk/84965/ accessed on 18th October 2018.

© University of Pretoria

Keay, A "Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective" (2005) 25 *Legal Studies* 431

Keay, A "Wrongful Trading: Problems and Proposals" 65 *N.Ir. Legal Q.* 63 (2014) 63

Keay, A and Loughrey, J "The Concept of Business Judgement" available online at http://eprints.whiterose.ac.uk/129655/ accessed on 4th November, 2018.

Keay, A and Murray, M "Making Company Directors Liable: A comparative analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" (2005) *Int. Insolv. Rev*. Vol 14, 28 available online at www.interscience.wiley.com accessed on 1st July 2018.

Landers, J M "Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy" (1976) *University of Chicago Law Review* 527.

Lin, L "Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors" (1993) *Vanderbilt Law Review 46:1485.*

Lombard, S "Claims Against Negligent of Fraudulent Directors: Proposed Amendments to South African Legislation" (2007) 16 *INT'L Insolvency REV* 75.

Mclaughlin, JM "Directors' and Officers' liability: Vicinity of insolvency claims" (2005) page 1, available online at http://www.stblaw.com/docs/default-source/cold-fusion-existing content/publications/pub499.pdf?sfvrsn=2#page=3 accessed on 17th March 2018.

Millet, J "Shadow Directorship - A Real or Imagined Threat to Banks" (1991) 1 *Insolvency Practitioner* 14.

Milman, D "Strategies for regulating managerial performance in the 'twilight zone' – familiar dilemmas; new considerations" (2004) *JBL* 493.

Mmakola, D "South Africa's SMME policy – the challenge remains" 2009 39(2) *Africanus* 66.

Mokal, R "An agency cost analysis of the wrongful trading provisions: Redistribution, perverse incentives and the creditors' bargain" (2000) 59 *Cambridge Law Journal* 335.

Mokal R, "Corporate Insolvency; Theory and Application" (2005) *Oxford University Press* 266.

Morgan, B and Underwood, H "Directors' Liability to Creditors on a Corporation's Insolvency in Light of the Dylex and Peoples Department Stores Litigation" (2004) 39 *Canadian Business Law Journal* 336.

© University of Pretoria

Mosley, J "Insolvent Trading: What is a debt and when is it incurred?" (1996) 4 *Insolvency Law Journal* 156.

Mumford, M and Katz, A "Making Creditor Protection effective" (2010) *ICAEW* 52.

Muswaka, L "Directors' Duties and the Business Judgement Rule in South African Company Law; An Analysis" (2013) *International Journal of Humanities and Social Science* Vol 3, No. 7 p.89.

Nimmerfall, P and Piessl, LJ "The Business Judgement Rule and its impact on Australian Law" (2015) page 352 available at https://journals.muni.cz/cpvp/article/viewFile/5273/4359#page=1 accessed on 16th June 2018.

Nwafor, AO "Exploring the Goal of Business Rescue through the Lens of the South African Companies Act 71 of 2008" (2017) 28 *Stellenbosch L. REV.* 597.

O'Donovan, J "Banks as Shadow Directors" 25 *Victoria U. Wellington L. Rev.* 283.

Paolini, A (Ed) (Article of Andrea Lista, p.73) "Research handbook on Directors' Duties" (2016) *Edward Elgar Publishing*, UK & USA

Payne, J and Prentice, D "Civil Liability of Directors for Company Debts Under English Law" in I Ramsay (ed) *Company Directors liability for Insolvent Trading* (CCH and University of Melbourne 2000).

Prentice, D "Corporate personality, limited liability and the protection of creditors" in Grantham, R and Rickett, C (edn) *Corporate Personality in the 20th Century* (Oxford, Hart Publishing 1998).

Prentice, D "Creditor's Interests and Director's Duties" (1990) 10 *Oxford Journal of Legal Studies* 265.

Prentice, D 'The Theory of the Firm: Minority Shareholder Oppression: Sections 459 – 461 of the Companies Act 1985' (1988) 8 *Oxford Journal of Legal Studies* 55.

Phungula, S "Lessons to be learned from reckless and fraudulent trading by a company, Section 424 (1) of the Companies Act 61 of 1973 and sections 22 and 77(3) of the Companies Act 71 of 2008" *SA Merc LJ* Vol. 28, No. 2, 2016.

Ponta, A and Catana, RN "The Business Judgement Rule and its Reception in European Countries" (2015) 4 *The Macrothene Review* 127.

Oditah, F "Wrongful Trading" (1990) *L.M.C.L.Q.* 205.

© University of Pretoria

Oesterle, DA "Corporate directors' personal liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England. A recipe for timid directors, hamstrung controlling shareholders and skittish lenders" in Ramsay, IM (ed) *Company director's liability for insolvent trading* (Melbourne: Centre for Corporate Law and Securities Regulation and CCH Australia, 2000).

Omar, PJ and Gant, J "Corporate rescue in the United Kingdom; past, present and future reforms" (2016) page 9, available at http://irep.ntu.ac.uk/id/eprint/27854/1/Pubsub5402_Omar.pdf#page=28 accessed on 25th October 2018.

Rajak, HH "Director and officer liability in the zone of insolvency: A comparative analysis" (2008) *PER* Vol.11 n.1.

Rajak, HH "Wrongful Trading" (1989) *NLJ* 1458.

Rousseau, S "The Duties of Directors of Financially Distresses Corporations: A Quebec Perspective on the Peoples Case" (2004) 39 *Canadian Business Law Journal* 368.

Sappideen, R "Fiduciary Obligations to Corporate Creditors" (1991) *Journal of Business Law* 365.

Sarra, J "Wise people, Fiduciary obligation and reviewable transactions, Director's liability to creditors" (2004) *Annual Review of Insolvency Law,* 42.

Schulte, R "Wrongful Trading: An Impotent Remedy?" (1996) *Journal of Financial Crime* Vol. 4 Issue: 1, 40.

Sealy, L 'Directors' 'Wider' Responsibilities- Problems Conceptual, Practical and Procedural' (1987) *Monash University Law Review* 164.

Sealy, L "Personal liability of directors and officers for debts of insolvent corporations: a jurisdictional perspective (England)" in Zeigel, J (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (Oxford: Clarendon Press 1994).

Simamba, B "Should Marginal Notes be Used in the Interpretation of Legislation?" (2005) *OUP* 125.

Simmons, M "Wrongful trading" (2001) 14 *Insolvency Intelligence* 12.

Smith, DG "The Critical Resource Theory of Fiduciary Duty" (2002) 5 *Vanderbilt Law Review* 1339.

© University of Pretoria

Spindler, G "Trading in the vicinity of insolvency" (2006) *European Business Organization Law Review* 7.

Stevens, R and De Beer, P "The Duty of Care and Skill, And Reckless Trading: Remedies in Flux" 2016, *SA Merc LJ* (28)2 250.

Syrota, G "Insolvent Trading: Hidden Risks for Accountants and Banks Participating in 'Work Outs" (1993) 23 *University of Western Australia Law Review* 329.

Terdpaopong, K and Farooque, O " Financial distress, restructuring and turnaround: evidence from Thai SME's" (2012) *RJAS* Vol. 2 No. 2, 119.

van der Linde K, "The Personal Liability of Directors for Corporate Fault – An Exploration" (2008) 20 *SA Merc LJ* 439.

van Zwieten, K "Director liability in insolvency and its vicinity: West Mercia Safety wear Ltd v Dodd Revisited" (*Oxford Legal Studies Research Paper* No. 38/2017) 1 available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2970913 accessed on 4th Sept 2018).

Varzaly, J 'The enforcement of directors' duties in Australia: An empirical analysis' (2015) 16 *Eur Bus Org Law Rev* 288.

Walters, A "Re Floor Fourteen Ltd in the court of Appeal" (2001) *Co Law* 215.

Williams, R "What can we expect to gain from reforming the insolvent trading remedy?" (2015) *The Modern Law Review* 55-84, available at https://onlinelibrary.wiley.com/doi/pdf/10.1111/14682230.12106#access Denial Layout accessed on 6th May 2018.

Worthington, S 'Directors' Duties, Creditors' Rights and Shareholder Intervention' (1991) 18 *Melbourne University Law Review* 121.

Ziegel, JS "Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo – Canadian Perspective" (1993) 43 *University of Toronto Law Journal* 511.

THESES

Lombard, S *Directors' Duties to Creditors* LLD Thesis (2006) UP 27, available at *https://repository.up.ac.za/bitstream/handle/2263/25731/Complete.pdf?sequence=6* accessed on 7th March 2018).

Pasban, MR *Directors' Duties and Liabilities in Corporate Insolvency in England and the US* PhD Thesis (1996) University of Sheffield.

© University of Pretoria

CASES

Adams vs. Cape Industries Plc. (1990) Ch. 433.

Airline Pilots Association International vs. UAL Corp. 717 F. Supp 575.

Androrin vs. Figlomeni (1996) 14 ACLC 1461.

Augustus Barnett & Son Ltd (1986) BCLC 170.

Australian Securities and Investments Commission (ASIC) vs. Healey (2011) FCA 717.

Ayerst vs. C & K (Construction) Ltd (1976) AC 167.

Bernstein vs. Bester (1996) 2 SA 751.

Bidald Consulting vs. Miles Special Builders 2005 NSWSC 1235.

Boschpoort Ondernemings (Pty) Ltd vs. Absa Bank Ltd 2014 (2) SA 518 (SCA).

Boulting vs. ACTT (1963) 2 QB 606.

Bovay vs. H.M. Byllesby & Co. (1944) 38 A.2d 808 Del.

Bowman vs. Sacks 1986 (4) SA 459 (W).

Brady vs. Brady (1988) 3 B.C.C. 535.

Brandt vs. Hicks, Muse & Co (In re Healthco Int'l Inc) (1997) 208 BR 296.

British Cash and Parcel Conveyors vs. Lamson Store Service Co. Ltd (1908) 1 KB 1006.

Broderip vs. Salomon (1895) 2 Ch 323.

Brooks & Willets vs. Armstrong and Walker, also known as *The Joint liquidators of Robin Hood Centre Plc) vs. Armstrong and Walker* (2015) EWHC 2289.

Buchler vs. Talbot (2004) UKHL 9.

Catholic Education Programming Foundation vs. Gheewalla 930 A.2d 92.

Chandler vs. DPP (1964) AC 763.

© University of Pretoria

Channel Collieries Trust Ltd vs. Dover, etc., Railway Co. (1914) 2 Ch 504.

Charitable Corporation vs. Sutton (1742) 2 ATK 400.

Chetty vs. Hart 2015 4 All SA 201 (SCA).

Chew vs. NCSC (NO 2) (1985) 3 ACLC 12.

Chew vs. The Queen (1991) 4 WAR 21.

Cobden investments Ltd vs. RWM Langport Ltd (2008) EWHC (Ch) 754.

Colin Gwyer vs. London Wharf (Limehouse) Ltd (2002) EWHC 2784.

Cooper vs. Luxor (Eastbourne) Ltd (1939) 4 All ER 411.

Cooper & Others NNO vs. SA Mutual Life Assurance Society & Others 2001 (1) SA 967 (SCA).

Coventry and Solihull Waste Disposal Co Ltd vs. Russel (1999) 1 WLR 2093.

Credit Lyonnais Bank vs. Pathe Communications Corp. (1991) WL 277613.

Cronje vs. Stone 1985 (3) SA 575 (T).

Cyberscene Ltd vs. i-Kiosk Internet and Information (Pty) Ltd 2000 (3) SA 806.

Deputy Commissioner of Taxation vs. Solomon (2003) 199 ALR 325.

DHN Food Distributors Ltd vs. Tower Hamlets LBC (1976) 1 WLR. 852.

Dorklerk Investments (Pty) Ltd vs. Bhyat (1980) 1 SA 443 (W).

Eastford Limited vs. Gillespie, Airdrie North Limited (2010) CSOH 132.

Ebrahim and another vs. Airport Cold Storage (Pty) Ltd (1996) 2 SA 751.

Ebrahim vs. Airport Cold Storage (2008) 6 SA 585 (SCA).

Engelbrecht NO and Others vs. Zuma and Others (2015) 3 All SA 590 (GP).

Equiticorp Finance Ltd vs. Bank of New Zealand (1993) 11 ACSR 642.

Ex Parte De Villiers; In re Carbon Developments 1992 2 SA 95 (W).

© University of Pretoria

Ex Parte De Villiers; In re MSL Publications (Pty)Ltd (1990) 4 SA 59 (W).

Facia Footwear Ltd (in Administration) vs. Hinchlife (1998) 1. B.C.L.C. 218.

First American Corporation vs. Al-Nahyan 17 F. Supp. 2d 10 (D.D.C. 1998).

Fisheries Development Corporation of SA Ltd vs. Jorgensen (1980) 4 SA 156.

Fourie vs. Newton (2011) 2 All SA 265 (SCA).

Fundstrust (Edms) Bpk (in likwidasie) vs. Marais 1997 3 SA 470 (K).

Geneva Finance Ltd vs. Resource and Industry Ltd (2002) 20 A.C.L.C. 1427.

Gilford Motor Co. Ltd vs. Horn, (1933) Ch. 935, CA.

Gilles vs. Thompson (1993) 3 All ER 321.

Goldbold vs. Branch Bank (1847) 11 Ala. 191.

Grace vs. Smith (1775) 96 ER 587.

Grove vs. Flavel (1986) 11 A.C.L.R. 161.

Guinness plc vs. Saunders (1998) 1 WLR 838.

Guy vs. Churchill (1888) 40 Ch D 481.

Hawcroft General Trading Co. Ltd vs. Edgar (1996) 20 ACRS 54.

Hawkes Hill Publishing Co. Ltd (2007) BCC 937.

Henewa ys Freight Services (Pty) Ltd vs. Grogor 2007 (2) SA 561 (SCA).

Hickman vs. Kent or Romney Marsh Sheep breeders Assn (1920) 37 TLR 163.

Hodges vs. New England Screw Co. 3R. I.9, 18 (1853).

Hogg vs. Cramphorn Ltd (1967) Ch 254.

Holdsworth & Co. vs. Caddies (1955) 1 WLR 352 HL.

Howard Smith Ltd vs. Ampol Petroleum Ltd (1974) AC 821.

© University of Pretoria

In Re Cleadon Trust Ltd (1938) 4 All ER 518.

In the Matter of East Africa Sailing and Trading Co Ltd, Com. Court Petition No. 4 of 2012.

J H Rayner (Mincing lane) Ltd vs. Department of Trade and Industry (1989) 3 WLR 969.

Kalinko vs. Nisbet 2002 5 SA 766 (W).

Kalis Enterprises Pty Ltd vs. Baloglow (2007) NSWCA 191.

Kamin vs. American Express Co. N.Y.S. @d 807 (Sup (t 1976).

Katz vs. Oak Industries, Inc., 508 A. 2d 873.

Kensington International Ltd vs. Republic of Congo (2006)2 B. C. L. C. 296.

Kinsela vs. Russell Kinsela Pty Ltd (1986) 4 NSWLR 722.

Klerk NO vs. SA Metal and Machinery Company (Pty) Ltd & Another 1996 [2001] All SA 276.

Koen vs. Wedgewood Village Golf & Country Estate (Pty) Ltd 2012 2 SA 378 (WCC).

Kumbatira t/a Taringa Enterprises vs. FDH Bank Bankruptcy Cause No. 3 of 2016 (Malawi).

L & P Plant Hire BK vs. Bosch (2002) 2 SA 662 SCA.

Linton vs. Telnet Pty Ltd (1999) NSWCA 33.

Liquidator of Marini Ltd vs. Dickenson (2004) BCC 172.

Liquidator of West Mercia Safetywear Ltd vs. Dodd (1988) 4 BCC 30.

Lonrho Ltd vs. Shell Petroleum Co. Ltd (1980) 1 WLR 627.

Mahony vs. East Holyford Mining Co. (1875) L.R. 7 H.L. 869.

Maple Leaf Foods Inc. vs. Scheider Corp 1998 Can LII 5121 (ONCA).

Metropolitan Fire Systems Pty Ltd vs. Miller (1997) 23 CSR 699.

Metropolitan Life Ins. Co vs. RJR Nabisco, Inc., 716 F. Supp. 1504.

Minister of Water Affairs and Forestry vs. Stilfontein Gold Mining Co Ltd 2006 (5) SA 333 (W).

© University of Pretoria

Mond (As Liquidator of Langreen Ltd) vs. Bowles and Others (2011) Lexis Citation 99.

Moris vs. Kanssen & Others (1946) 1 All ER 586.

Morphitis vs. Bernasconi (2003) Ch 552.

Morris vs. Bank of India (2005) BCC 739.

Nel and others NNO vs. McArthur and others 2003 (4) SA 142 (T).

Nicholson vs. Permakraft (NZ) Ltd (1985) 1 NZLR 242.

Nicholson and Another vs. Fielding and Others (2007) All ER (D) 156.

Norglen Ltd vs. Reeds Rains Prudential (1998) 1 All ER 218.

Oakdene Square Properties (Pty) Ltd vs. Farm Bothasfontein (Kyalami) (Pty) Ltd 2012 2 All SA 433 (GSJ).

Official Comm. Of Unsecured Creditors vs. Mellon Bank N.A. (1995) B.R. 455.

Official Receiver vs. Doshi (2001) 2 BCLC 23.

Operations Pty Ltd (in liq) vs. Apple Computer Australia Pty Ltd (2011) NSWCA 109.

Percy vs. Millaudon (1829) 8 Mart. (n.s.) 68 La. 1829.

Philotex (Pty) Ltd vs. Snyman (1998) 2 SA 138 SCA.

Pickstone vs. Freemans Plc (1989) AC 66.

Powerteck Industries Ltd vs. Mayberry & Another 1996 (2) SA 742 (W).

Pressma Services (Pty) Ltd vs. Schuttler 1990 2 SA 411 (C).

Production Resources Group, L.L.C. vs. NCT Group Inc. (2004) 862 A.2d 772.

PWA Corporation vs. Gemini Automated Distribution systems Inc (1993) 8 BLR (2d) 221.

Rainham Chemical Works vs. Belvedere (1912) 2 AC 465 HL.

Regentcrest plc vs. Cohen 2001 2 BCLC 80.

© University of Pretoria

R vs. Kritzinger (1971) 2 SA 57.

R vs. Mall (1950) (4) SA 607.

R (Westminster City Council) vs. National Asylum Support Service (2002) 1 WLR 2956.

Ramsey vs. Hartley (1977) 1 WLR 686.

Re A company (No. 005009 of 1987) (1998) 4 BCC 424.

Re Akron Roads Pty (in liq) [No 3] (2016) VSC 657.

Re Barleycorn Enterprises Ltd (1970) Ch. 465.

Re Bath Glass Ltd (1988) BCLC 329.

Re Brian D. Pierson (Contractors) Ltd (1999) BCC 26.

Re Bugle Press (1961) Ch. 270.

Re Continental Insurance Assurance Co of London Plc (2001) BPIR 733.

Re Continental Assurance Co of London Plc (2007) 2 BCLC 287.

Re CS Holidays Limited (1997) 1 WLR 407.

Re CU Fittings Ltd (1989) BCLC 556.

Re Darby (1911) 1 KB 95.

Re David Lloyd & Co (1877) 6 Ch. D 339.

Re DKG Contractors Ltd (1990) BCC 903.

Re Douglas Construction Services Ltd (1988) BCLC 397.

Re Exchange Travel (Holdings) Ltd, Katz vs. Mc Nally (1997) 2 BCLC 579 (CA).

Re Farmizer (Products) Ltd (1997) BCC 655.

Re Floor Fourteen Ltd, Lewis vs. Inland Revenue Commissioner (2001) 2 BCLC 392 (CA).

Re Gerald Cooper Chemicals (1978) 2 All ER 49.

© University of Pretoria

Re H (1996) 2 All ER 291 CA.

Re Heffron Kearns Ltd (No. 2) (1993) 3 IR 191.

Re HH Co. Ltd (1995) 2 BCLC 63.

Re HLC Environmental Projects Ltd (in liquidation) (2013) EWHC 2876.

Re Horsely Weight Ltd (1982) Ch. 442.

Re Hydrodam (Corby) Ltd (1942) 2 BCLC 180.

Re Idessa (UK) Ltd (2012) 1 BCLC 80.

Re Kaytech International Plc (1992) 2 BCLC 351.

Re Kudos Business Solutions Ltd (2011) EWHC 1436.

Re Lo-Line Electric Motors Ltd (1988) Ch 477.

Re London Metallurgical Company (1895) 1 Ch 758.

Re MDA Investment Management Ltd (2003) EWHC 227.

Re MC Bacon Ltd (No. 2) (1991) Ch 127.

Re Movitor Pty Ltd vs. Sims (1996) 19 ACSR 440.

Re MT Realisations Ltd (2003) EWHC 2895.

Re New World Alliance (1994) 51 FCR 425.

Re Oasis Merchandising Ltd (1997) 1 BCLC 689.

Re Oasis Merchandising Services Ltd (in Liquidation) (1998) Ch. 170.

Re Pantone 485 Ltd (2002) 1 BCLC 266.

Re Park Gate Waggon Works Co. (1881) 17 Ch. D 234 (CA).

Re Patrick & Lyon Ltd (1933) Ch. 786.

Re Park Gate Waggon Works Co. (1881) 17 Ch. D 234 (CA)

© University of Pretoria

Re PFTZM Ltd (1995) BCC 280.

Re Produce Marketing Consortium Ltd (No. 2) (1989) BCLC 520.

Re Purpoint Ltd (1991) BCC 121.

Re Ralls Builders Ltd (2016) Bus LR 555.

Re Ralls Builders Ltd (in Liquidation) (2016) EWHC 243 (Ch).

Re Rolus Properties Ltd (1988) 4 BCC 466.

Re Sherbone Associates Ltd (1995) BCC 40.

Re Smith and Fawcett Ltd (1942) Ch. 304.

Re Tasbian (No 3) (1991) BCC 436.

Re The Walt Disney Company Derivative Litigation (2003) Del. Ch. 825 A. 2d. 275.

Re Toshoku Finance (UK) Plc (2002) BCC 110.

Re Wanzer Ltd (1891) 1 Ch. 305

Re Welfab Engineers Ltd, (1990) BCLC 833.

Re White & Osmond (Parkstone) Ltd. (1960) 30 July Unreported.

Re William C. Leitch Brothers Ltd (1932) 2 Ch. 71.

Re Wilson Lovatt & Sons Ltd (1977) 1 All ER 274.

Re Working Urban District Council (Basingstoke Canal) Act 1911 (1914)1 Ch 300.

Rees vs. Bank of New South Wales (1963-1964) 111 CLR 210.

Regina vs. Montila and Others (2004) UKHL 50.

Retail Management Services (Edms) Bpk vs. Schwarts 1992 (2) SA 22 (W).

Revlon Inc. vs. Cripp & Lee Ltd (1980) FSR 85.

Revlon, Inc. vs. MacAndrews and Forbes Holdings, Inc., 506 A.2d 173.

© University of Pretoria

Roberts vs. Frolich (2011) EWHC 257 (h).

Royal British Bank vs. Tarquand (1856) 6 El. & Bl. 327.

Rubin vs. Gunner & Another (2004) EWCH 316.

S vs. De Jager (1965) 2 SA 616 (A).

S vs. Hepker (1973) 1 SA 472 (W).

S vs. Ressel (1968) 4 SA 224.

S vs. Shaban (1965) (4) SA 646 (W).

Saincic & others vs. Industro-Clean (Pty) Ltd & Another (2009) 1 SA 538 (SCA).

Salomon vs. A Salomon & Company (1897) AC 22 HL.

Secretary of State for Trade and Industry vs. Becker (2003) 1 BCLC 555.

Secretary of State for Trade and Industry vs. Deverell (2001) Ch. 340.

Secretary of State for Trade and Industry vs. Jones (1999) BCC 366.

Secretary of State for Trade and Industry vs. Kaczer (1992) 2 BCLC 351.

Secretary of State and Industry vs. Taylor (1997) I WLR 407.

Secretary of State for Trade and Industry vs. Tjolle (1998) 1 BCLC 333.

Seear vs. Lawson (1880) 15 Ch. D 426.

Selang or United Rubber Estates Ltd vs. Cradock and others (1968) 2 Lloyds Rep 289.

Scottish Co-operative Wholesale Society Ltd vs. Meyer (1959) AC 324 HL.

Shuttleworth vs. (Maiden head) Ltd (1942) Ch. 304 (CA).

Smith (Administrator of Cosslett (Contractors) vs. Bridgend County Borough Council (2001) UKHL 58; (2002) 1 AC 336.

Southern vs. Watson (1940) 3 All ER 349.

Standard Chartered Bank of Australia Limited vs. Antico (1995) 13 ACLC 1381; 18 ACSR 1.

© University of Pretoria

Stein vs. Blake (1996) 2 AC 243.

Strong vs. Carlyle Press (1893) 1 Ch. 268

Strut Ahead Natal (Pty) Ltd vs. Burns 2007 (4) SA 600 (D)

Sydney Land Corp (Pty) Ltd vs. Kalon (Pty) Ltd (1998) 26 ACSR 593.

The Liquidator of Wendy Fair (Heritage) Ltd vs. Hobday (2006) EWHC 5803.

The Roberta (1937) 58 LLR 159.

Ultraframe (UK) Ltd vs. Fielding (2003) EWCA Civ. 1805.

Vrisakis vs. Australian Securities Commission (1992-1993) 9 WAR 395.

Walker vs. Winborne (1975-76) 137 CLR 1.

Waugh vs. Carver (1793) 126 ER 525; 2 Hy Bl 235.

West Mercia Safetywear Ltd vs. Dodd (1988) BCLC 266.

Williams vs. Farrow (2008) EWHC 3663.

Winkorth vs. Edward Baron Development Co Ltd (1987)1 All ER 114.

Woodgate vs. Davis (2002) 42 ACSR 268.

3M Australia Limited vs. Kernish (1986) 10 ACLR 371.

LEGISLATION

Bankruptcy Act of 1928, Malawi.

Bankruptcy Act of 1914, United Kingdom.

Companies Act of 1984, Malawi: Chapter 46:03 of the Laws of Malawi.

Companies Act 71 of 2008, South Africa.

Companies Act of 1929, United Kingdom.

© University of Pretoria

Companies (Consolidation) Act, 1908, United Kingdom.

Companies Act, 1913, United Kingdom.

Company Directors Disqualification Act 1986, United Kingdom.

Company Law Enforcement Act 2001, Ireland.

Constitution of the Republic of Malawi, 1994.

Coronavirus Economic Response Omnibus Act of 2020, Australia.

Corporations Act 50 of 2001, Australia.

Corporate Insolvency and Governance Act of 2020, United Kingdom.

Deeds of Arrangement Act, Cap 11: 02 of the Laws of Malawi.

Disaster Management Act 57 of 2002, South Africa.

Financial Services Act of 2010, Malawi.

General Interpretation Act of 1966, Chapter 1:01 of the Laws of Malawi.

Insolvency Act of 2016, Malawi; Chapter 11:01 of the Laws of Malawi.

Insolvency Act of 1986, United Kingdom.

Mental Treatment Act, Cap 34:02 of the Laws of Malawi.

Small Business, Enterprise and Employment Act 2015, United Kingdom.

REPORTS

A report on the introduction of a new standalone restructuring procedure and the introduction of a greater accountability for directors of distressed companies. Nick Moser; reported for Taylor Wessing, available at http://united-kingdom.taylorwessing.com/en/insights/rcr-update/major-uk-restructuring-and-insolvency-reforms-announced accessed on 18th February 2019.

© University of Pretoria

CAMAC *Personal Liability for Corporate Fault Report* (2006); Report of the Corporations and Markets Advisory Committee (CAMAC) available at www.camac.gov.au accessed on 26th June 2019.

House of Representatives Standing Committee on Legal and Constitutional Affairs, Corporate Practices and the Rights of Shareholders AGPS, Canberra, 1991 also known as the 'Lavarch Report' available at https://www.aph.gov.au/parliamentary_business/committees/house_of_representatives_committees?url=reports/1991/1991_pp293a.pdf accessed on 1st September 2018.

Insolvency law and practice: Report of the Review Committee (Chairman, Sir Kenneth Cork) "The Cork Report." Cmnd 8558 (1982) HMSO.

Jenkins Report on Company Law, available at https://www.actuaries.org.uk/documents/jenkins-committee-company-law-abstract-discussion-opened-k-w-wright accessed on 19th September 2018

King Report on Corporate Governance, 1994 ('King 1') available at https://www.mervynking.co.za/pages/publications.htm accessed online on 12th June 2017.

King Report on Corporate Governance for South Africa, 2002 ('King 2'), a summary of the report available at http://www.mervynking.co.za/downloads/CD_King2.pdf accessed on 14th November 2018.

King IV Report on Corporate Governance for South Africa, available at https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf accessed on 14th November 2018.

Law Reform Commission, *General Insolvency Inquiry* [Report No 45, 1998] ['Harmer Report'], summary of the report available at https://www.alrc.gov.au/wp-content/uploads/2019/08/alrc45_Summary.pdf accessed online on July 17th 2018.

Malawi Insolvency Framework Report, dated 15 March 2010, by Burdette D, prepared under the Doing Business Reform Advisory (DBRA) team within the Investment Climate Department of the World Bank Group in preparation of the insolvency law reform process, available at www.openknowledge.worldbank.org accessed on 10th August 2019.

Report of the Company Law Amendment Committee, *HMSO*, *London* Cmnd 2657, available at https://www.worldcat.org/search?q=au%3AGreat+Britain.+Board+of+Trade.+Company+Law+Amendment+Committee.&qt=hot_author accessed on 5th June 2018.

© University of Pretoria

Taylor Wessing report by Nick Moser on United Kingdom's restructuring and insolvency reforms, available at http://united-kingdom.taylorwessing.com/en/insights/rcr-update/major-uk-restructuring-and-insolvency-reforms-announced accessed on 18th February 2019.

OTHER

A revised framework for insolvency law, (Cmnd 9175 (1984), available at https://www.amazon.co.uk/Revised-Framework-Insolvency-Law-Cmnd/dp/0101917503 accessed on 12th June 2018.

Department of Trade and Industry, *A Revised Framework for Insolvency Law* HMSO, London, Cmnd 9175, 1984, accessed online at https://www.amazon.co.uk/Revised-Framework-Insolvency-Law-Cmnd/dp/0101917503 accessed on 14th December 2018.

Department of Trade and Industry *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform May 2004* (2004) 10, available at http://0- discover.sabinet.co.za.innopac.up.ac.za/webx/access/policydocuments/policies04/DD078362.pdf accessed on 23rd November 2020.

Explanatory Memorandum, *Treasury Laws Amendment* 2017 Enterprise Incentive No 2 Bill (Cth) 12 [1.43] Australia, accessed online on 23rd May 2019 at https://www.aph.gov.au/Parliamentary_Business/Bills_Search_Results/Result?bld=r5886

Harmonization of Insolvency Law at EU Level (2010 *note prepared for the European Parliament's Committee on Legal Affairs*) PE 419.633, available at https://www.europarl.europa.eu/meetdocs/2009_2014/documents/empl/dv/empl_study_insolvencyproceedings_/empl_study_insolvencyproceedings_en.pdf accessed on 23rd August 2020.

Insolvency (Amendment) (No 2) Rules 2002 (SI 2002/2712) available at http://www.legislation.gov.uk/uksi/2002/2712/made accessed online on 27th May 2018.

Official Records of the General Assembly, Twenty-First Session, Resolution 2205(XXI), A,/RES/2205(XXI), Dec.17, 1966" available at http://daces.un.org/doc/RESOLUTION/GEN/NRO/005/08/IMG/NR000508.pdf?OpenElement accessed on 22nd January 2018.

Practice notice issued by the Companies and Intellectual Property Commission (CIPC) in terms of paragraph 4(1)(b) of the Companies Regulation (GNR 351 of 26 April 2011) on COVID-19 pandemic, accessed online on 7th February 2021 at http://www.cipc.co.za

Proposal by INSOL International: Directors' and Officers' responsibilities and liabilities in insolvency and pre-insolvency cases" (3 April 2010) *Submitted to UNCITRAL Working Group*

© University of Pretoria

V (Insolvency Law), A/CN.9/WG.V/WP.93/Add.3. available at https://undocs.org/en/A/CN.9/WG.V/WP.93/Add.3 accessed on 2nd February 2018.

Small Business, Enterprise and Employment HC Bill (2014-2015) Cl 105 (proposing the insertion of a new section 246ZB into the Insolvency Act 1986 available at https://publications.parliament.uk/pa/bills/cbill/2014-2015/0011/15011.pdf accessed on 12th September 2019.

Statement by the vice-president and general counsel of the World Bank Group: *Principles for Effective Insolvency and Creditor/Debtor Regimes* (2016) available at http://documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtorregimes accessed online on 10th July 2020.

The published statistics for liquidations in the Republic of South Africa available at http://statssa.gov.za/Publications/P0043/P0043June2013.pdf

United Nations Commission on International Trade Law, (UNCITRAL) Working Group V (Insolvency Law), *Insolvency Law: Directors' obligations in the period approaching insolvency* (43rd Session, New York, 15-19 April 2013) available at https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/leg-guide-insol-part4-ebook-e.pdf. accessed on 7th October 2018.

World Bank Doing Business 2014: Understanding Regulations for Small and Medium-size Enterprises. Washington, DC: World Bank Group (country profile: South Africa) 2013 (DOI: 10.1596/978-0-8213-9615-5 available at http://doingbusiness.org/reports/globalreports/~/media/giawb/doing%20business/documents/profiles/country/ZAF.pdf accessed on 17th December 2018.

© University of Pretoria