Kurt Hyzler

The Principle of *Pari Passu* in Corporate Insolvency.

This thesis has been submitted to the Faculty of Laws in partial fulfilment of the LL.D degree.

May, 2006
Abstract

Prior to the winding-up of an insolvent company any of its creditors may individually enforce any measure available to them in order to obtain payment of the debt owed to them by such company. However, upon the opening of the winding-up proceedings these individual actions are replaced by a collective insolvency regime which attempts to ensure the rateable and equitable distribution of the assets of the insolvent company among its creditors. This distribution is known as pari passu distribution.

The pari passu principle admits of certain exceptions. These are either entrenched in the law or are provided for in contractual agreements entered between the company in question and its creditors. These exceptions create a situation where certain creditors are paid out the insolvent company’s limited pool of assets prior to the other ordinary creditors are paid through the pari passu system of distribution.

The law also provides creditors with devices which enable them to keep particular assets out of the estate of the insolvent company. These devices give the creditors a right in rem over a particular asset in the possession the insolvent company. They therefore have the effect of subtracting such assets from the grasp of the ordinary creditors as they will not be available for pari passu distribution.

The exceptions and creditors’ rights in rem have, in practice, the same net effect of substantially reducing the corpus of assets available for pari passu distribution. Their plurality and the frequency of use may be seen as distorting and diluting the equitable distribution which is attempted to be guaranteed by the pari passu principle. Thus pari passu is exposed to criticism from various authors who regard it as a redundant principle.

Yet, pari passi remains the most effective and fair method of distribution of the assets of the insolvent company being wound-up.

---

1 These agreements are entered before the insolvency of the company being wound up.
Table of Contents:

Table of Statutes 6

Table of Judgements 8

Introduction 10

Chapter 1. The Pari Passu Principle 13

1.1. Introduction 13
1.2. The Object of Pari Passu 14
1.3. The Road to the Distribution of Assets 15
  1.3.1. The Commencement of the Liquidation Process 15
  1.3.2. Realisation of the Company’s Assets 18
    1.3.2.1. Unlawful Preference 19
    1.3.2.1.1. Transaction at an Undervalue 21
    1.3.2.1.2. Preferences 23
    1.3.2.2. Provisions under the Commercial Code 26
  1.3.3. Proof of Debt 28
  1.3.4. Ranking of Claims 30
    1.3.4.1. Priority of Payment under English law 32
      1.3.4.1.1. Liquidation Expenses 33
      1.3.4.1.2. Preferential Debts 34
      1.3.4.1.3. Debts Secured by a Floating Charge 34
      1.3.4.1.4. Ordinary Debts 36
      1.3.4.1.5. Post-Insolvency Interest on Debts 37
      1.3.4.1.6. Deferred Debts 38
      1.3.4.1.7. Return to Contributories 38
    1.3.4.2. Ranking of Claims which have a Cross-Border Effect 38
  1.4. The Impact of the Pari Passu Principle within the Liquidation Process 39
    1.4.1. Dispositions of Company Property 39
    1.4.2. Provision for the Acceleration of Liability on Winding-up 40
    1.4.3. Provision for Divestment of Ownership on Winding-up 41
    1.4.4. Provision for the Determination of Lease or Agreement on Winding-up 42
    1.4.5. Provision for Security or Increased Security on Winding-up 43
# Chapter 2

**Exceptions to the Pari Passu Principle**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1.</td>
<td>Introduction</td>
<td>44</td>
</tr>
<tr>
<td>2.2.</td>
<td>The Exceptions</td>
<td>44</td>
</tr>
<tr>
<td>2.2.1.</td>
<td>Expenses of Liquidation</td>
<td>44</td>
</tr>
<tr>
<td>2.2.1.1.</td>
<td>Payment of Pre-liquidation Debts to Preserve Assets or Avoid other loss</td>
<td>46</td>
</tr>
<tr>
<td>2.2.1.2.</td>
<td>Post-Liquidation Creditors</td>
<td>47</td>
</tr>
<tr>
<td>2.2.2.</td>
<td>Preferential Debts</td>
<td>50</td>
</tr>
<tr>
<td>2.2.2.1.</td>
<td>Preferential Debts under Maltese Law</td>
<td>51</td>
</tr>
<tr>
<td>2.2.2.1.1.</td>
<td>Preferential Debts under the Civil Code</td>
<td>51</td>
</tr>
<tr>
<td>2.2.2.1.1.1.</td>
<td>Ranking of Preferential Debts under the Civil Code</td>
<td>54</td>
</tr>
<tr>
<td>2.2.2.1.1.2.</td>
<td>Preferential Debts and their Ranking under Specific Legislation</td>
<td>56</td>
</tr>
<tr>
<td>2.2.3.</td>
<td>Claims which by Statute are Deferred</td>
<td>60</td>
</tr>
<tr>
<td>2.2.4.</td>
<td>The Right of Set-off</td>
<td>60</td>
</tr>
<tr>
<td>2.2.4.1.</td>
<td>Insolvency Set-Off under the Maltese Civil Law</td>
<td>60</td>
</tr>
<tr>
<td>2.2.4.1.1.</td>
<td>The Effects of Insolvency Set-off</td>
<td>62</td>
</tr>
<tr>
<td>2.2.4.1.1.1.</td>
<td>The Nature of Insolvency Set-off under UK law</td>
<td>64</td>
</tr>
<tr>
<td>2.2.4.2.</td>
<td>Contractual Set-off</td>
<td>65</td>
</tr>
<tr>
<td>2.2.4.2.1.</td>
<td>Contractual Set-off under UK Insolvency Law</td>
<td>65</td>
</tr>
<tr>
<td>2.2.4.2.2.</td>
<td>Contractual Set-off under Maltese Law</td>
<td>66</td>
</tr>
<tr>
<td>2.2.4.3.</td>
<td>Set-off under EC Council Regulation 1346/2000</td>
<td>68</td>
</tr>
<tr>
<td>2.2.5.</td>
<td>Subordination Agreements</td>
<td>69</td>
</tr>
<tr>
<td>2.2.6.</td>
<td>Special cases</td>
<td>72</td>
</tr>
<tr>
<td>2.2.7.</td>
<td>Conclusion</td>
<td>73</td>
</tr>
</tbody>
</table>

# Chapter 3

**Bypassing Pari Passu**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>Introduction</td>
<td>75</td>
</tr>
<tr>
<td>3.2</td>
<td>Devices to Bypass Pari Passu Distribution</td>
<td>77</td>
</tr>
<tr>
<td>3.2.1.</td>
<td>Security</td>
<td>77</td>
</tr>
<tr>
<td>3.2.1.1.</td>
<td>Comparison Between Maltese And UK Law</td>
<td>77</td>
</tr>
<tr>
<td>3.2.1.2.</td>
<td>The Case in Favour of Securities</td>
<td>78</td>
</tr>
<tr>
<td>3.2.1.2.1.</td>
<td>The Security has been Freely Bargained</td>
<td>79</td>
</tr>
<tr>
<td>3.2.1.2.2.</td>
<td>It does not Deprive the Company of Value</td>
<td>80</td>
</tr>
<tr>
<td>3.2.1.2.3.</td>
<td>The Notice Justification</td>
<td>81</td>
</tr>
<tr>
<td>3.2.2.</td>
<td>Retention of Title and Quasi-Security</td>
<td>82</td>
</tr>
<tr>
<td>3.2.2.1.</td>
<td>Title Retention of Mixed Goods</td>
<td>85</td>
</tr>
<tr>
<td>3.2.2.2.</td>
<td>All-Monies Provision</td>
<td>87</td>
</tr>
<tr>
<td>3.2.2.3.</td>
<td>The Benefit of ROT Clauses</td>
<td>87</td>
</tr>
<tr>
<td>3.2.2.4.</td>
<td>The Unfairness of ROT Clauses</td>
<td>88</td>
</tr>
<tr>
<td>3.2.2.5.</td>
<td>EU Law Provisions on ROT Clauses</td>
<td>89</td>
</tr>
</tbody>
</table>
3.2.2.6. Jus Retentionis 90
3.2.3. Trusts 91
3.2.3.1. Background Provisions 91
3.2.3.2. The Concept of a ‘Ring Fenced Fund’ 92
   3.2.3.2.1. ‘Ring Fenced Fund’ under the Civil Code 93
   3.2.3.2.2. ‘Ring Fenced Fund’ under the Trust
                and Trustees Act 93
   3.2.3.2.3. ‘Ring Fenced Fund’ under Specific Laws 94
3.2.3.3. The Relevance of Trusts in Corporate Insolvency 96
   3.2.3.3.1. Advances for Particular Purposes 97
   3.2.3.3.2. Consumer Prepayments 99
   3.2.3.3.3. The Validity of such Trusts under Maltese Law 101
3.2.3.4. Conclusion on Trusts 102

Chapter 4. Alternatives to Pari Passu Distribution 103

4.1. What Pari Passu Attempts to Achieve 103
4.2. Limitations of the Pari Passu Principle 104
   4.2.1. Limitation in Scope 104
   4.2.2. Needs Clarity 105
4.3. The Alternatives to the Pari Passu Mode of Distribution 105
   4.3.1. Debts Ranked Chronologically 107
   4.3.2. Debts Ranked Ethically 108
   4.3.3. Debts Ranked According to Size 108
   4.3.4. Debts Ranked on Policy Grounds 109
4.4. Conclusion 110

Conclusion 111

Appendix 1 114

Bibliography 115
Table of Statutes:

I. Maltese:

1. Companies Act, Laws of Malta, Ch. 386
2. Commercial Code, Laws of Malta, Ch. 13
3. Civil Code, Laws of Malta, Ch. 16
4. Employment and Industrial Relations Act, Laws of Malta, Ch. 452
5. Social Security Act, Laws of Malta, Ch. 318
6. Income Tax Management Act, Laws of Malta, Ch. 372
7. Value Added Tax Act, Laws of Malta, Ch. 406
8. Duty on Documents and Transfers Act, Laws of Malta, Ch. 364
9. Set-Off and Netting on Insolvency Act, Laws of Malta, Ch. 459
10. Trust and Trusteees Act, Laws of Malta, Ch. 331.
11. Insurance Brokers and other Intermediaries Act, Laws of Malta, Ch. 404.
12. Investment Services Act (Control of Assets) Regulations, Laws of Malta, Ch. 370.05
13. Companies Act (Investment Companies with Variable Share Capital) Regulations, Laws of Malta, Ch. 386.02.
16. Insurance Business (Reorganisation and Winding-up of Insurance Undertakings) Regulations, Legal Notice 208 of 2004
17. Credit Institutions (Reorganisation and Winding-up of Insurance Undertakings) Regulations, Legal Notice 228 of 2004
18. Commercial Partnerships’ Ordinance, Ch. 168 of the Revised Edition of the Laws of Malta
II. UK:
1. Insolvency Act 1986
2. Companies Act, 1985
3. Insolvency Rules, 1986

III. European Statutes:
1. Regulation 1346/2000, On Insolvency Proceedings

IV. Other:
1. Codice Civile Italiano
**Table of Judgments**

**I. Maltese:**

4. Ragonesi noe vs. Refalo noe., Commercial Court, 4th November, 1979
5. Dr. Leslie Grech noe v. Registrar of Partnerships, Commercial Court, 23rd May, 1977
6. Edward Xuereb et ne vs. Robert Micallef, 8 ta’ Gunju 1942
7. L-avukat Dr. John Mamo noe vs. Edward Borg pro et noe, Commercial Court, 1st June, 1990.
10. Regina Auto Dealer Limited vs Miller Distributors Limited, First Hall Civil Court, 30th May 2002
11. Carmelo Vella vs. Commissioned Gunner Steward R. Honour, R.N First Hall Civil Court, 26th October, 1953
12. V. Bonnett vs G Azzopardi, A.K. 28 ta’ Gunju 1922
II. English:

2. Borden (UK) Ltd v. Scotish Timber Ltd. [1979] 3 WLR 672
3. Re Peachdart [1984] Ch 131 466
4. Re Jeavons, ex parte Mackay (1873) 8 Ch App 643
7. Re, Maxwell Communications Corporation (No.2) (1994) 1 B.C.L.C. 1
8. Re National Permanent Building Society (1869)
10. Re MC Bacon Ltd [1994]BCC 688, CA
11. ABC Coupler and Engineering Co. Ltd (No.3) [1970] 1 All ER 656
15. Re Kayford 1975(1975) 1 WLR 279
18. RE J.D. Swain Ltd (1965) 1 WLR 909
Introduction

Before delving in the pari passu principle, a brief historical overview of how the pari passu principle and Maltese insolvency provisions in general have developed under Maltese law is in order.

The Commercial Code\(^2\) contains a number of articles which deals with bankruptcy. They apply to any trader who suspends payment of his debt. A trader by definition in this Code includes any commercial partnership\(^3\). Before the enactment of subsequent legislation\(^4\) all partnerships *en nom collectif, en commandite* and limited liability companies were regulated by the bankruptcy provisions of the abovementioned code. This goes to mean that, initially corporate insolvency was regulated by the Commercial Code. Today the Commercial Code regulates solely the bankruptcy of the individual trader.

The first specialised and systematic legislation which purported to regulate corporations under Maltese law was the Commercial Partnerships’ Ordinance\(^5\). It came into force on the 19\(^{th}\) April 1965 by virtue of L.N. 5 of 1965. It is not a coincidence that the entry into force of the Ordinance coincided with a time when other European countries were changing their company laws. The two main sources of the Commercial Partnership Ordinance were the UK Companies Act 1948 and the Italian Civil Code 1942.

In 1995, after numerous calls for the introduction of a new legislation\(^6\), a draft bill for a comprehensive amendment to the Commercial Partnerships’ Ordinance was brought forward for consideration to Parliament. The resulting legislation was Act XXV of 1995 entitled the Companies Act\(^7\). This legislation is, in the main part, inspired by

\(^2\) Ch. 13 of the Laws of Malta  
\(^3\) Commercial Code, article 4.  
\(^4\) i.e. the Commercial Partnerships’ Ordinance and the Companies Act  
\(^5\) Ch. 168 of the Revised Edition of the Laws of Malta  
\(^6\) In 1979, Professor Micallef published a set of notes – The Law of Liquidation and Winding-up—where he called the law of the time ‘deficient and laconic’.  
\(^7\) Ch. 386 of the Laws of Malta
the UK Companies Act 1985 and the UK Insolvency Act 1986. The Maltese Companies Act was a landmark piece of legislation as it brought about a major change in the law of liquidation, dissolution and insolvency of companies. This shows the significant influence of UK law on Maltese corporate law.

The UK Insolvency Act 1986 was itself the result of the studies of the Cork Committee Report. This committee was appointed by the English Government in 1977 and was headed by Sir Kenneth Cork. Its specific mandate was that of reviewing the whole of the UK’s insolvency law. Many of the committee’s recommendations were implemented in the Insolvency Act of 1986. Also, the UK Insolvency Rules were introduced in 1986 to compliment the Insolvency Act.

Whereas the UK has a specific piece of legislation on insolvency, which throughout the years underwent studies and amendments, the Maltese insolvency provisions are what can be called ‘rudimentary’. The provisions in the Companies Act do not provide for a comprehensive set of rules on insolvency. It is indeed unfortunate that many specific aspects of insolvency law which come to the fore in Malta necessitate reference to foreign laws and jurisprudence.

It is owing to the above considerations that, during the progression of this thesis an extensive reference to UK law and jurisprudence has been made. It is generally acknowledged that, although the articles on insolvency and liquidation entrenched in the Companies Act have gone a long way to bring Maltese law on a decent level in relation to corporate insolvency, they are still somewhat laconic. This situation may be rectified by the introduction into the Laws of Malta of an ad hoc insolvency legislation.

Since Malta’s accession to the European Union, it has steadfastly applied EU law. In the context of insolvency law, Malta has implemented EC Council Regulation 1346/2002. This regulation provides for an efficient method of determining in which

---

8 On Insolvency Proceeding, entered into force on the 31st May 2002
member state insolvency proceedings shall be opened and therefore which laws shall apply in insolvencies which have a cross-border effect. Regulation 4.1 provides:

Save as otherwise provided in this Regulation, the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened, hereafter referred to as the ‘State of the opening of proceedings’.

The Regulation represents a major improvement to the operation of insolvency law and practice across the EU Member States, significantly in reducing uncertainty for stakeholders, improving the prospects of restructuring and/or selling insolvent businesses and increasing the efficiency of administration of insolvent estates. The UK, who, as has been said, are a major source of Maltese insolvency provisions, have also adopted this Regulation.

However, the Regulation does not purport to regulate the insolvencies of all types of undertakings. In fact Rule 9 of Regulation 1346/2000 states:

Insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings holding funds or securities for third parties and collective investment undertakings should be excluded from the scope of this Regulation.

This is also reflected under Maltese Law by legal notices 208\(^9\) and 228\(^10\) of 2004. These embody specific insolvency rules relating to insurance undertakings and credit institutions respectively. Thus the insolvencies of these undertakings follow the insolvency provisions set out in these laws and therefore do not follow the general insolvency proceedings.

The point to be made here is that EU law serves as a stimulus for revising and upgrading local law. The implementation of the above Regulation together with various other Directives shows how this is being done on the context of corporate insolvency law.

---


\(^10\) Under ch. 371of the Laws of Malta, Banking Act: Credit Institutions (Reorganisation and Winding-up of Insurance Undertakings) Regulations, 2004
Chapter 1.  The *Pari Passu Principle*

1.1. Introduction

*Pari passu* distribution operates within a collective insolvency process. Its comes to the fore when the company being wound-up is insolvent and therefore its assets are not sufficient to fulfill the admitted claims of its creditors. It requires the liquidator of an insolvent company in the winding-up process to distribute rateably$^{11}$ the available assets of the company among the general body of unsecured creditors$^{12}$ in satisfaction of their individually admitted claims.

*Pari passu* is a system of distribution which, in theory, should ensure an equitable distribution of the insolvent company’s estate among its creditors. Paolo Debono in his ‘Appunti di Lezioni sul Fallimento nel Diritto Maltese’$^{13}$ holds that the creditors of the bankrupt have ‘un eguale diritto’ in the estate of the bankrupt$^{14}$. However, this principle is subject to various exceptions and devices which give priority in payment to certain creditors. This has the effect of reducing the pool assets of the insolvent company which would be available for distribution. The most notable of the exceptions are the preferential debts.

Article 287 of the Companies Act provides:

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

This article is found under Chapter IV of the Companies Act entitled ‘Provisions applicable to every voluntary winding-up’. There is no similar provision is found in

---

$^{11}$ The assets of the company are to distributed to the individual creditors in proportion to their admitted claims.
$^{12}$ Throughout the progression of the thesis the phrases ‘general body of unsecured creditors’ and ‘ordinary creditors’ are used interchangeably.
$^{13}$ Seconda edizione riveduta, ampliata e corretta, 1907
$^{14}$ Although this point relates to bankruptcy it can safely be applied to corporate insolvency as at the time they were written the bankruptcy provisions also applied corporate insolencies.
the Companies Act in respect of provisions applicable to winding-up by the court. However, the above provision should be seen so as to also apply when the winding-up of the insolvent company is by the court. It would indeed be difficult to think that this type of winding-up has different rules as to the asset distribution of an insolvent company. In fact, under UK law *pari passu* applies to both compulsory\(^\text{15}\) and voluntary winding-up\(^\text{16}\). This is one of the lacunae which evidence the need for a thorough revision of the Maltese insolvency provisions and their transposition in an ad hoc insolvency law.

1.2. The Object of *Pari Passu*

Prior to the commencement of the winding-up process each creditor of the insolvent company is free to pursue whatever enforcement measures available to him by law in order to obtain payment. Liquidation marks the end of this race. The multitude of individual actions gives way to the liquidator who realises the assets of the company being wound-up and distributes the net proceeds according to the ranking and admitted claims of the creditors. The ordinary creditors within this ranking will have their share distributed to them on *pari passu* basis.

To explain further, the effect and object of the *pari passu* principle is to render inoperative all agreements which would give unfair preference to particular creditors. The agreements which are rendered inoperative are those which have the effect of removing from the estate being wound-up assets which would otherwise have been available for the general body of creditors. As the *pari passu* principle cancels contracts which were freely bargained, it finds opposition from authors who invoke the freedom of contract.

Hence, there are legislative provisions which freeze the pursuit of individual debt enforcement remedies against the insolvent company being wound-up in favour of

\(^{15}\) Insolvency Rules 1986, r 4.181(1)

\(^{16}\) Insolvency Act 1986, s. 107
collective actions by the creditors as an entity. This is seen article 222 of the Companies Act:

When a company is being wound-up by the court, any act or warrant, whether precautionary or executive, other than a warrant of prohibitory injunction, issued or carried into effect against the company after the date of its deemed dissolution, shall be void.

Moreover, article 224(2) of the same Act has the same effect of not allowing any individual action for payment against the insolvent company being wound-up by the court:

Where a winding-up order has been made or a provisional administrator has been appointed in accordance with the provisions of article 228, no action or proceeding shall be proceeded with or commenced against the company or its property except by the leave of the court and subject to such terms as the court may impose.

In the absence of such provisions there would be a free for all scenario where creditors would be left free to pursue their rights and to enforce judgments by execution against the company’s assets. A consequence of such multiplicity of actions coupled with the limited amount of assets within the estate of the insolvent company being wound-up would be the rapid disappearance of the assets of the insolvent company. This would leave the creditor who ‘came too late’ with a right to enforce his claim however with no assets to enforce it on.

Therefore, the \textit{pari passu} principle and the collectivity of the liquidation process are interdependent. \textit{Pari passu} distribution requires that all those interested in the estate of the insolvent company being wound-up, are seen as one entity. Indeed the liquidator will take decisions on behalf and in the interest of the body creditors of the insolvent company being wound-up. It is only in this way that the equitable distribution of \textit{pari passu} can be ensured.

1.3. The Road to the Distribution of Assets

1.3.1. The Commencement of the Liquidation Process

As was stated above, after the commencement of the liquidation process, the individual actions for payment by the creditors may not be instituted. In the case of
winding-up by the court, for a company to be so placed into liquidation there must be
filed a winding-up application against such company. This may be filed by one or
more of the company’s unpaid creditors. This was not provided for in the
Commercial Partnership’s Ordinance. However, the case Daniel Cremona noe. v.
Joseph Lanfranco noe., decided by Mr. Justice Schembri, the court made it clear
that any person who has an interest in the liquidation of the company has the right to
institute proceedings for the dissolution of the company. A creditor falls under the
category of an interested party. He is therefore entitled to file a winding-up
application to put the company in question in the winding-up process for its eventual
dissolution. Today article 218 of the Companies Act provides that a winding-up
application may be filed by:

…either by the company following a decision of the general meeting or by its board of
directors, or by any debenture holder, creditor or creditors, or by any contributory or
contributories.

Creditors are given the right to file a winding-up application due to the fact that they
have a direct interest in the debtor company. However, the winding-up process will
not be commenced at the whim of any creditor. In fact the court must accede to the
winding-up application in order for the winding-up process to begin. To this end the
First Hall Civil Court will listen to the submissions of the applicant and the
respondents. The court will, upon these submissions, decide whether to dismiss or
accede to the winding-up application. If the winding-up application is acceded to
the company shall be deemed to have been dissolved at the time of the filing of the
winding-up application. R. Goode states that there is no statutory provision
imposing a minimum amount of indebtedness which must be owed by the company
to the petitioning creditor. However, according to the same author, a winding-up

---

17 The wording of article 218 of the Companies Act indicates that both secured and unsecured creditors
file a winding-up application.
18 9th September 1975
19 Companies Act, article 218(6).
20 Ibid. article 219.
21 Ibid. article 223.
22 This is subject to the provisos of article 223 and to the provision found in art. 223(2).
order will not normally be granted where the petitioning creditor’s debt is less than significant.

It is not necessary that the applicant be the original creditor of the company against which the application is being filed. From English case law it transpires that a creditor by subrogation\textsuperscript{24} or a creditor to whom the debt has been legally assigned\textsuperscript{25} may properly petition for winding-up. The position is similar under Maltese law. In both situations the person acquires the rights and obligations of the original creditor and therefore may file the winding-up application in his stead.

According to Fletcher\textsuperscript{26}, an unpaid creditor is entitled to file a winding-up application against the debtor company \textit{ex debito justitiae}.\textsuperscript{27} This seems to run counter to the principle that winding-up is a collective procedure and that the court will accordingly have regard to the wishes and interests of the majority of creditors in order to determine the most appropriate way in which to dispose of the petition\textsuperscript{28}. It is in fact not difficult to imagine a situation where some creditors are comfortable with the insolvent company not being wound-up\textsuperscript{29}. This highlights the friction between the rights of the petitioning creditor vis-à-vis the company and the petitioning creditor vis-à-vis the other body of creditors as a whole. However, it must be remembered that the collectivity of the insolvency regime ensues once a company is put into liquidation. It is after the winding-up application is acceded to that the creditors of the company being wound-up lose their ability to pursue their individual claims. Indeed the deemed date of dissolution signals the switch from an individualistic to a collective regime as briefly mentioned above. Hence, in effect, the above principle quoted by Fletcher does not run counter to the collective nature of the insolvency

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{24} \textit{Re National Permanent Building Society (1869)}
\item \textsuperscript{25} Civil Code, article 1477(1): The assignor is not answerable for the solvency, whether present or future, of the debtor, unless he has expressly bound himself thereto, either by declaring the debt good and collectable or by other words to that effect.
\item \textsuperscript{26} Fletcher, The Law of Insolvency, 3\textsuperscript{rd} Edition, 2002
\item \textsuperscript{27} The law regards the creditor as enjoying a \textit{prima facie} right to obtain a winding-up order.
\item \textsuperscript{28} \textit{RE J.D. Swain Ltd (1965) 1 WLR 909}
\item \textsuperscript{29} The stronger creditors are in a better position to enforce their claim outside the insolvency process.
\end{itemize}
\end{footnotesize}
process as at the time when the said principle becomes effective\textsuperscript{30}, the collective regime is not yet in operation.

In the case of a voluntary winding-up of an insolvent company, the liquidation process commences by the extraordinary resolution of the company\textsuperscript{31}. Due to the insolvency of the said company there could be no declaration of solvency and therefore the winding-up will be a creditors’ voluntary winding-up\textsuperscript{32}. The deemed date of dissolution shall be on the date of the passing of the extraordinary resolution\textsuperscript{33}.

1.3.2. Realisation of the Company’s Assets

One of the main aims of insolvency law is the orderly collection of and realisation of the insolvent company’s assets and their fair distribution according to the creditors’ claims.

When a company is put into liquidation the liquidator will take in his custody and control all the assets and rights of the company\textsuperscript{34}. He will then proceed to realise them\textsuperscript{35} and place the proceeds in a common pool for them to be distributed among the creditors according to their ranking at law\textsuperscript{36}. Due to the inherent nature of insolvency proceedings not all claims will be fully discharged. Obviously the more the liquidator manages to collect and realise, the more there will be available for the distribution among the creditors.

In order to realise and augment the company’s assets, the liquidator has the power to retrieve assets which were previously disposed of by the company in a manner which gave the receiving creditor an unlawful preference\textsuperscript{37}. Moreover, investigation\textsuperscript{38} into

\begin{itemize}
\item \textsuperscript{30} I.e. when the creditor files the winding-up application.
\item \textsuperscript{31} Companies Act, article 214(1)(b)
\item \textsuperscript{32} Ibid., article 268(5)
\item \textsuperscript{33} Ibid., article 266
\item \textsuperscript{34} Ibid., article 237.
\item \textsuperscript{35} Ibid., article 238(2).
\item \textsuperscript{36} Ibid., article 238(1)(c).
\item \textsuperscript{37} This shall be seen in 1.3.2.1.
\end{itemize}
the company’s affairs may reveal instances of misconduct on the part of directors and managers. In addition to being criminally liable they may be personally liable to contribute to the company’s assets. Moreover, under article 238(e) of such Act, the liquidator with sanction of the court or of the liquidation committee, in order to augment the pool of assets will also call on contributories:

in relation to debts, liabilities and claims of the company present or future, certain or contingent, ascertained or which may be due in damages, subsisting or supposed to subsist between the company and a contributory or alleged contributory or other debtor or alleged debtor…

As has already been hinted above, and as shall be seen in more detail during the progression of this thesis, it is only those assets in which the company has a beneficial interest which may be realised and are therefore available for distribution to its creditors. Therefore, property held by the company being wound-up on trust or goods held by the company under a contract of sale reserving title until full payment, if such payment has not been completed, shall not form part of the common pool as they do not enter the estate of the company being wound-up. Therefore, the asset over which there is a right in rem shall be only realised by the creditor who holds such right to the exclusion of the other creditors who do not hold a similar right in the asset.

1.3.2.1. Unlawful Preference

Although the collectivity of the insolvency process comes into play when the insolvent company is in the winding-up process, the object of pari passu may be hindered by fraudulent pre-liquidation transactions entered by the company. These give unlawful preference to the ordinary unsecured creditor in whose favour the transaction was made. Moreover, although these transactions are entered before the commencement of winding-up of the company, they still have the effect of reducing the pool of assets which would eventually be available for the general body of creditors.

38 Under article 227 of the Companies Act such investigations are carried out by the official receiver.
39 Ibid., article 320.
40 The object refers to ensuring equality among the unsecured creditors in the distribution of the assets of the insolvent company.
Article 303 states:

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

Once a company is dissolved, the transactions entered by such company within six months prior to the dissolution will be scrutinized. Therefore, if any of such transactions are proved to constitute a transaction at an undervalue or a preference in terms of sub-article 2(a) and (b) of the same article, and they are entered within six months before the dissolution of the company, then they shall be presumed to be fraudulent and therefore be voided. This will have the effect of augmenting the pool of assets available for distribution among the creditors.

The presumption created by the above article implies that, there is no need to prove the intention on the part of the company being wound-up to give an advantage to the individual creditor who benefited from the transaction. However, this presumption may be rebutted if it is proved that, the person in whose favour the unlawful preference was made, ‘did not know and had no reason to believe that the company was likely to be dissolved by reason of insolvency’. If this is proved then the unlawful preference would not be voided.\[41\]

As an aside, this article should have been worded differently. The time period of ‘six months before the dissolution of the company’ does not suffice. The effectiveness of the article is dependent the expediency of the winding-up process. Hence, by means of the current wording, if there is a large time gap between the commencement of the winding- process and the dissolution of the company, then the article would have

\[41\] Article 303: “…unless the person in whose favour it is made, done or incurred, proves that he did not know and did not have reason to believe that the company was likely to be dissolved by reason of insolvency…”
little application. In any case, any disposition of property done after the commencement of winding-up process but before the dissolution of the company is caught under article 221 of the Companies Act\(^\text{42}\). The wording should have read: ‘within six months before the deemed dissolution of the company’ or ‘within six months before the commencement of the winding-up proceedings’. In fact UK Insolvency Act states that such relevant time shall be taken from the commencement of liquidation.\(^\text{43}\)

1.3.2.1.1. Transactions at an Undervalue

These are transactions, entered by the debtor company within six months prior to the dissolution of the insolvent company, where the said company would have either received no consideration for such transaction or a consideration of value considerably less than what it gave.

Sections 238 and 339 of the UK Insolvency Act list three categories of transaction which are voidable as having been entered into at an undervalue. These are:

1. gifts or transactions for which the debtor received no consideration\(^\text{44}\);
2. transactions entered into by the debtor in consideration of marriage\(^\text{45}\);
3. transactions for which the debtor received consideration which was significantly less, in money or money’s worth, than the consideration it gave\(^\text{46}\);

Similar provision is found in Sub-article 2(a) of Article 303 of the Companies Act which indicates what constitutes a transaction at an undervalue:

a company enters into a transaction at an undervalue if:
(i) the company makes a gift or otherwise enters into a transaction on terms that provide for the company to receive no consideration, or
(ii) the company enters into a transaction for a consideration the value of which, in money or money’s worth, is significantly less than the value in money or money’s worth of the consideration provided by the company

\(^{42}\) This article shall be discussed in more detail in 1.4.1.
\(^{43}\) Insolvency Act 1986, sections 238-240.
\(^{44}\) Insolvency Act 1986, Section 238(4)(a)
\(^{45}\) Ibid., Section 339(3) (b)
\(^{46}\) Ibid., Section 238(4)(a)
An English case, *Re MC Bacon Ltd*[^47^] held that in order to identify whether a transaction was entered at an undervalue the key question to ask is whether the debtor company benefited sufficiently from the transaction. Millett J held:

“A comparison is to be made between the value obtained by the company for the transaction and the value of consideration provided by the company. Both values must be measurable in money or money’s worth and both must be considered from the company’s point of view.”

Section 238(5) of the UK Insolvency Act states that the transaction would not be voided if the insolvent company entered such a transaction:

- In good faith and for the purposes of carrying on its business; and
- At the time there were reasonable grounds for believing that the transaction would benefit the company

The UK’s good faith defence requires only the insolvent company to act in good faith and therefore it would seem irrelevant if the recipient/creditor acted in bad faith. This is in stark contrast with the Maltese position which holds that, it shall not be considered to be an unlawful preference if the person, in who favour the transaction at the undervalue[^48^] was made, proves that he did not know and did not have reason to believe that the company was likely to be dissolved by reason of insolvency[^49^].

Therefore, a transaction at an undervalue has the effect of reducing the pool of asset available to the creditors. In practical terms, if a piece of machinery which has a value of Lm 4000 is sold by the debtor company for a miserable Lm 2000, this has the net effect of depriving the creditors of the company from Lm 2000 which would have been available for distribution. This runs counter the object of the *pari passu* principle as it gives unlawful preference to the ordinary creditor in whose favour the transaction was made. Hence, if this transaction was entered within six months prior to the dissolution of the company, then it will be liable to be voided unless the buyer

[^47^]: [1994]BCC 688, CA

[^48^]: Or preference.

[^49^]: Companies Act, article 303.
proves that he did not know and had no reason to believe that the company was likely to be dissolved by reason of insolvency’. In this latter situation the unlawful preference would not be voided.

1.3.2.1.2. Preferences

Professor Weisberg describes what a preference is:

“A transfer of money or of some interest in property by a debtor to a creditor to settle an antecedent debt; it occurs when the debtor faces imminent bankruptcy [or liquidation]; and it benefits that creditor to the prejudice of other creditors by granting the favoured creditor a greater share of the diminished assets of the debtor than that creditor would enjoy under the formal system of bankruptcy [or liquidation] distribution.”

Therefore, preferences occur when there is a pre-liquidation agreement which enables the favourable treatment, in the liquidation process, of one creditor over the others. Preferences allow creditors to jump to the front of the queue for payment ahead of the general unsecured creditors. This results in such creditors receiving from the insolvent company, before it goes into liquidation, more than they would have otherwise received through the liquidation process.

In the context of the pari passu scheme of distribution, what is important to keep in mind is that: when a preference is given by an insolvent company, whether motivated by kindness, a sense of duty or some fraudulent intent, the company is in effect robbing the general body of unsecured creditors in order to pay one of the unsecured general creditors.

Under UK law only ‘bad’ preferences are voidable. Thus only advantages that are given by the debtor just before the declaration of its winding-up who is influenced by a desire to improve the position of the creditor can be set aside. If just before the winding-up order of the debtor company a creditor has for example obtained payment as a result of aggressive debt collection tactics in the period leading up to the

---

50 R. Weisberg, Commercial Morality, the Merchant Character, and the History of Voidable Preference’, 1986, 39 Stanford LR 3
winding-up or bankruptcy there can be no challenge made. These practices are very
difficult to mask due to their subjectivity. However, Maltese law does not contain this
element of subjectivity. In fact, under Maltese law the liquidator does not need to
prove that the insolvent company was influenced by a desire to give preference.
Article 303 of the Companies Act creates a presumption to the effect that if any
preference \(^{51}\) is given by the company within six months before the dissolution of the
company than, that would constitute a fraudulent preference.

Article 303(2)(b) of the Companies Act provides us with what constitutes the
granting of a preference:

\[(b)\] a company gives a preference to a person if:
(i) that person is one of the company’s creditors or a surety or guarantor for any of the
company’s debts or other liabilities; and
(ii) the company does anything or suffers anything to be done which, in either case, has the
effect of putting that person into a position which, in the event of the company going into
insolvent winding-up, will be better than the position he or she would have been had that act or
omission not occurred

Therefore, under Maltese law, in order for a liquidator to successfully attack a
transaction as a preference, the liquidator has to prove that:

- The transaction was entered into within six months before the dissolution of
  the company \(^{52}\);
- The recipient of the preference is one of the company’s creditors or surety or
  guarantor for any of the company’s debts;
- The transaction has the effect of putting the recipient into a position which,
  which in the event of the company entering liquidation, will be better than the
  position he or she would have been had the transaction not been entered.

Moreover, as seen in the case of transactions at an undervalue in 1.3.2.1.1., under
Article 303 of the Companies Act it is essential that the recipient of the preference
does not manage to prove that he did not know nor have reason to believe that the

\(^{51}\) Or any transaction at an undervalue.
\(^{52}\) As stated above the wording of the article should be changed.
company was going to be dissolved by reason of insolvency. As, if he so proves that he was in good faith the transaction will not be voided.

Professor Andrew Keay\(^{53}\) has identified three rationales for voiding preferences:

a) To foster the collective process of asset distribution

Liquidation is a procedure which is collective in that each creditor forfeits his individual right to take action to enforce the debt owed. This ensures that the primary beneficiary of the liquidation proceedings is the general group of unsecured creditors as a whole. Therefore, the courts will not permit a single creditor to obtain a personal advantage through a preference as it would undermine such collective process. If there was no collective procedure, then creditors would enforce their debts on a ‘first come, first served’ basis which as shall be discussed, produces a disorderly distribution of assets which advantages the few stronger creditors.

b) Maintenance of the *pari passu* scheme of distribution

One of the fundamental principles of the law of insolvency is that the assets of an insolvent company are to be distributed fairly and rateably among creditors, hence by means of the *pari passu* distribution. A justification for not allowing preference provisions is the maintenance of the equality principle and the prohibition of its undermining. It would be impossible to achieve equality if the law was to disregard what occurred prior to the lodging of the winding-up proceedings. Preferences distort what creditors receive vis-à-vis one another, this is why they should be voided.

c) Deterring Dismemberment

As already mentioned, when a company is known to be insolvent and close to being wound-up, there is often a scramble for payment among creditors. If this is not prevented there would be a situation where there will be a dismemberment of the residual estate of the insolvent company. Preference provisions are viewed as

---

a means of deterring creditors from engaging in the scramble and therefore of securing benefits ahead of others. Therefore, “if there was no provision providing for the voidability of the preferences, the creditors would have every incentive to, grab what they could, and as quickly as they could.”

1.3.2.2. Provisions under the Commercial Code

Before the enactment of the Commercial Partnerships Ordinance and the Companies Act corporate insolvency law was regulated by the Commercial Code. Today, its provisions on bankruptcy relate solely to the individual trader. Under article 485(1)\(^54\) of the Code, any type of transaction mentioned in this article, entered by the bankrupt under a gratuitous title for the purpose of defrauding his creditors shall be void\(^55\), even though the party with whom the transaction was entered was in good faith. What is essential under this article is that the curator\(^56\) proves that the transaction was entered for the purpose of defrauding his creditors. This burden of proof does not exist under article 303 of the Companies Act due to the presumption that any transaction entered six months before the dissolution of the company constitutes a fraudulent preference if it constitutes a transaction at an undervalue or a preference.

Moreover, the Code also makes provision for onerous obligation, act or payment of the same kind as those mentioned in sub-article 1 of the same article entered by the bankrupt. Under article 485(2) these can be annulled if both the bankrupt and the interested party acted fraudulently. Whilst the fraud on the part of the bankrupt must be proved by the curator, article 485(3) of the Commercial Code lays down a presumption that the act shall be deemed to be fraudulent with respect to the interested party:

...if it is proved that such party knew of the bankruptcy or of the existence of circumstances giving rise to a declaration of bankruptcy.

\(^54\) Commercial Code, article 485. (1): Every act transferring property, whether corporeal or incorporeal, including any renunciation of any succession whatsoever or of an acquired prescription, and every obligation incurred or other act made by the bankrupt under a gratuitous title for the purpose of defrauding his creditors, shall be null and void as regards the body of creditors, of whatever kind they may be, even though the parties interested be in good faith.

\(^55\) This action is known as the Actio Revocatoria Fallimentaris.

\(^56\) The curator undertakes the action in the general interest of the creditors.
The *Actio Revocatoria Fallimentaris* is exercisable in relation to those acts performed between the cessation of payments and the declaration and adjudication of bankruptcy of the court. This principle also comes out in *Camilleri v. Pantalleresco*\(^57\):


On the other hand, any act in fraud of a creditor’s claims which is performed prior to the cessation of payment has to be voided by the individual creditor by means of the *Actio Pauliana* of article 1144 of the Civil Code\(^58\). Therefore, this latter action is not a collective action available to the body of creditors of the company.

As in the case of the *Actio Revocatoria Fallimentaris*, the *Actio Pauliana* requires the creditor to prove the intention of the debtor to defraud him of his claims. In fact, under both actions, if the act in question was under an onerous title, the creditor must prove that there was fraud on the part of both contracting parties\(^59\). On the other hand, if the act was under a gratuitous title, it shall be sufficient for the creditor to prove fraud on the part of the debtor\(^60\). This requirement to prove the fraud of the debtor is not required under article 303 of the Companies act.

Both article 303 of the Companies Act and article 485 of the Commercial Code and to a certain extent article 1144 of the Civil Code, are actions which seek to preserve *par conditio creditor*\(^61\) and therefore *pari passu* in general. They attempt to preclude any person from obtaining any benefit to the prejudice of the general body of creditors.

\(^{57}\) Court of (Commercial) Appeal, 27\(^{th}\) February, 1959

\(^{58}\) Civil Code, article 1144. (1): It shall also be competent to any creditor in his own name to impeach any act made by the debtor in fraud of his claims, subject to the right of the defendant to plead the benefit of discussion.

\(^{59}\) Civil Code, article 1144(2)

\(^{60}\) Ibid., article 1144(3).

\(^{61}\) Equality between creditors.
Thus, the collected assets of the company which is in liquidation, including those collected through article 303 of the Companies Act and amounts collected from contributories in respect of unpaid share capital, are put in a single fund. Out of this fund the expenses and the liabilities of the insolvent company are discharged. This takes us to the next sub-title.

1.3.3. **Proof of Debt**
Proceeds form the realisation of the company’s assets are distributed only among those creditors who individually lodge a formal claim with the liquidator in respect of the amounts which are legally due to them by the company undergoing the winding-up proceedings. The onus of proving the amount due to him lies on the creditor. This formal claim is known a ‘proof of debt’.

The creditor’s proof of debts may be admitted for payment either for the whole amount claimed, or for part of that amount, or may rejected in its entirety. A creditor shall not be entitled to the proceeds if his proof has been rejected.

Once the claim has been admitted article 238 (1)(d) of the Companies Act states that the liquidator has the power to:

- to make any compromise or arrangement with creditors or persons claiming to be creditors, or having or alleging themselves to have any claim, present or future, certain or contingent, ascertained or which may be due in damages against the company or whereby the company may be rendered liable, and to refer any such matter to arbitration;

This formal claim is also important in order to entitle the creditor to vote in the meeting of creditors. Article 232(1) states that:

In the case of a first meeting of creditors or of an adjournment thereof a person shall not be entitled to vote as a creditor unless he has duly lodged with the liquidator, not later than the time mentioned for that purpose in the notice convening the meeting or adjourned meeting, a proof of the debt which he claims to be due to him from the company.
In the case of any subsequent meeting the creditor will only be entitled to vote if his proof of debt was ‘admitted wholly or in part before the date on which the meeting is held.’\textsuperscript{62} To this end article 232(3) reads:

The chairman as provided for in article 297(3) shall have power to admit or reject a creditor’s proof of his debt for the purpose of voting, but his decision shall be subject to appeal to the court.

According to Judge P. De Bono, the creditor in the formal claim, apart from indicating the credit, should also indicate the lawful causes of preference in his favour\textsuperscript{63}.

By means of article 301 of the Companies Act, proof may be lodged in respect of debts which are present or future, certain or contingent, ascertained or which may be due in damages\textsuperscript{64}. This means that for a creditor to be able to submit a formal claim it is not necessary that the amount being claimed should be due for payment by the date of liquidation, for example, pre-liquidation debts maturing after liquidation may be claimed by creditors.

This article expressly states that it applies to ‘every winding-up of a company the assets of which are sufficient to meet the liabilities’. It is therefore debatable whether this article applies to the winding-up of insolvent companies. Due to the absence of any other provision providing which debts shall admissible as proof against an insolvent company being wound-up, the above article should be seen so as to apply also to this latter instance. However, the position and wording of the article should be clarified.

\textsuperscript{62} Companies Act, article 232(2)
\textsuperscript{63} Appunti di Lezioni sul Fallimento nel Diritto Maltese, Seconda edizione riveduta, ampliata e corretta, 1907.
\textsuperscript{64} Companies Act, article 301: In every winding up of a company the assets of which are sufficient to meet the liabilities, all debts payable on a contingency, and all claims against the company, present or future, certain or contingent, ascertained or which may be due in damages, shall be admissible as proof against the company, a just estimate being made, so far as possible, of the value of such debts or claims as may be subject to any contingency or which are due in damages but not ascertained, or which for some other reason do not bear a certain value.
Rule 4.89 of the UK Insolvency Rules states that a creditor must deduct from the amount of his proof all trade and other discounts which would have been available to the insolvent company if it had not gone into liquidation, whether the discount was expressly or impliedly agreed upon or was allowed by trade usage. However no deduction need to be made of discounts allowed for immediate, early or cash settlement. This provision for discounts is also seen under the Companies Act. In fact article 301 states that the value of the provable debts may be ‘subject to any contingency’.

It is empirical to note that a debt or claim can be proved in a winding-up only if it could have been recovered or enforced by an action brought against the company before it went into liquidation. Consequently, a debt or claim which is avoided by statute or the general law, or which is made unenforceable by statute or by a rule of public policy, cannot be proved in liquidation.

1.3.4. Ranking of Claims

“Il concorso dei creditori sul patrimonio del fallito e le prelazioni, che potrebbero essere richiamate dagli uni sopra gli altri, inducono la necessità’ di determinare il grado ossia l’ordine in cui ciascuno di tali creditori sara’ chiamato nella ripartizione del patrimonio medesimo. Questa operazione e’ appunto quell’ ache addimandasi graduazione dei creditori del fallito.”

The ranking of creditors comes into play when the property of the debtor, present and future, fails to satisfy the claims of the creditors. If the debtor’s estate is extensive enough to satisfy his liabilities in full, there would not be a ‘dog eat dog’ battle between the creditors for the assets of the debtor. In this scenario all the creditors would be sure of being paid albeit in order of preference chosen by the debtor who would still be completely in control of his estate. This means that all creditors whether they hold any kind of preference or not, are on equal footing and the debtor’s property is their common guarantee.

---

65 For example, an illegal debt.
66 Judge P. De Bono, Appunti di Lezioni sul Fallimento nel Diritto Maltese, Seconda edizione riveduta, ampliata e corretta, 1907.
67 Tonia Huntingford, LL,D, The ranking of Creditors Under Maltese Law, August 1977, p.40
On the other hand where the assets of the debtor are insufficient to guarantee the claims of all the creditors, the preferences in favour of the creditors become relevant as they give the latter an advantage over other creditors who do not have a preference or have one which ranks subsequently to theirs. T. Huntingford states that ‘right of preference presupposes a competition between the creditors, which competition emerges when the debtor’s property is no longer sufficient to meet the claims towards which it is bound’\(^{68}\). In *Mamo vs. Burroni*\(^{69}\) the court held:

“Non vi e’ luogo a discutere privilegio in contestazione col solo debitore, ma in concorso con altri creditori”

Article 302 of the same the Companies Act reads:

In the winding-up of a company the assets of which are insufficient to meet the liabilities, the rights of secured and unsecured creditors and the priority and ranking of their debts shall be regulated by the law for the time being in force.

Therefore, the liquidator must declare and distribute what he has realised from the company assets among the creditors in respect of the debts which they have respectively proved in an order of priority determined by law. Article 238(1)(c) gives the power to the liquidator of a company in winding-up to pay creditors according to their ranking at law. However, ranking may prove to be a tricky task as it is influenced by various techniques adopted by creditors such as securities or subordination.

The above process is summed up in a Maltese judgment *Salvatore Bondin vs. Paul Vella noel*\(^{70}\) where the court stated:

“Huwa f att indiskuss illi war a r-risoluzzjoni tax-xoljiment l-iskop tas-socjeta’ jinbidel u jittrasforma ruhu minn dak ta’ prosegwiment ta’ attivitajiet normali kummercjal ghal dak ta’ realizzazzjoni ta’ l-assi u hlas tal-passivita’ u distribuzzjoni bejn is-socji ta’ dak li jkun baqa’ biex is-socjeta’ tigi estinta. … l-funzjoni tal-likwidatur…ta’ socjeta’ dixxolta huwa dak li inter alia jikkustodixxi l-patrimonju tas-socjeta’, jinvestiga il-pretizi kollha avanzati kontra s-socjeta’ mill-kredituri taghha, jiddecidi l-kwistjonijiet ta’ gradwazzjoni li jinqalghu,\

\(^{68}\) Ibid.
\(^{69}\) 1865. Koll. Vol. III, 312
\(^{70}\) *Vol. 77 Part 4 page 308, 10th May, 1993*
In the case of a voluntary winding-up, an alternative ranking of creditors could be formulated by means of article 291 of the Companies Act. The article provides for the possibility of an arrangement between a company in the course of it being wound-up and its creditors to establish in what priority the assets of the company will be distributed. This arrangement will be binding on the company if it is sanctioned by an extraordinary resolution, and on the creditors if acceded to by two-thirds in value. However, the arrangement is subject to the right of appeal. The law recognises the risk involved in the above article, it therefore allows any creditor or any contributory to make an objection to the voluntary arrangement being proposed:

Any creditor or contributory may, within fourteen days from the completion of the arrangement, apply to the court contesting the arrangement, and the court may thereupon, as it thinks fit, amend, vary or confirm the arrangement.

1.3.4.1. **Priority of Payment under English Law**

Under Maltese law the ranking of creditors is regulated by the current law being in force. This law is scattered around in various pieces of legislation. Maltese law does not therefore have a comprehensive law which clearly indicates the ranking of creditors. On the other hand UK insolvency legislation lays down a detailed system of priorities for dealing with claims. The forthcoming list refers to the ranking of creditors under English law. The Maltese ranking has a similar chronological order however without the categories which are extraneous to Maltese law.

---

71 Companies Act, article 291(1): Any arrangement entered into between a company in the course of being wound-up, and its creditors shall, subject to the right of appeal under this article, be binding on the company if sanctioned by an extraordinary resolution, and on the creditors if acceded to by two-thirds in value.
72 Ibid., article 291(2).
73 The Maltese priority of claims shall be discussed in more detail in chapter 2.
74 Companies Act, article 302.
75 UK Companies Act, section 328.
According to Fletcher\textsuperscript{76}, the order of priority for payment under UK law is as follows\textsuperscript{77}:
1. The costs and expenses of the liquidation, including the liquidator’s own remuneration;
2. Preferential debts;
3. Debts secured by a floating charge
4. Ordinary debts
5. Post-insolvency interest on debts
6. Deferred debts;
7. The balance (if any), to be returned to the contributories.

According to the same author, the “fundamental principle to be followed is that all liabilities belonging to a higher category must be fully discharged, or provided for, before any payment may take place in respect of a liability belonging to a lower rank\textsuperscript{78}. This is also the situation under the Maltese system.

1.3.4.1.1. Liquidation Expenses
Assets may not be distributed \textit{pari passu} until the expenses of the liquidation have been deducted from the net realisations available for distribution and the preferential debts have been paid in full. Section 328 of the Insolvency Act 1986 provides that the preferential debts will be postponed to the expenses of liquidation which will in turn be paid in priority of other debts.

The expenses which fall in this category are those which were properly incurred in the winding-up of the company such as the remuneration of the liquidator. Therefore such expenses are paid out of the company’s assets in priority to all other claims.

\textsuperscript{76}Fletcher, The Law of Insolvency, 3\textsuperscript{rd} edn. (2002) p.650
\textsuperscript{77}All liabilities belonging to the higher category of priority must be fully discharged before any payment may be made to a lower category.
\textsuperscript{78}Fletcher, The Law of Insolvency, 3\textsuperscript{rd} edn. (2002) p.650
Under the UK Insolvency Act 1986, if the company’s assets are insufficient to satisfy all the expenses incurred by the liquidator in carrying out the liquidation, the expenses properly incurred by him are paid in order of priority directed by the court. There is no similar provision in respect of voluntary liquidations. This order of priority may also be found in the article 258 of the Companies Act and it applies to both voluntary and winding-up by the Court.

1.3.4.1.2. Preferential Debts

Preferential debts are given priority over all other debts of the company in winding-up. Section 175(1) of the UK Insolvency Act reads:

In a winding-up the company's preferential debts shall be paid in priority to all other debts.

Sub-section 2 of the above UK section states that preferential debts shall ‘rank equally among themselves after the expenses of winding-up. Moreover, the same section states that they shall be paid in full, unless the assets are insufficient to meet them, in which case they abate in equal proportions.’

Section 386 of the UK Insolvency Act gives a list of which are the preferential debts:

A reference in this Act to the preferential debts of a company or an individual is to the debts listed in Schedule 6 to this Act (money owed to the Inland Revenue for income tax deducted at source; VAT, car tax, betting and gaming duties; social security and pension scheme contributions; remuneration etc. of employees); and references to preferential creditors are to be read accordingly.

1.3.4.1.3. Debts Secured by a Floating Charge

Under UK law debts may be secured by two devices: a fixed or floating charge. Whilst the fixed charge attaches to the asset it secures from the moment the charge is created and thus the borrower cannot sell such asset without the permission of the lender, in the case of a floating charge the charge attaches to the asset only when the

---

79 UK Insolvency Act, section 156
80 This shall be looked into in more detail in 2.2.1.
81 Preferential debts and their scope in insolvency law shall be discussed in more detail in the forthcoming chapter of this thesis.
82 A similar comprehensive list is not found under Maltese law.
charge ‘crystallises’. This means that until the charge crystallises the assets which relate to the charge may be sold, consumed or traded in the normal course of business. A floating charge would crystallise on the commencement of winding-up in which case the assets which were under the charge at the time of the crystallisation would become attached to the charge and thus become a fixed charge. Thus, the borrower would not be able to sell the assets.

Section 175(2)(b) of the UK Insolvency Act provides that, preferential debts have priority over the claims of holders of debentures secured by, or holders of, any floating charge created by the company. Therefore, floating charges rank after preferential debts and are paid out of any property comprised in or subject to that charge.

Within this category any question of priority will be determined according to the rules regarding successive securities, based on the registration and on the doctrine that the first in time prevails\(^3\).

Formerly, through the doctrine of crystallisation of the assets covered by the floating charge, holders of such a charge enhanced their level of protection. This was possible by the insertion of an express provision in the instrument creating the floating-charge whereby on the occurrence of certain events, typically occurring immediately prior to the commencement of insolvency proceedings, the charge may be converted into a fixed one. This would be capable of enforcement independently of winding-up and thus ahead of the satisfaction of the expenses of the liquidation and claims of preferential creditors. Such payment would be out of the assets under charge at the time of the crystallisation.

This increased protection enjoyed by secured creditors has been eliminated by virtue of the amended definition of the expression ‘floating charge’ contained in section 251 of the UK Insolvency Act which reads “a charge which, as created, was a floating

\(^3\) UK Companies Act 1985
charge”. This had the effect of ensuring that any floating charge created is permanent and cannot be changed into a fixed one before the commencement of liquidation. Hence, floating charges remain payable after the liquidation expenses and the preferential debts and cannot be payable before the commencement of liquidation.

The concept of a floating charge is not found under Maltese law. Therefore, when reference is made to floating charges during this thesis, this shall be done solely in the context of UK law. Yet, there is a similarity between a floating charge and a general hypothec under the Maltese Civil Code. Article 2012(1) of the Code reads:

A hypothec is general or special: it is general when it affects all the property present and future of the debtor;

As in the case of floating charges, general hypothecs do not attach to specific property. Moreover, by means of Article 2013(1)(b) of the same Code, just as in the case of a floating charge, the assets under the general hypothec may be sold and there is no consequential droit de suite as would be in the case of a special hypothec:

A general hypothec attaches to the property affected thereby only so long as such property does not pass into the hands of a third party.

Therefore, the difference between the two concepts is that: whilst floating charges do not attach to the asset until the commencement of winding-up of the company, in the case of a general hypothec, the charge attaches to the assets under hypothec as soon as it is created. Despite this the assets under a general hypothec may still be sold and replaced. This shows that the two concepts have a similar effect. Having said that, general hypothecs are categorized and rank as preferential debts, and not as floating charges.

1.3.4.1.4. Ordinary Debts

Once all the debts and expenses found in above three categories have been fully paid, the liquidator would proceed to distribute the dividends to the general body of

---

84 Civil Code, article 2013(1)(b).
85 Ibid., article 2012(1).
86 The word ‘dividend’ in the context of this thesis means the amount which the creditor is paid from the estate of the insolvent company according to his claim.
ordinary creditors. Fiona Tolmie describes this category of creditors as a ‘residual class comprising all creditors not specifically designated as preferential or deferred’.\(^{87,88}\)

Unsecured creditors of an insolvent company are in an unenviable position. In practice, unsecured creditors will be lucky to receive a small portion of the amounts due to them. Often they will receive nothing at all. Obviously this depends on the level of indebtedness of the company being wound-up. David Milman and Christopher Durrant state that ‘it is not surprising that he (the unsecured creditor) will be inclined to exploit any ploy which will improve his plight’.\(^{89}\) The ruling of the House of Lords in *British Eagle International Airlines Ltd. v. Compagnie Nationale Air France*\(^{90}\) ensures equality of misery for unsecured creditors as it states that contracting out of the statutory regime for repayment of unsecured claims *pari passu* is contrary to public policy and therefore unlawful.

All creditors within this category stand on equal footing irrespective of the chronological order in which their claims originated. As the remaining funds of the insolvent company being wound-up will not be sufficient to pay the totality of its debts of the ordinary creditors, the principle of equally-proportioned abatement will operate. This is in effect what constitutes the *pari passu* principle of distribution.

### 1.3.4.1.5. Post-Insolvency Interest on Debts

In line with the recommendations of the Cork Report\(^{91}\) section 189 of the UK Insolvency Act 1986 provides for the payment of interest at a prescribed rate in respect of debts which have been outstanding since the company went into liquidation. Payment of post-liquidation interest can only occur if there is a surplus of money, after all the creditors’ claims have been met in full, including claims for pre-insolvency interest as this can be incorporated into the amount for which proof was

---

\(^{87}\) The term ‘deferred creditor’ shall be explained below.


\(^{90}\) *[1975]* *W.L.R. 758*

\(^{91}\) Cmnd. 8558, Chap.31.
lodged\textsuperscript{92}. The payment of interest under this section is to be performed without any differentiation between preferential and non-preferential debts\textsuperscript{93}. There is no similar provision for such payment under Maltese law.

1.3.4.1.6. Deferred Debts

These are debts which, by virtue of some statutory provision are postponed for payment in a liquidation until the company’s other debts and liabilities have been paid in full. These classes of debts rank between themselves in the order in which they are set out, and not ratably, as in the case of preferential debts. The concept of ‘Deferred debts’ is extraneous to Maltese law.

1.3.4.1.7. Return to Contributories

In insolvency law there is vital distinction between shareholders and creditors. When an insolvent company goes into liquidation its creditors are entitled to be paid before its shareholders. Shareholders of a company in liquidation have no claim to payment from the company except when a dividend is declared or there is a surplus of assets over liabilities on the winding-up of the company. Hence, in the rare event that the company being wound-up is in a solvent condition and therefore has funds or assets remaining after all the expenses of the winding-up have been met, and after all debts and liabilities of the company in winding-up have been paid, each individual member shall be entitled to a proportion of the surplus in accordance with the provisions of the Memorandum Articles of Association\textsuperscript{94}. This is also seen in Maltese law\textsuperscript{95}.

1.3.4.2. Ranking of Claims which have a Cross-Border Effect

In today’s commercial world it is inevitable that there be situations where the insolvent debtor and creditor company be of different nationalities. In this event, it is essential to identify which law is to be applicable in respect of the rights and ranking of creditors. Every legislature has its own principles and hence would produce

\textsuperscript{92} Insolvency Act 1986, s.189(1), (2)
\textsuperscript{93} ibid; s. 189(3)
\textsuperscript{94} Insolvency Act (1986), ss. 107, 154
\textsuperscript{95} Companies Act, article 287.
different results. Without a proper framework to address this question confusion will subsist. This will be to the detriment of the creditors and also of the European internal market in general. EC Council Regulation 1346/200096 addresses this situation.

Where insolvency proceeding have a cross-border effect it is very important to identify in which Member State the insolvent company has its centre of main interests. This will be the factor which will determine in which Member State the insolvency proceedings will be opened and therefore which laws will be applicable.

In fact Article 4 of the EC Council Regulation 1346/2000 provides that:

The law of the State of the opening of proceedings shall...determine in particular:
(i) the rules governing the distribution of proceeds from the realisation of assets, the ranking of claims and the rights of creditors who have obtained partial satisfaction after the opening of insolvency proceedings by virtue of a right in rem or through a set-off;

1.4. The Impact of the Pari Passu Principle within the Liquidation Process

1.4.1. Dispositions of Company Property

Article 221 of the Company Act reads:

In a winding-up by the court, any disposition of the property of the company, including any rights of action, and any transfer of shares, or alteration of the status of the members of the company, made after the date of its deemed dissolution, shall be void, unless the court otherwise orders.

Therefore, in a winding-up by the court, any dispositions of the company’s property after commencement of the winding-up but before the liquidator is appointed, is void, unless the court otherwise orders.

There is what may be called a ‘tense period’ between the time after the winding-up order has been acceded and before the appointment of the liquidator. In fact in this window the directors and secretary would still hold the ropes of the company. It is only when the liquidator is appointed that the powers of the directors and secretary

96 On Insolvency proceedings.
will cease\textsuperscript{97}. Article 221 attempts to address this problem by voiding any disposal of company property made by its directors or any person purporting to act on its behalf after the presentation of the winding-up application for the winding-up order\textsuperscript{98}.

The purpose for this article is to prevent the improper alienation and dissipation of the property of a company which would reduce the common pool of assets available to the creditors.

1.4.2. Provision for the Acceleration of Liability on Winding-up

Under the Commercial Code, debts owing by the bankrupt but which have not yet fallen due, even if privileged, secured by pledge, or hypothecary, become exigible upon the declaration of bankruptcy made by the trader himself or upon the judgment of the court declaring the bankruptcy\textsuperscript{99}. No similar provision is found under the Companies Act. Therefore doubt is expressed whether the position is similar under Maltese corporate insolvency provisions.

However, under article 238(1)(d) of the Companies Act, the liquidator has the power:

\begin{quote}
\textit{to make any compromise or arrangement with creditors or persons claiming to be creditors, or having or alleging themselves to have any claim, present or future, certain or contingent, ascertained or which may be due in damages against the company…}
\end{quote}

Therefore, as the liquidator has the power to make a compromise or agreement with a creditor who has a future claim then, this implies that although the debts have not yet fallen due they may still be subject to a compromise or agreement as stipulated. Moreover, article 301 of the Companies Act enshrines that future debts may be provable:

\begin{quote}
all debts payable on a contingency, and all claims against the company, present or future, certain or contingent, ascertained or which may be due in damages, shall be admissible as proof against the company…
\end{quote}

\textsuperscript{97} Companies Act, article 295.
\textsuperscript{98} This is also the deemed date of dissolution.
\textsuperscript{99} Commercial Code, article 487.
However, neither of the above two articles expressly hold that debts which have not yet fallen due are exigible. They merely show how future debts will be considered by the liquidator when making a compromise and when admitting the formal claims of the creditor.

R. Goode\textsuperscript{100} states that in the case of an executed contract, the winding-up of a company which is a party to the contract automatically accelerates the debt. Hence, the debt becomes due. Under UK law this is subject to a statutory discount on the amount of the debt to allow for the acceleration when a dividend distribution comes to be made\textsuperscript{101}.

On the other hand, the same author claims that where a contract is still executory at the time of winding-up, the liquidator has the prerogative whether to adopt such contract or not\textsuperscript{102}. When making this decision the liquidator will regard the economic benefit and risk involved in the transaction. A clause in the contract providing for the acceleration of the company’s liability in regards to a contract which is still executory in the event of its going into liquidation would be void. Goode explains that if this were not the case there would be a scenario where either the liquidator adopts the contract and the company’s assets would be used to make payment before the company receives the benefit against which the payment was made. Or, in the situation where the liquidator does not adopt the contract, the other party would be in the legal position to receive payment for a supposed debt in respect of which payment had not been earned.

\subsection*{1.4.3. Provision for Divestment of Ownership on Winding-up}

Goode states that a clause in the contract of sale of an asset which stipulates that an asset would revert back to the transferor in the event that the transferee company goes into liquidation is null as it is inconsistent with the principle of outright transfer of ownership and also with the insolvency law principle of \textit{pari passu}. If property is

\begin{itemize}
  \item \textsuperscript{100} R. Goode, Principles of Corporate Insolvency Law, 2nd ed., (Sweet & Maxwell, 1997) p. 146
  \item \textsuperscript{101} Insolvency rules 1986, r. 11.13(2)
  \item \textsuperscript{102} This point will be explained in more detail in the forthcoming chapter
\end{itemize}
transferred to a person then such property must be available to his creditors. Therefore, such forfeiture clauses will be struck down. However, there is the possibility of reserving title on the asset until full payment is made by the purchaser\textsuperscript{103}. In which case, if there is default in payment the asset would revert back to the transferor.

Goode goes on to state that insolvency law distinguishes between a \textit{limited interest} and an \textit{absolute interest}. In the former case there is no legal objection to a disposition of property which was granted to the company for an interest coming to an end on winding-up. On the other hand, an absolute interest is one which is granted outright and if it is granted with a proviso for retransfer if the company goes into liquidation such proviso would be void as it would be a forfeiture of the outright interest.

\textbf{1.4.4. Provision for the Determination of Lease or Agreement on Winding-up}

Based on the previous sub-title, Goode states that, agreements entitling a party to terminate a \textit{limited interest} conferred on another if that other becomes insolvent, define liquidation as the event on which the interest becomes terminable. The termination may either be automatic, in which case there is no removal of an asset from the estate as it no longer exists, or it may be at the discretion of the grantor of the interest which binds the liquidator and creditors as it binds the company in liquidation. Therefore, provision for the termination of a lease on winding-up does not contravene the \textit{pari passu} principle since it is a limited right. The effect of such termination provision is that the lease or contract right which prior to liquidation constituted an asset of the company is removed from the reach of the general body of creditors.

Therefore, as seen above, there is a distinction between the ‘recapture’ of an outright interest and the termination of a limited interest. However, both have the effect of

\textsuperscript{103} This shall be seen in 3.2.2.
removing from the debtor’s estate property which could be available to the general body of creditors.

Unfortunately, there are no provisions under Maltese law which make a distinction between limited and outright interests and whether a provision for their forfeiture on winding-up is void. Such provisions are called for, as may create legal uncertainty. However, article 1569 of the Civil Code holds that a contract of lease can be dissolved *ipso jure* upon the fulfillment of a condition expressly contemplated in the contract of lease. Thus, this leaves open the possibility of such condition being the winding-up of the leasee.

1.4.5. **Provision for Security or Increased Security on Winding-up**
Objectively speaking, there is no law under Maltese legislation which forbids any agreement which provides that on liquidation an unsecured debt shall become secured or that the amount already secured on those assets shall increase. Any such agreement would contravene the *pari passu* principle as it would diminish the estate of the insolvent company at the time of liquidation. Goode writes that such provisions would be null.
Chapter 2. Exceptions to the *Pari Passu* Principle

### 2.1. Introduction

The *pari passu* principle is not absolute. It admits of certain deviations. These have the effect of granting priority of payment, out of the estate of the insolvent company, to certain creditors over the other ordinary creditors. Due to such payments, the residual amount which will be available for *pari passu* distribution among the ordinary creditors may prove to be negligible.

The scope of this chapter is to discuss the exceptions of *pari passu* in relation to the distribution of the assets owned by the company being wound-up.

It is important to point out that *pari passu* distribution does not apply to the rights of suppliers of goods under agreements reserving title or to creditors for whom the company holds assets on trust or on any other fiduciary capacity. These instruments are not exceptions to the *pari passu* principle but relate to assets which, although are in possession of the insolvent company do not belong to it, and thus, do not fall to be distributed among the insolvent company’s creditors. This difference shall come to the fore during the progression of the thesis.

### 2.2. The Exceptions

#### 2.2.1. The Expenses of Liquidation

Article 293 of the Companies Act provides:

> All costs, charges and expenses properly incurred in the winding-up, including the remuneration of the liquidator, shall be payable out of the assets of the company in priority to all other claims, and they shall, in so far as applicable, be paid in the order of priority established under article 258 of this Act unless the Court otherwise directs.

---

104 Therefore shall not be discussed in this chapter.
The expenses properly incurred\textsuperscript{105} by the liquidator in the winding-up of the company, whether it is wound-up by the court or voluntarily\textsuperscript{106}, are payable out of the company’s assets in priority to the debts, obligations and liabilities of the company incurred before the liquidation began. They are therefore paid ahead of all other claims.

These expenses include the costs and expenses incurred by the company to comply with the procedure of liquidation as for example the remuneration of the liquidator.

Article 258 of the Companies Act provides that if the company being wound-up is so insolvent that its assets are insufficient to fully pay all the liquidation expenses, then court may make an order as to their payment. This article holds:

The court may, in the event of the assets being insufficient to satisfy the liabilities, make an order as to the payment out of the assets of the costs, charges and expenses incurred in the dissolution and winding-up in such order of priority as the court thinks fit.

(2) In so doing the court shall have regard to the following general order of priority -
\begin{itemize}
\item[(a)] expenses properly chargeable or incurred by the official receiver or the liquidator in preserving, realising or collecting any of the assets of the company;
\item[(b)] any other expenses incurred or disbursements made by the official receiver or under his authority, including those incurred or made in carrying on the business of the company;
\item[(c)] the remuneration of the provisional administrator, if any;
\item[(d)] the costs of the applicant, and of any person appearing on the application whose costs are allowed by the court;
\item[(e)] the remuneration of the special manager, if any;
\item[(f)] any amount payable to a person employed or authorised to assist in the preparation of a statement of affairs or of account;
\item[(g)] any allowance made by order of the court, towards costs on an application for release from the obligation to submit a statement of affairs, or for an extension of time for submitting such a statement;
\item[(h)] any necessary disbursements by the liquidator in the course of his administration, including any expenses incurred by members of the liquidation committee or their representatives and allowed by the liquidator;
\item[(i)] the remuneration of any person employed by the liquidator to perform any services for the company, as required or authorised by the provisions of this Act;
\item[(j)] the remuneration of the liquidator.
\end{itemize}

\textsuperscript{105} The phrase 'properly incurred', here implies that expenses of liquidation do not include expenses incurred through transactions which involve breaches of duty on the part of the liquidator.

\textsuperscript{106} Although article 293 of the Companies Act applies to voluntary winding-up.
Liquidation expenses are followed by the claims of the preferential creditors. Only the pool of assets remaining after all these claims have been paid shall be available for the general body of ordinary unsecured creditors\textsuperscript{107}.

2.2.1.1. Payments of Pre-liquidation Debts to Preserve Assets or Avoid other Loss

Article 258(2)(a) quoted above includes as liquidation expenses payments incurred by the official receiver or the liquidator in carrying out contracts which the company entered before the commencement of the liquidation process of the insolvent company. These are contracts which the liquidator finds necessary to satisfy in order to preserve the asset to which debt relates to. A typical example is a payment to avoid forfeiture of a lease.

As these payments are classified as costs of liquidation, they do not have to be proved as in the case of pre-liquidation debts.

In the context of this sub-article there may be some difficulty in identifying which debts fall under the scope of this article. It is clear that new transactions entered by the liquidator constitute post-liquidation claims whilst liabilities accrued under contracts such as that of lease before winding-up are caught by the \textit{pari passu} principle and enjoy no priority. However, difficulties arise in relation to obligations under contracts or leases entered prior to the liquidation process and which continue to remain effective during the period of liquidation. Under English case law the test is: if the liquidator adopts the transaction entered prior to liquidation, for the benefit of the winding-up, it shall be considered to constitute a post-liquidation expense\textsuperscript{108}. However, if the liquidator merely continues in passive possession of the subject of the transaction, the debt will enjoy no priority in payment. Hence, rent or other liability accruing after the adoption of the transaction is an expense of the liquidation, whereas

\textsuperscript{107} R. Goode, Principles of Corporate Insolvency Law, 2nd ed., (Sweet & Maxwell, 1997) pg 154

\textsuperscript{108} \textit{ABC Coupler and Engineering Co. Ltd (no.3)} [1970]1 All ER 656
the rent accruing after the commencement winding-up but before adoption is merely a provable debt.

2.2.1.2. **Post-Liquidation Creditors**

Article 258(2)(b) classifies expenses incurred or disbursements made for the purpose of carrying on the business of the company as expenses of liquidation.

Post-liquidation creditors are those who transact with the company being wound-up after the commencement of the liquidation process. Article 238(1)(b) gives power to the liquidator with sanction of the court or of the liquidation committee to carry on the business of the company so far as may be necessary for the beneficial winding-up thereof.

Before discussing the merits as to the reason why post-liquidation creditors are paid before the ordinary creditors, it is appropriate to highlight the legitimacy of transactions incurred by the liquidator after the liquidation process commences.

Article 4 sub-article (4) of the Companies Act provides for the distinct legal personality of the commercial partnership:

A commercial partnership has a legal personality distinct from that of its member or members, and such legal personality shall continue until the name of the commercial partnership is struck off the register, whereupon the commercial partnership shall cease to exist.

Only once a company is struck off the register does its personality cease to exist. As winding-up is a process which leads to the striking off from the Register of Companies, a company which is being wound-up maintains its distinct legal personality. In the case *Ragonesi noe vs. Refalo noe*\(^{109}\) the court stated that:

“…kumpanija f’ stat ta’ likwidazzjoni tirritjeni l-personalita’ guridika taghha”

\(^{109}\) *4th November, 1979 Commercial Court*
This was also seen in *Dr. Leslie Grech noe v. Registrar of Partnerships*\(^{110}\) where it was stated that:

“Bix-xoljiment tal-kuntratt ma tispiccax il-personalita’ guridika tas-socjeta’ stante li din tispicca meta jsir il-kancellament mir-Registru”

It is essential that during the winding-up process the company continues to have a separate legal personality as the liquidator may need to continue trading as far as is necessary for the beneficial winding-up of the company and therefore for the benefit of the existing creditors. In order to do so the liquidator might incur further expenses called ‘post-liquidation expenses’.

The notion of post-liquidation creditors is best understood by distinguishing them from the pre-liquidation creditors of the company being wound-up. Whereas, the pre-liquidation creditors need to prove their debt and rank for a ‘share of the insolvent estate’\(^{111}\) on a *pari passu* basis\(^{112}\), the post-liquidation creditors are entitled to be paid in full and need not prove their debt in competition with the other creditors.

The disparity of treatment between the post-liquidation creditors and pre-liquidation creditors is justified. The liquidator enters post-liquidation transactions in order to attempt salvaging as much as possible from the estate of the insolvent company\(^{113}\). In theory, by means of these transactions, the estate of the insolvent company increases. “If creditors were asked to supply funds during the post-liquidation period they would be unlikely to oblige if the debts involved were not to enjoy priority over pre-liquidation creditors, as, if so, they would be seen as subsidising the pre-liquidation creditors”\(^{114}\). Hence the claims of post-liquidation creditors are paid in full in priority of other debts.

---

\(^{110}\) *23rd May, 1977 Commercial Court*

\(^{111}\) Hereon referred to as ‘dividend’.

\(^{112}\) Unless they benefit from a lawful preference.

\(^{113}\) To achieve the beneficial winding-up of the company.

In *Bondin vs. Vella noe*\(^{115}\) the court made an express distinction between pre-liquidation and post-liquidation claims. In this case Bondin instituted an action against the liquidator of a company in liquidation for the payment of the outstanding debt which constituted the rent for two garages which were rented by the said insolvent company. From the facts of the case it transpired that the contract of rent of one of the garages, “Huttafa” was entered before the company was put into liquidation\(^{116}\), whilst the contract of rent of the other garage “St. Joseph” was entered after the company was put into liquidation\(^{117}\). The liquidator did not protest the payment of amount owed for the rent of this latter garage “dan ghas-sempliċi raguni illi dik il-kirja saret bl-intervent u koxxenza tieghu”. In fact, in regard to this garage the court held:

Il-konvenut *nomine* ghandu jkun obligat jaghmel taghha in kwantu din tikkostitwixxi nefqa jew spiza necessarja waqt il-kors ta’ l-istralc.

However, in regard to the garage “Huttafa”, the court held that Bondin was not yet in a position to ask for the amount due in rent as the court held that the timing for requesting such payment was “intempestiva”. This as the court held:


Therefore the rent of one of the garage ‘St. Joseph’ was considered to be a post-liquidation transaction as it was entered knowingly by the liquidator and creditor after the liquidation proceedings were initiated. Hence the amount of the rent was to be was paid to Bondin before the distribution to the preferential and general body of creditors. On the other hand the contract for the rent of the garage ‘Huttafa’ was entered before the liquidation process commenced and therefore had to be paid

\(^{115}\) 10\(^{th}\) May, 1993

\(^{116}\) it was therefore a pre-liquidation claim

\(^{117}\) it was therefore a post-liquidation claim
subsequently together with the other claims of the general body of creditors. Hence, Bondin had to prove his claim for the rent of this latter garage.

2.2.2. **Preferential Debts**

After the expenses of liquidation have been fully satisfied the liquidator is to satisfy the preferential debts of the company being wound-up. Article 287 of the Companies Act states:

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

Preferential claims are those claims that must be satisfied in priority to the claims of any other creditor who does not have a similar or prior ranking preference. Hence, preferential debts are those which, by force of statute, fall to be paid in a winding-up in priority to all other debts except those which constitute liquidation expenses as discussed above. Moreover, preferential claims must be discharged in full before the remaining assets may be distributed on a *pari passu* basis to the ordinary creditors.

Just as in the case of liquidation expenses, payments of preferential claims are taken from the general assets of the company being wound-up. These essentially affect the ordinary creditors who would see reduce the assets available for distribution. Therefore, the more preferential claims the company has to satisfy, the less assets would be available to the ordinary creditors. In fact, it is only after all the preferential debts have been fully satisfied and there still are funds available in the estate of the company being wound-up, that this residual estate shall be distributed *pari passu* to the rest of the ordinary creditors. The Cork Committee noted that *pari passu* distribution of assets was in practice seldom, if ever, attained because, in the overwhelming majority of cases, the existence of preferential debts frustrates such distribution

---

“Since the existence of any preferential debt militates against the principle of pari passu distribution and operates to the detriment of ordinary unsecured creditors, we have adopted the approach that no debt should be accorded priority unless can be justified by reference to the principles of fairness and equity which would be liable to command the general public.”

It is thus empirical, for the purpose of this thesis to take cognizance of the preferential debts available at law. Unlike the UK who have an Insolvency Act, Malta does not have a specific insolvency legislation which comprehensively lists according to priority all the preferential debts. In fact under Maltese law, preferential debts are scattered in various pieces of legislation. This system creates a complex web of preferences. One may question why they have not been incorporated in a single legislation, ideally in the Civil Code or in an ad hoc legislation.

2.2.2.1. Preferential Debts under Maltese law

2.2.2.1.1. Preferential Debts under the Civil Code

It is important to note that UK law gives a creditor, in whose favour a privilege or a hypothec has been constituted, a property right over the asset so burdened. This means that the said creditor may realise the asset and retain the proceeds to exclusion of the other creditors, up the amount of the debt which the charge covered. Therefore under UK law, the assets covered by these charges fall outside the scope of liquidation and therefore do not need to be proved. On the other hand, under Maltese law, privileges and hypothecs give creditors a mere right of preference over the assets burdened by the charge. Hypothecs and privileges are therefore found among the list of lawful preferences which are liable to be paid ahead of other creditors in the liquidation process. Unlike under UK law, these assets do not fall outside the ambit of the liquidation process and therefore need to be proved. To this end one may read:

“La obbligazione personale lascia la liberta’ dei beni in mano al debitore; egli puo’ vincolarli al credito di un altro, o anche alienarli a prezzo libero, eccettuato il caso in cui il proposito di defraudare i creditori presenti sia evidente. E’ dunque un ben

119 Ibid, para. 1398.
120 As seen in 1.3.4.1.2.
121 This distinction shall become more apparent in 3.2.1.1.
122 Companies Act, article 1996.
labile garanzia quell ache dicesi ‘comune’ e garanzia puo’ dirsi nell’ oggetto anziche’ nell’ effetto.”

On the other hand,

“il creditore che stipula una ipoteca…non rinunzia alla sua garanzia generale, che assume una importanza sociale, quindi forma quell ache dicesi ‘la condizione’ e intanto imprime il suo diritto sopra cose particolari del patrimonio che piu’ non si confondono colle altre. La proprieta’ ne rimane come ferita e s’indebolisce di mano in mano” 123

Borsari says that the property, although affected by the real rights, do not cease to be the common guarantee of all the creditors, including the unsecured creditors. Such property always remains subject to the rights of the other creditors who may issue warrants of seizure or garnishee orders over it. Their right, however, is in turn subject to that of the preferred creditors who are paid first out of the price obtained from the sale of the property. The unsecured creditor will only be paid out of the surplus of such price, if any.

These lawful preferences found in the Civil Code are governed by the general principles of civil law. These are:

Principle 1:

Article 1995 of the Civil Code holds that:

The property of a debtor is the common guarantee of his creditors, all of whom have an equal right over such property, unless there exist between them lawful causes of preference.

Judge P. De Bono states:

“Il prezzo de’ beni venduti, le rendite de’ beni sequestrate, qualsisiano altri denari che possano essere rimasti, o che potranno pervenire in qualsiasi tempo nel patrimonio del fallito formano la commune garanzia de’ creditori do lui, i quali tutti vi hanno un eguale diritto, se fra essi non vi siano legettime cause di prelazione.” 124

123 Codice Civile Italiano, Vol. IV. ii, 443
124 Appunti di Lezioni sul Fallimento nel Diritto Maltese, Seconda edizione riveduta, ampliata e corretta, 1907.
The above article and quote, together with article 287 of the Companies Act, all suggest that that the property of a debtor shall be equally available to all his creditors unless they hold lawful causes of preference.

Principle 2:
These lawful causes of preference, include hypothecs and privileges. They ensure priority of payment to the creditor so secured in preference of post-ranking creditors or unsecured creditors. In fact article 1996 of the Civil Code provides:

The lawful causes of preference are privileges, hypothecs and the benefit of the separation of estates.

Also, article 1964 of the Civil Code states that pledge is a contract created as a preference for an obligation. Article 1966 of the Civil Code reads:

A pledge confers upon the creditor the right to obtain payment out of the thing pledged with privilege over other creditors…

T. Huntingford contends that the contract of pledge should not be classified as a privilege but should more generally be described as a cause of preference and hence listed along with the other lawful causes of preference mentioned in article 1996 of the Civil Code.

Principle 3:
Privileges and hypothecs, being real rights, are constituted over the property of the debtor. They are constituted either over the totality of the property or over one or more determinable movables or immovables. Article 2000 of Civil Code:

Privileges may exist over movables as well as over immovables.

Also article 2012 of the same code reads that:

A hypothec is general or special: it is general when it affects all the property present and future of the debtor;

---

125 Civil Code, article 2011: Hypothec is a right created over the property of a debtor or of a third party, for the benefit of the creditor, as security for the fulfillment of an obligation.
126 The benefit of separation of estates is granted to the creditors and legatees of a deceased person who may demand that the property of the inheritance be separated from that of the heir. This preference shall not be discussed as it is not relevant to this thesis.
127 Tonia Huntingford, LL.D., The Ranking of Creditors under Maltese Law, August 1977, p.36
128 In the case of general privileges and general hypothecs.
Although special hypothecs affect only specific immovable property, general hypothecs cover all property without distinction.

It is important to note, in the context of this thesis that, by means of article 303 of the Companies Act, unless the person in whose favour the privilege, hypothec or any other charge was constituted proves that he did not know and did not have reason to believe that the company was likely to be dissolved by reason of insolvency, any charge constituted by the company within six months before its dissolution shall be void if such constitution was proved to be at a significant undervalue or by way of preference to a creditor.129

2.2.2.1.1.1. Ranking of the Preferential Debts under the Civil Code130

Maltese law establishes a ranking system of the various types of preferential debts. Each preferential debt in a prior rank must be satisfied in full before a subsequent rank is paid.

Judge De Bono131 quotes article 305 of the Ordinanza132 which reads:

“I creditori con pegno, privilegiati, o ipotecari saranno graduati secondo le leggi attualmente in vigore.”

A replica of this article is today’s article 535 of the Commercial Code which holds:

Creditors having pledges, privileges or hypothecs shall be ranked according to the law for the time being in force.

The wording ‘for the time being in force’ implies that preferences shall be ranked according to laws in force at the time when the preference being ranked becomes effective.

---

129 This was discussed in 1.3.2.1.
130 For a sketch of the preferential claims ranking list please refer to Appendix 1
131 Appunti di Lezioni sul Fallimento nel Diritto Maltese, Seconda edizione riveduta, ampliata e corretta, 1907.
132 VII del 1868, art. 1767.
Article 1999 of the Civil Code describes a privilege as a right of preference that always ranks prior to a hypothec, even if the latter is registered at an earlier date\footnote{Ibid., article 1999: Privilege is a right of preference which the nature of a debt confers upon a creditor over the other creditors, including hypothecary creditors.}. A privilege exists only in the cases stipulated by law and hence, in this sense, a privilege is always legal. Therefore the law has selected certain circumstances that it considers expedient and necessary to encourage by giving them priority. Among themselves, privileged debts rank according to the particular nature of each privilege\footnote{Civil Code, article 2088.}.

Article 2089 of the Civil Code holds that:

Debts having a general privilege for any of the causes mentioned in paragraphs (a), (b) and (c) of article 2003 are paid in preference to those having any other privilege, excepting only the debt due to the pledgee as provided in paragraph (a) of article 2009.

Therefore, ‘the debt due to the pledgee, over the thing which he holds as a pledge’\footnote{Ibid., article 2009(a).} is liable to be paid before any other privilege and hypothec. What ranks after the pledge are those general privileges over property in general found in paragraphs (a)-(c) of article 2003. These are:

- (a) judicial costs;
- (b) funeral expenses;
- (c) death-bed expenses;

By means of article 2090 of the Civil Code\footnote{Ibid., article 2090 reads: Debts having a general privilege for any of the causes mentioned in paragraphs (d) and (e) of article 2003 are paid in preference to those having any other privilege, excepting the debts mentioned in paragraphs (a), (b) and (c) of the said article, the debt due to the pledgee as aforesaid, and the debt due to the hotel-keeper as provided in paragraph (b) of article 2009.}, after the above privileges have been fully paid, what ranks next is the debt due to the hotel keeper as provided in article 2009(b). This debt is immediately followed by the other privileges found in paragraphs (d) and (e) of article 2003 of the Civil Code namely ‘wages of servants’ and ‘supplies of provisions’.

55
All the special privileges over particular immovables rank after the general privileges and special privileges over movables.

Hypothecs, which as already stated are always paid after all the privileges have been satisfied, shall be paid in accordance with the order of their registration once all the privileges are fully paid.

2.2.2.1.2. Preferential Debts and their Ranking under Specific Legislation

These are preferences which are found in various chapters of the Laws of Malta. In effect they could be seen as bolstering the lawful preferences ranking structure established by the Civil Code. It is important to keep in mind here, the principle that any preference within the same rank shall be paid rateably.

Article 20 of the Employment and Industrial Relations Act provides:

Notwithstanding the provisions of any other law any claim by any employee in respect of a maximum of three months of the current wage payable by the employer to the employee, and compensation for leave to which the employee is entitled, together with any compensation due to the employee in consideration of the termination of employment, or any notice thereof, shall constitute a privileged claim over the assets of the employer and shall be paid in preference to all other claims whether privileged or hypothecary.

Therefore, the above provided compensation to employees shall be paid before any other claim of preference, even before any privilege or hypothec. However, the wording ‘shall be paid in preference to all other claims whether privileged or hypothecary’ does not make reference to the debt due to the pledgee, over the thing which he holds as a pledge. This seems to indicate that the ranking of the above privilege does not rank prior to that of pledge.

Council Directive 80/987/EEC applies to employees' claims arising from contracts of employment or employment relationships and existing against employers who are

---

137 Ibid., article 2092.
138 Excluding the Civil Code.
139 Ibid., article 2094.
140 Ch. 452 of the Laws of Malta
in a state of insolvency. It aims to provide a minimum degree of protection for employees in the event of the insolvency of their employer. The Directive was amended by Directive 2002/74/EC of the European Parliament and of the Council. Article 4 gives the option to Member States to:

…specify the length of the period for which outstanding claims are to be met by the guarantee institution. However, this may not be shorter than a period covering the remuneration of the last three months of the employment relationship

In line with the above provision of the Directive, Maltese law puts a cap on the amount which can constitute the privileged claim under this article. The amount cannot exceed the wage of three months. Moreover, by means of a proviso, Maltese law further qualifies the maximum amount which can constitute the preferential claim in that the amount shall not exceed the national minimum wage of six months.

According to V. Finch preferential debts constituted in favour of employees of the insolvent company are justified on the ground that this class of creditors are not able to adjust the terms on which they provide credit in order to provide for default of payment risks. Moreover, as opposed to trade creditors, employees are rarely in a financial position to be able to spread the default of payment risk. This means that employees are the ones who will suffer the most in economic hardship out of all other creditors. This is why they are given priority over other creditors. The same author is of the opinion that on efficiency grounds, “only employees, as an identifiable class of creditors merit special treatment…the characteristics of the other creditors are too diverse to enable the formulation of a general rule which favours them and which is justified on the basis of their ability to adjust credit terms or to bear risk of loss”.

The Social Security Act also provides for privileged claims over the assets of the employer and the self-employed for the Social Security contributions which they are bound by law to pay. Article 116(3) of the said Act reads:

---

141 Of 20 October 1980 on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer.
142 Of 23 September 2002
144 Ch. 318 of The Laws of Malta
Notwithstanding the provisions of any other law, the claim of the Director of any amount due by way of any Class One or Class Two contribution under this article shall constitute a privileged claim in the case of a Class One contribution, ranking equally with wages of employees over the assets of the employer, and, in the case of a Class Two contribution, over the estate of the self-employed or self-occupied person concerned and shall be paid in preference to all other claims (excluding wages) whether privileged or hypothecary.

The ranking established by this Act is twofold: as mentioned above, Class One contributions\(^{145}\) share the same ranking as wages of employees over the assets of the employer, and are satisfied between themselves on a pro rata basis\(^{146}\); Class Two contributions\(^{147}\) rank below Class One contributions, and are a reflection of the welfare state philosophy which opposes the bestowing of extra privileges on the self-employed.

The *Income Tax Management Act*\(^{148}\) makes income tax a privileged claim over the assets of the employer. This privileged claim ranks immediately after the privileged claims emanating from the Employment and Industrial Relations Act and the Social Security Act discussed above:

> Notwithstanding the provisions of any other law...the amount due to be paid under this article, shall constitute a privileged claim over the assets of the employer ranking immediately after the wages of employees and claims of the Director of Social Security for any amounts due by way of contribution under article 116 of the Social Security Act, and shall be paid after such wages and claims in preference to all other claims whether privileged or hypothecary\(^{149}\).

Article 62 of the *Valued Added Tax Act*\(^{150}\) holds:

> The Commissioner shall have a special privilege over the assets forming part of the economic activity of a person in respect of any tax due by that person under this Act and the said tax shall, notwithstanding anything contained in any other law, be paid in preference to a debt having any other privilege, excepting a debt having a general privilege and a debt mentioned in article 2009(a) or (b) of the Civil Code.

---

\(^{145}\) “Class One contribution" means a contribution which an insured person pays as an employed person;

\(^{146}\) Claims in the same rank shall be paid on a *pari passu* basis.

\(^{147}\) “Class Two contribution" means a contribution which an insured person pays either as a self-employed person, or as a self-occupied person;

\(^{148}\) Ch. 372 of The Laws of Malta

\(^{149}\) Article 23(1) of Ch. 372 of The Laws of Malta

\(^{150}\) Ch. 406 of The Laws of Malta
Therefore, the preference emerging out of this article ranks immediately after the general privileges found in article 2003 (d) and (e) of the Civil Code.

Moreover other special privileges are found in the Duty on Documents and Transfers Act\textsuperscript{151}. Article 49(b) provides for a special privilege in favour of notaries for the duty payable or paid by him on transfers of property \textit{inter vivos}. This special privilege has to be registered and shall rank together with the privilege contemplated under article 2010(c) of the Civil Code. Moreover the same Act, under article 66(4), creates a special privilege in favour of the Government of Malta for the duty payable over all property transferred \textit{causa mortis}.

It is not the main purpose of this thesis to list down in detail the ranking of privileges. However, it is appropriate for the reader to take cognizance of the various lawful preferences which give priority to certain creditors and which therefore have the effect of reducing the assets available for \textit{pari passu} distribution.

In fact it is only after the all lawful causes of preference indicated above have been fully satisfied that the ordinary creditors are paid out of the residual estate of the insolvent company. Judge P. De Bono states:

```
“Dedotte le spese di giustizia e di amministrazione del fallimento ed i soccorsi accordati al fallito e alla sua famiglia, demessi, secondo il loro grado, i creditori privilegiati e ipotecari, sul residuo del patrimonio si pagano i creditori chirografari in proporzione dei loro crediti verificati”\textsuperscript{152}
```

Judge De Bono continues to state that creditors whose claims exceed the amount which is covered by their privilege or hypothec ‘concorrono nella distribuzione del resto dell’ attivo, per quanto rimano loro dovuto.\textsuperscript{153} Preferential creditors are therefore considered to be ordinary creditors in respect of the difference between the amount of the creditor’s claim and the amount covered by the charge. This residual amount must be proved as is liable to be paid on a \textit{pari passu} basis.

\textsuperscript{151} Ch. 364 of The Laws of Malta
\textsuperscript{152} Appunti di Lezioni sul Fallimento nel Diritto Maltese, Seconda edizione riveduta, ampliata e corretta, 1907.
\textsuperscript{153} Ibid.
2.2.3. Claims which by Statute are Deferred
Under UK law, claims may be deferred by statute\textsuperscript{154}. This means that through statute, particular claims of creditors are placed below the claims of other creditors. For example, under Sections 213 to 215 of the UK Insolvency Act, debts owed by the insolvent company to a director found liable for wrongful or fraudulent trading may be directed by the court to be paid after all the debts of the company have been paid. No express or implied reference to deferred claims is found under Maltese law.

2.2.4. The Right of Set-off
Set-off is the right of a party to secure payment of what is due to him from the other party by reducing that amount due from what he owes himself, on a separate account, to the same other party. Set-off is thus a reciprocal payment which extinguishes, totally or partially, two debts which are mutually due by a debtor and a creditor.

Set-off is available both outside and within liquidation. In both cases it provides for a speedy remedy to secure payment as it avoids the duplication of action for payment. In fact, article 1196 of the Civil Code enshrines that when two parties are reciprocally in debt with each other the debts are set-off automatically. Therefore, in insolvency set-off, as in the case of ordinary set-off, there is no need for a defence or counterclaim by the insolvent debtor in order for set-off to operate.

There is moreover a moral justification for allowing set-off. The parties who engaged in mutual dealings extended each other’s on the reliance that there was the ability to take what is due from what is owed. If there wasn’t the reliance on such fact the credit would not have been extended in the first place. Hence, set-off is applied to make good for this reliance.

2.2.4.1. Insolvency Set-off under Maltese Civil Law
Whist the UK Insolvency Act creates specific rules for insolvency set-off, the articles of the Maltese Civil Code on set-off apply to both ordinary and insolvency set-off.

\textsuperscript{154} As seen in 1.3.4.1.6.
Section 1196 of the Civil Code states that set-off takes place automatically: ‘where two persons are mutual debtors.’ Sub-article 2 reads:

Set-off operates *ipso jure*, and even without the knowledge of the debtors. The moment two debts exist simultaneously, they are mutually extinguished to the extent or their corresponding amounts.

This occurs also in the context of insolvency law, if the two debts exist simultaneously then set-off shall operate automatically notwithstanding the fact that either one of the parties is insolvent or is in the process of liquidation.

Requisites for insolvency set-off to ensue:\textsuperscript{155}:

- Article 1197 of the Civil Code provides:

  Set-off shall only take place between two debts both of which have for their subject-matter a sum of money or a determinate quantity of fungibles of the same kind, and which are both for a liquidated\textsuperscript{156} amount and exigible.

Therefore, both debts must be monetary in nature and must be certain liquid and due. This principle came to the fore in the case *Edward Xuereb et ne vs. Robert Micallef*\textsuperscript{157}. It was held:

“Biex ikun hemm lok ghall-kompensazzjoni gudizzjali huwa mehtieg li jkun hemm zewg debiti li ghandhom bhala oggett flus jew determinate kwantita’ ta’ hwejjeg fungibili ta’ l-istess speci u li huma ugwalment likwidu u ezigibili”

- As in the case of ordinary set-off, insolvency set-off occurs where before liquidation there have been mutual credits, mutual debts or other mutual dealings between the company in liquidation and any creditor. Mutuality or reciprocity entails that the two parties each have a debt owed by and to the other. According to R. Derham\textsuperscript{158}, the mutual claims involved need not be connected or of the same type. For example one debt may be emerging from a

\textsuperscript{155} These are the same as the requisites for ordinary set-off to ensue as they are based on the same article.

\textsuperscript{156} Article 1197(2) of the Civil Code reads:

a debt shall be deemed to be for a liquidated amount if it is certain even with respect to the quantity thereof.

\textsuperscript{157} 8 ta’ Gunju 1942

\textsuperscript{158} R. Derham, The Law of Set-Off, 3\textsuperscript{rd} Ed., 2003, Oxford University Publishing. p.444
contract whilst the other from tort. They may also emerge from statutory or other legal origin. There is no provision under Maltese law which contrasts this position. In the English case *Morris v. Agrichemicals*\(^\text{159}\) a bank, BCCI, loaned money to company A. Subsequently, company B, who was the major shareholder of company A, deposited a sum of money with the same bank. The question which arose was whether the bank could apply the rules of insolvency set-off and use the deposits from B to reduce the debts owed to the bank by company A. The House of Lords answered in the negative due to the lack of mutuality as the borrower company A and the depositor were legally separate entities, though not separate economically.

- Although all the above requisites may be present, article 1199 of the Civil Code limits the applicability of set-off:

  Set-off takes place whatever may be the consideration of either of the debts, except in the following cases:
  1. when a demand is made for the restoration of a thing of which the owner was unjustly deprived;
  2. when a demand is made for the return of a deposit, or of a loan for use or commodatum;
  3. in the case of a debt in respect of maintenance not subject to attachment.

  In the case *L-avukat Dr. John Mamo noe vs. Edward Borg pro et noe*\(^\text{160}\) the Court held that ‘it-tpacija ssir, tkun xi tkun ik-kawza tad-dejn il-wiehed u l-iehor’ unless the debt of one of the parties falls within the exceptions listed in the aforementioned article or the debt is not certain or liquidated.

2.2.4.1.1. **The Effects of Insolvency Set-off**

Insolvency set-off is a major incursion of the *pari passu* principle as the creditor need not prove his claim and compete with the other creditors for payment. The creditor who sets-off his debt with the company in winding-up does not pass through the ordinary liquidation process as the amount which is owed to him is set-off as soon as the two debts are certain, liquid and due.

\(^{159}\) (1997)

\(^{160}\) ta’ Gunju, 1990, Hon. Carmelo Scicluna LL.D
Therefore, this institute has the net effect of ensuring that the creditor of the company being wound-up would receive the full or partial amount of his claim ahead of the other unsecured creditors. The creditor’s loss is limited to the difference which he would have to prove with the other creditors in the event that the creditor is owed more than what is actually set-off. On the other hand, if the creditor owes more to the company than what was set-off, then the difference would be available for distribution among the other creditors of the company.

Vanessa Finch states that allowing insolvency set-off worsens the position of other creditors who are not engaged in a mutual debt relationship with the insolvent company. She contends that the effect of set-off is to remove from the insolvent estate the value of the asset which represents the debt due to the creditor. Yet she concedes that it guards against injustice to the solvent creditor, who, had this institute not been allowed, would have had to pay in full the debt he owes to the insolvent company knowing he will not in turn receive what is owed to him in full\textsuperscript{161}.

The same author goes on to state that the only situation in which the insolvency set-off rule operates to the advantage of the company being wound-up (company A) and therefore of the general body of creditors, is where the claimant (company B) is more insolvent than company A. In this situation, if insolvency set-off were not ensue the debts would have to be proved and be paid on a \textit{pari passu} basis. Due to the fact that the company B is more insolvent than company A and therefore has less funds available\textsuperscript{162}, the percentage of dividend which would be paid by the company B to company A\textsuperscript{163} on a \textit{pari passu} basis would be smaller than what would be paid to company B by company A. On the other hand, insolvency set-off would guarantee that company A gets paid ahead of other creditors in full\textsuperscript{164}. In this case the amount

\begin{footnotes}
\item[162] For distribution among the creditors.
\item[163] As an ordinary creditor
\item[164] Unless company B owes more to company A than vice versa in which case the difference would have to be proved as an ordinary creditor.
\end{footnotes}
received by company A from the set-off would exceed the amount it would receive as an ordinary creditor had there not been the set-off.

### 2.2.4.1.1.1. The Nature of Insolvency Set-off under UK law

The statutory rules set out in Rule 4.90 of the UK Insolvency Rules 1986 make set-off on winding-up mandatory. From English jurisprudence it transpires that the reason for the mandatory nature of insolvency set-off is that the statutory provisions relating to set-off of an insolvent company are considered to regulate matters of public interest and that the orderly administration of such company’s estate is not deemed to be a source of private rights enacted for the benefit of individual debtors. This is seen in *Rolls Razor v. Cox* where the court held that a washing machine salesman was entitled to set-off sale proceeds against retained commission that the insolvent company owed him. The court justified its decision on the legal fact that set-off could not be excluded by contractual agreement between parties which had purported to rule it out.

Although the Cork Committee urged that contracting out of set-off should be allowed in *Maxwell Communications Corporation (No.2)* Vinelott J. urged that the mandatory nature of insolvency set-off could be justified in efficiency terms because this was a procedure whereby the company and body of creditors could benefit. The creditor could settle at least part of his debt without having to prove it and the troubled company would be relieved of the need to engage in potentially expensive proceedings in order to recover the debt due to it. Moreover, in the *Halesowen* case Lord Simon stated that set-off was not a private right which those who benefited from it were free to waive. It was a matter in which the commercial community generally had an interest and accordingly this was a right that could not be contracted out of. It was held that since the regime for the administration of

---

165 The mandatory rule of set-off could be seen in *National Westminster Bank Ltd. v. Halesowen Presswork and Assemblies Ltd (1972)*
166 [1967] 1 QB 552 439
167 Cork Report, para. 1341-62
168 (1993)
169 *National Westminster Bank Ltd. v. Halesowen Presswork and Assemblies Ltd (1972)*
insolvent estates embodies important elements of public policy, and since the rights of insololvency set-off form part of that regime, the creditor given such right of set-off cannot contract out of them.

In line with the above reasoning, the English rules on insolvency set-off displace all other forms of set-off not exercised prior to the winding-up. They therefore displace all other forms of set-off including contractual set-off not exercised prior to the winding-up\textsuperscript{170}.

\subsection*{2.2.4.2. Contractual Set-off}
Whilst insolvency set-off operates when there are mutual debts which are certain liquid and due, contractual set-off provides for the set-off of mutual debts of parties to a contract who agree to set-off such debts before they become certain, liquid and due. This basic form is typically used where it is known in advance that the mutual obligations will be monetary and therefore no special contractual arrangements are required to convert non-monetary obligations into monetary obligations. However, contractual relationships which are not of this character require a process that leads to consolidation of mutual claims into a single net balance. This contractually adopted process is known as netting.

\subsubsection*{2.2.4.2.1. Contractual Set-off under UK Insolvency Law}
In contractual set-off the parties are free to agree on almost any kind of netting and set-off arrangement they choose. However, as has just been discussed in the previous sub-title, once a company has gone into liquidation the rules of insolvency set-off displace all other forms of set-off not exercised prior to the winding-up. Thus, under UK law, the provisions of contractual set-off will cease to be operative upon the winding-up of one of the parties to the contract.

\textsuperscript{170} However, set-off implemented before winding-up remains effective.
2.2.4.2.2. Contractual Set-off under Maltese Law

Contractual set-off is regulated in Malta by of the Set-Off and Netting on Insolvency Act\textsuperscript{171}. Article 3(1) of this Act states that:

Notwithstanding the provisions of any other law, any close-out netting provision or any other provision in any contract providing for or relating to the set-off or netting of sums due from each party to the other in respect of mutual credits, mutual debts or other mutual dealings shall be enforceable in accordance with its terms, whether before or after bankruptcy or insolvency, in respect of mutual debts, mutual credits or mutual dealings which have arisen or occurred before the bankruptcy or insolvency of one of the parties, against:

(a) the parties to the contract,
(b) any guarantor or any person providing security for any party to the contract,
(c) the liquidator, receiver, curator, controller, special controller or other similar officer of either party to the contract, and
(d) the creditors of the parties to the contract.

Before enactment of the Set-Off and Netting on Insolvency Act any non-legal set-off, including contractual set-off, was blocked on insolvency of one of the parties\textsuperscript{172}. Thus contractual set-off was negatively effected by bankruptcy or insolvency as it could not be availed of by the parties. Today by means of the above Act, close-out netting provisions (or any provision in any contract providing for the set-off or netting of sums due in respect of mutual credits, mutual debts or other mutual dealings) are valid and enforceable under Maltese law, whether such close-out netting takes place before or after bankruptcy or insolvency. However, the mutual debts, mutual credits or mutual dealings must have arisen or occurred before the bankruptcy or insolvency of one of the parties or else the contractual stipulation would be held to be void as it would confer on the creditor an unfair advantage on the other creditors. In fact sub-articles (4) and (5) of the same Act state:

(4) Subarticle (1) shall not apply in respect of any close-out netting agreement entered into at a time at which the other party knew or ought to have known that an application for the dissolution and winding-up of the company by reason of insolvency was pending, or that the company has taken formal steps under any applicable law to bring about its dissolution and winding-up by reason of insolvency.

(5) Subarticle (1) shall also not apply where the insolvent party is an individual or a commercial partnership other than a company and the other party knew or ought to have known of events of the same nature as stated in the preceding subarticle in relation to the insolvent party.

\textsuperscript{171} Ch. 459 Laws of Malta, Set-Off and Netting on Insolvency Act.

\textsuperscript{172} Dr. Salvatore Schembri nomine vs. Mons. Can. Cap. Don Michele Farrugia, Civil Court of Appeal, 23\textsuperscript{rd} May, 1917
The principles established in the Set-off and Netting on Insolvency Act derived mainly from the Directive 98/26/EC of the European Parliament. By means of this Act, the parties may expressly agree through a contract for set-off to take place in a particular way or for mutual obligations to be netted out against each other in the event of the termination of the agreement because of any reason including insolvency.

The Maltese Act enshrines that set-off and netting occurs only if there is a contractual stipulation, called a ‘close out netting provision’, to that effect between the debtor and the creditor. This shall be ‘enforceable in accordance with its terms’. Thus the agreement for set-off is effective on the happening of any particular event bargained for by the parties and is not displaced by legal set-off in the event of the liquidation of one of the parties.

Thus the requisites for set-off on insolvency under this Act to ensue are the following:

- There must be a contract which contains a close-out netting provision or any other provision relating to the set-off or netting of sums due;
- There must be mutual credits, mutual debts or other mutual dealings;
- Such mutual credits, mutual debts or other mutual dealings must be enforceable, either before or after the insolvency;
- The mutual credits, mutual debts or other mutual dealings must have arisen before the insolvency of one of the parties.

The Set-Off and Netting on Insolvency Act provides for a very strong protection for the application of the contractual set-off. Sub-article (6) of Article 3 states:

(6) Notwithstanding the provisions of any other law, nothing shall limit or delay the application of any provision of any contract providing for or relating to set-off or netting which would otherwise be enforceable and no order of any court nor any warrant or injunction or similar order issued by a court or otherwise and no proceedings of whatever nature shall have any effect in relation thereto.
There is another important difference between Insolvency set-off under the Civil Code and the Contractual set-off under the Set-off and Netting on Insolvency Act. Whilst the former requires the mutual debts, credits or dealings must be monetary in nature, article 4(a) of the Set-Off and Netting on Insolvency Act states that the parties to the contract providing may for the purposes of set-off ‘agree on any system or mechanism which will enable the parties to convert a non-financial obligation into a monetary obligation of equivalent value’. Dr. Portanier to this end writes:

“The effect of the Set-Off (and Netting on Insolvency) Act has been to legislatively cater for close-out netting, whether before or after insolvency, and for related matters such as the ability to convert a non-financial obligation into a monetary obligation of equivalent value. This facilitates the entering into of repurchase agreements, swaps and similar financial transactions with Maltese counterparties.”

Moreover, in the context of this thesis, contractual set-off increases the scope of set-off which is in itself an institute which reduces the pool of assets available for distribution. It therefore has the effect of further reducing the effect and application of the *pari passu* principle.

### 2.2.4.3. Set-off under EC Council Regulation 1346/2000

In the case of cross-border insolvency proceedings the Regulation 1346/2000 establishes which laws on set-off shall be applicable. Regulation 4.2:

> The law of the State of the opening of proceedings shall determine the conditions for the opening of those proceedings, their conduct and their closure. It shall determine in particular:
> (d) the conditions under which set-offs may be invoked;

Here it is seen that laws of set-off which will be applicable shall be those in which the insolvency proceedings were opened, therefore in the Member State where the debtor has the centre of his main interests. Yet, the Regulation provides that if a set-off is not permitted under the law of the opening State, a creditor should nevertheless be

---

173 Dr. C. Portanier, Insolvency Close-Out Netting in Malta, The Company Lawyer, Vol. 26 No. 11, November 2005
174 On insolvency proceedings.
entitled to the set-off if it is permissible under the law where the insolvent debtor’s claim arises. In fact Article 6 of the EC Regulation provides that:

The opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor’s claim.

2.2.5. Subordination Agreements

There are some relatively modern English pronouncements which state that the *pari passu* principle constitutes a mandatory rule as it constitutes a principle of public policy expressed through legislation. From this reasoning it follows that, it is not open to parties to exclude themselves by any private arrangement from the operation of the principle.\(^\text{175}\) Therefore, any contractual provision excluding the principle of *pari passu* distribution, whether in bankruptcy or in winding-up, is void. In *Ex p. Mackay*\(^\text{176}\) it was held:

“…a man is not allowed, by stipulation with a creditor, to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides”\(^\text{177}\)

“…a person cannot make it a part of his contract that, in the event of his bankruptcy, he is then to get some additional advantage which prevents the property form being distributed under the bankruptcy laws.”\(^\text{178}\)

However, under article 291 of the Companies Act provides that in the case of any voluntary winding-up, ‘any arrangement entered between a company in course of being wound-up and its creditors shall, subject to the right of appeal, be binding on the company if sanctioned by an extraordinary resolution, and on the creditors if acceded to by two-thirds in value. Hence, this article may be seen as implying that the company and its creditors may agree to deviate from the *pari passu* principle.

Subordination agreements are agreements entered before the company goes into liquidation which have the effect of distorting the queue of creditors which the *pari

\(^{175}\) *National Westminister Bank Ltd v. Halesowen Presswork & Assemblies Ltd* (1972) A.C. 785 (HL)  
\(^{176}\) *Ex p. Mackay* (1873) 8 Ch. App. 643  
\(^{177}\) James L.J. at 647  
\(^{178}\) Mellish L.J at 648
*pari passu* principle seeks to maintain. They enable creditors to contractually agree that their secured or unsecured claim be subordinated to the claims of other creditors.

English case law raised a debatable concern that, in the event of winding-up, a subordination agreement might be held as void as it would be running counter to the mandatory provisions of the insolvency legislation. This was a consequence of the decision of the House of Lords in *National Westminster Bank Ltd. v. Halesowen Presswork and Assemblies Ltd*\(^{179}\) where it was held that, as a debtor could not contract out of his statutory right of set-off then by analogy a creditor could not subordinate his claim in winding-up to a claim of equal rank as this would infringe the *pari passu* rule.

British courts consistently held that an agreement that purports to improve the position of a creditor who would normally be subject to the *pari passu* rule, will not, for reasons of public policy, be effective when the debtor company is in liquidation. However, although under certain conditions subordination may cause unfairness to be occasioned, generally subordination only worsens the position of the contracting party. It therefore involves no unfairness to other creditors. Moreover, the UK Insolvency Rules expressly recognise the right of a creditor to assign his right of dividend to another creditor\(^{180}\) which is what subordination really is. Upon this reasoning, contracting out of the *pari passu* principle through subordination agreements was thus allowed.

The above seems to indicate that one can contract out of one’s assigned place in the queue if the result would be to increase the insolvency value available for the remaining unsecured creditors but not if it would decrease that value. However, in *National Westminster Bank Ltd. v. Halesowen Presswork and Assemblies Ltd* it was held that one is not allowed to change one’s place in the queue for the pool of the insolvent’s assets simply because that would increase the insolvency share for the

---

\(^{179}\) *(1972)* *A.C.* 75

\(^{180}\) Insolvency Rules 1986, r. 11.13(2)
remaining creditors. Hence, in this case the House of Lords struck down the
subordination agreement.

Some years later, English jurisprudence changed its abovementioned reasoning in the
ground-breaking decision *Re Maxwell Communications Corp. (No.2)*. Here,
Vinelott J. did not see why bondholders, who had entered into an investment
arrangement fully aware of the subordination of their claims, should be treated as the
rest of the creditors at the time of the insolvency. The judge read the *British Eagle*
case as laying down the rule that ‘a creditor cannot validly contract with his debtor
that he will enjoy some advantage in a bankruptcy or winding-up which is denied to
other creditors’. However, Vinelott J. held that subordination agreements do not all
have this effect of bringing an advantage, on the contrary, they could have the
opposite effect of benefiting all the ordinary unsecured creditors, at the expense of
the creditor in whose favour the subordination was agreed. The agreement in the case
in question did not give any advantage to the creditor over the others and it was
therefore allowed. Moreover, a recent English *Squires and others (liquidators of
SSSL Realisations (2002) Ltd) v AIG Europe (UK) Ltd and another* confirmed that
subordination clauses are effective. This was the first time that the English Court of
Appeal upheld the validity of subordination agreements.

Maltese law and jurisprudence has, for a long time, been silent on the subordination
of creditor’s rights. This is why the discussion revolving around it is based on UK
law. The only justification under Maltese law for allowing the subrogation of claims
in the event of the insolvency of the company was found in the general principle of
the Civil Code which reads:

Contracts legally entered into shall have the force of law for the contracting parties.

This was confirmed by the advent of the Securitisation Act, 2003. This Act
expressly provides for an amendment to the Civil Code which gives the creditor

---

182 [2006] EWCA Civ 7
183 Civil Code, article 992.
rights to modify his/her rights. This implies that a creditor can, even in insolvency subordinate his claim for payment:

It shall be lawful for a creditor to agree to subordinate, waive or otherwise modify his rights of payment, enforcement, ranking and other similar rights to the rights of other creditors and any such agreement shall be binding on the parties to the contract, whether before or after the insolvency of any party to the contract.”

2.2.6. Special Cases

Professor Goode lists two special cases which do not fit with the above classification but which in his opinion should not be included in the pari passu system of distribution.:

- Contracts related to the operation of financial and money markets, exchanges and clearing house;
- Environmental Liability

The first category is protected under Maltese law through the concept of ring fenced funds. This shall be seen in more detail in 3.2.3.2.3.

The latter category is a clean up liability which should be enacted for the protection of the environment. Roy Goode\textsuperscript{185} is of the opinion that, if before winding-up the company’s operations have caused damage to the environment, the liquidator should be have the obligation to apply to the assets of the company to remedy the damage in priority to the claims of other creditors.

Goode points out that there is public interest argument that such claims are given priority. However, he indicates that the courts will probably construe legislation to ensure that the burden of environmental liabilities does not fall onto creditors. In light of this he states that it is therefore likely that no priority will be accorded to such claims\textsuperscript{186}.

\textsuperscript{184} Government Gazette of Malta No. 17,873 - 31st January, 2006
\textsuperscript{185} R. Goode, Principles of Corporate Insolvency Law, 2nd ed., (Sweet & Maxwell, 1997) p. 162
\textsuperscript{186} Ibid.
As Maltese and UK legislation is silent on this question, much depends on how the court decides to characterise the liability. Hence, is it to be considered an ordinary unsecured debt which needs to be proved? Or is to be considered a post-liquidation expense payable ahead of other creditors? Or is it to be treated separately as a public liability carrying a distinctive priority?

2.2.7. Conclusion
The departures from the *pari passu* principle highlighted in this chapter are based on a combination of history policy and pragmatism and reflect a wide range of considerations:

- The protection of legitimate expectations, ensured by the institute of set-off;
- The need to obtain the continuing supply of goods and services for the beneficial winding-up of the business thus necessitating the payment in full of debts arising under post-liquidation contracts;
- The desire to provide safeguards for those who have not voluntarily assumed a risk and are ill-equipped to provide for it, such as employees;
- And the wish to subordinate the claims to those who are expected to bear a higher risk than the general body of creditors.

It is said that *pari passu*, as a principle of corporate insolvency law provides an efficient and fair method for allocating the insolvent estate. However, as discussed during the progression of the previous chapter, the exceptions to *pari passu* leave this principle looking complex and uncertain.

Moreover, R. Mokal opines that the multiplicity of these exceptions leave little room for anything to be distributed *pari passu*. In his words: the ‘equality’ principle, which is at the basis of *pari passu*, ‘does not have too much application in the real world’\(^\text{187}\). He claims that the exceptions hinder the application of the principle making it one that is seldom applied in practice. He claims that, although English judgments hail the

\(^{187}\) R. Mokal, Corporate Insolvency Law, Oxford University Press, 2005. p.95
pari passu principle as mandatory, in reality it is “far from sacrosanct”.\textsuperscript{188}

\textsuperscript{188} R. Mokal, Corporate Insolvency Law, Oxford University Press, 2005. p.94
Chapter 3 Bypassing *Pari Passu*

3.1. Introduction

As seen in the previous chapter, when dealing with the insolvent estate of the company being wound-up, the law does not readily allow contracting out of collective arrangements. There is a subtle line between contracting out of *pari passu* and avoiding it altogether. The individual creditors benefit from devices which ensure that certain assets remain outside the insolvent company’s estate and therefore not available to its general body of creditors.

Once assets are caught in the estate of the insolvent company being wound-up they cannot be subsequently withdrawn. If this were not the case the situation would be unfair to the general body of creditors who would see reduce the pool of assets available for distribution. However, a creditor may avoid the collective insolvency regime of *pari passu* by *a priori* ensuring certain assets do not enter the estate of the insolvent company. These assets would only be available to those creditors who have a right *in rem* on them to the exclusion of the general body of creditors.

Goode\(^{189}\) draws a distinction between property rights and personal rights. Whereas the holder of a property right can enforce such right on an asset/s of the company being wound-up ahead of the general body of creditors, the holder of a personal right can only prove for dividend in competition with other creditors. Therefore, in the context of insolvency law, a creditor who does not have a property right in any asset held by the company and who fails to exercise any other form of self-help open to him before winding-up process commences, may only obtain payment by means of the insolvency procedure.

Allowing property rights to be enforced ahead of the general body of creditors’ rights in the insolvency estate has a twofold effect:

---

1. The claimant who holds a property right can often recover most, sometimes all that is owing to him from the insolvent company;

2. The assets available for distribution will be reduced to the detriment of the ordinary unsecured creditors. In Goode’s words:

“At the heart of insolvency law lies the principle of pari passu distribution: all creditors share and share alike. Every proprietary right given against assets held by the debtor reduces the value of its estate available for distribution and, as a corollary, the interest of unsecured creditors in the liquidation process and the value of insolvency law itself.”

Therefore, creditors who have a claim in rem over a particular asset fall outside the ambit of the collective regime of the pari passu distribution as the asset is not considered to be within the estate of the company being wound-up. Hence, such creditor may proceed on the asset without needing to prove his claim.

This chapter shall explore the methods and extent to which pari passu can be bypassed. A central issue here will be whether its effectiveness of this principle is undermined due to the frequency of practice of these bypassing devices.

What must be kept in mind throughout this chapter is:

- Article 5 of the EC Council Regulation on Insolvency Proceedings which holds that:

  The opening of insolvency proceedings shall not affect the rights in rem of creditors…in respect of tangible or intangible, moveable or immoveable assets—both specific assets and collections of indefinite assets as a whole which change from time to time — belonging to the debtor which are situated within the territory of another Member State at the time of the opening of proceedings.

- Moreover, all these devices which give a right in rem to a creditor are subject to the limitation of article 303 of the Companies Act discussed in 1.3.2.1.

---

191 Property right and rights in rem have the same meaning.
3.2. Devices used to Bypass Pari Passu Distribution

3.2.1. Security

3.2.1.1. Comparison between Maltese & UK law

As briefly discussed in 2.2.2.1.1., under UK law securities are considered as property rights whilst in Malta they are merely seen as giving the creditor lawful causes of preference. Hence, within the classification adopted in this thesis, under the UK system, securities are considered to be devices which bypass pari passu, whilst under Maltese law they are considered to be exceptions to the pari passu principle.

Under Maltese law preferential creditors debtors are paid out of the proceeds of the secured asset so secured in priority to the general body of creditors. This may lead to the conclusion that the Maltese system does not differ that much in effect from that of the UK. In fact, as under the latter system, although the asset is considered to be outside the liquidation process, it also gives the secured creditor a right of priority over the proceeds.

However, under the Maltese system the secured asset remains part of the estate of the company being wound-up. Such asset does not cease to constitute a guarantee for the rest of the unsecured creditors. The preferential debt still has to be proved and therefore the asset/s which are under the charge are subject to the administration of the liquidator. Therefore, the creditor who holds a security in his favour is paid in preference to the general body of creditors out of the proceeds of the secured asset which would be realised by the liquidator.

As under UK law the asset is considered to be outside the estate of the insolvent company, it does not constitute a guarantee for the rest of the unsecured creditors. A UK creditor who holds a security interest or other real right in an asset owned or possessed by the company, is paid what is due out of the proceeds of the said assets to the exclusion of all other creditors, except for those who have a stronger claim than him in that particular asset. Moreover, as the assets are considered to be outside the

193 Civil Code, article 1996.
estate of insolvent company such assets covered by the security will not be under the administration of the liquidator. Goode states that ‘in winding-up, security rights may be asserted so as to inhibit the liquidator’s ability to deal with the company’s trading stock for the purpose of beneficial winding-up of the business’\textsuperscript{194}.

Under both systems, after the secured debts are paid out of the proceeds of the asset, any surplus shall be available for distribution to the general body of creditors. Under the UK system the creditor may realise the asset which is under the security at his discretion. He need not ensure that he gets the best price for the asset. Indeed his sole concern is that he gets paid what is due to him and does not care whether there could be a surplus. On the other hand, if the asset were under the administration of the liquidator, as in the Maltese system, the latter would have the duty towards all the proved creditors of the company. Hence, the liquidator would have a duty to realise the asset at its best price. Hence, the Maltese classification of securities seems to be more friendly to the general body of creditors.

\textbf{3.2.1.2. The Case in Favour of Securities}

Irrespective of whether the securities are considered as preferential claims\textsuperscript{195} or as property rights\textsuperscript{196}, they play a crucial part in expanding the availability of credit and therefore of raising finance. However, in both cases, once the company becomes insolvent and the secured creditors call in their debts, securities have the effect of reducing the pool of assets available for the general body of creditors. At face value, this can be argued to be unfair on the unsecured creditors. However there are three arguments which counter this proposition and advocate the fairness of security devices.

\textsuperscript{195} Maltese system
\textsuperscript{196} UK system
3.2.1.2.1. The Security has been Freely Bargained

When a debtor fails to pay a debt on its due date, the creditor is entitled to avail of all the rights and remedies given to him by his contract and by law. This rationale is found in article 1994 of the Civil Code which states:

Whosoever has bound himself personally, is obliged to fulfill his obligations with all his property, present and future.

This justification postulates that it would be contrary to the principles of contract law to deny the creditor an advantage which he legally ensured. Hence, once a creditor freely bargained for the security it is just to give such creditor priority over the proceeds of the asset. This is unless the security which was freely bargained is proved to be a fraudulent preference in terms of article 303 of the Companies Act\(^\text{197}\).

Moreover, although the granting of security to a creditor will increase the risks faced by other creditors because it reduces the expected value of the insolvent estate, such other creditors may become aware of this risk and could adjust their loan rates accordingly to make good for this risk or seek their own security or quasi-security\(^\text{198}\).

Yet there are some objections to the ‘bargain’ justification in favour of securities:

- Those who enter into such arrangements for credit do not have the same leverage to negotiate a security structure or at least loan rates which would cover them from the risks of the insolvency of the borrower. A clear example would be small trade creditors who may lack adequate information, expertise and economies of scale which would allow them to evaluate the risks involved and make them equal bargainers with those seeking security\(^\text{199}\).

- There could be a number of involuntary creditors who would have not taken account any security arrangements of the company with other

\(^{197}\) As referred in 1.3.2.1.
creditors as they would have become creditors against their will. Tort victims fall within the ambit of this objection.  

- Some text writers are of the opinion that the freedom of contract is not sacrosanct:

“When the contract impinges on the right third parties, there is no prima facie presumption of freedom of contract.”  

### 3.2.1.2.2. It does not Deprive the Company of Value

This argument is closely linked to the bargaining issue raised above. It asserts that when a creditor takes a security for the value of the loan he is not withdrawing from the company more than he or she has actually paid in. Hence, the third party unsecured creditors are not prejudiced by the secured creditor.

However, in the UK, securities may be granted with ‘after-acquired property’ clauses. These clauses direct property, which is acquired by the company subsequently to the creation of the security, to fall within the original security arrangement and not into the pool for the benefit of the unsecured creditors. This may be seen as unfair as the secured creditor’s risk will diminish but the interest rate which he bargained for will remain the same (high). For this reason floating charges have been criticised as they are seen as unfairly allowing a charge on all future property. This criticism may be extended to general hypothecs granted under Maltese law. They too relate to ‘all the property present and future’. Hence, if the security granted by the debtor is a general hypothec, all the property which he may subsequently acquire will fall under the security, thus reinforcing the position of the secured creditor and reducing that of the unsecured creditors.

---

203 Civil Code, article 2012 (1).
3.2.1.2.3. The Notice Justification

This argument urges that securities are justified when the other unsecured creditors are duly informed of any grant of security which may affect them. This justification presumes that upon such information the ordinary creditors would adjust the terms of their supply or loan.

Moreover, according to article 2032 of the Civil Code:

General privileges, and special privileges over movables, are not subject to registration. Only special privileges over immovables\(^{204}\) and hypothecs\(^{205}\) need to be registered in order to be effectual. Hence, under Maltese law, the notice justification does not find much support and application.

V. Finch\(^{206}\) opines that unfairness can be reduced by improving information flows to unsecured creditors. Proposals have been made to the effect that secured creditors might have to go beyond mere registration and take reasonable steps to inform unsecured creditors of their intentions if they are to place the latter in a subordinate position. Yet such requirements may increase costs.

Moreover, as stated in 3.2.1.2.1., the notice justification does not give appropriate consideration to involuntary creditors or to voluntary creditors who, although would be informed, would not be in a position to adjust their terms to the granting of security\(^ {207}\).

---

\(^{204}\) Civil Code, article 2029.
\(^{205}\) Ibid., article 2033.
3.2.2. Retention of Title and Quasi-Security

‘Quasi-security’ devices such as retention of title, hire purchase and lease agreements, factoring and sale and lease-back contracts are used in order to supply credit to a company and avoid the scope of pari passu in the event of it becoming insolvent. Rather than deal with all the varieties of quasi-security, this chapter shall focus on the retention of title clauses.

In the case *V. Bonnett vs G Azzopardi*, the court explained the nature and effects of the contract *pactum cum riservati dominii* under Maltese Law:

“In natura intrinsika ta’ dan il-kuntratt hija li fih zewg stadji ben distinti. Is-sid ta’ l-oggett jittrasferixxi lill-kerrej l-uzu u l-pussess ta’ l-oggett ghall-kirja specifika, b’dan li l-proprjeta’ ta’ l-oggett ma tgħaddix ghand ix-xerrej sakemm il-prezz ma jkunx imhallas kollu. Il-venditur jibqa’ legalment konsidrat li hu s-sid ta’ l-oggett u l-proprjeta’ tieghu ma tgħaddix lill-venditur sakemm il-prezz tieghu ma jkunx gie saldat”

Robert Goff LJ in *Clough Mill Ltd. v. Martin* held that a retention of title (ROT) clause ‘consists of an act of reservation by the seller of his pre-existing proprietary rights over the thing to be sold.’ This is therefore a clause which ensures that the ownership of assets delivered to the debtor company remains vested in the transferor until the purchaser pays the full price of the sale. This is seen in a number of local cases. In *Carmelo Cremona vs. Salvatore Farrugia* the defendant claimed that the plaintiff had no right to bring an action for payment as the time to bring such an action was extinguished through prescription. The court held that in a hire purchase system the “oggett issir tal-konvenut malli tivverifika ruhha l-kundizzjoni tal-pagament tal-prezz kollu kif gie stipulat.” Therefore, as the defendant was not holding the object as his, prescription could not start running in his favour.

---

208 Goode has employed the phrase ‘quasi-security’ to describe certain legal devices which by law reinforce the likelihood that an obligation will be performed, but which are not characterised as security interest at law.
209 ([A.K. 28 ta’ Gunju 1922)]
210 [1985] 1 WLR 111, 116
211 Primi Awla tal-Qorti Civili, 24 ta’ Ottubru, 1964
212 The defendant was not holding as owner.
Hence, in default of such payment the object sold reverts back to the seller. This presupposes that on the insolvency of the buyer it is inevitable that there would be the default of payment and therefore the reversion of the object back to the seller. However, if there isn’t such default before the company goes into liquidation, the liquidator may keep on paying the installments in the name of the insolvent company in order not to forfeit the insolvent company’s right to the asset\textsuperscript{213}.

Under section 1526 the Italian Civil Code in the event of the termination of the agreement, the seller must repay the price installments he has received, with the exception of a certain amount of money, which he is entitled to withhold as an indemnity for the use of the asset. This amount is not established by the Italian law, rather it is assessed by the judge on the basis of ‘fair compensation’ for depreciation and use of goods. Under Maltese law the nature of the institute of ROT is contractual and therefore any provision for compensation or repayment must be provided in the contract of supply.

In order for the supplier to retain title on the goods supplied a clause to this effect must be entered in the contract of sale or supply. This is seen in local cases such as \textit{Regina Auto Dealer Limited vs Miller Distributors Limited}\textsuperscript{214}. This judgment made reference to other pronouncements:


\textsuperscript{213} As was seen in 2.2.1.1.
\textsuperscript{214} Regina Auto Dealer Limited vs Miller Distributors Limited u Dr. Anthony Cutajar u P.L. Victor Bugeja li b’digriet tad-9 ta’ Ottubru 2000 gew nominate kuraturi deputati sabiex iharsu l-interessi tal-assenti Renato Caruana u dana ghal kull interess li jista` jkollu: Il-Prim Awla tal-Qorti Civili, 30 ta’ Mejju 2002
The importance of the contractual stipulation is also evident in English case law. In *Aluminium Industrie Vaassen B.V. v. Romalpa Aluminium Ltd.* a Dutch supplier had sold aluminium foil to an English company. Under the terms of supply the Dutch company had retained title to the foil until it was fully paid. The English purchaser went into receivership and the question arose as to whether the Dutch suppliers were entitled to recover the foil which was in the hands of the liquidator. If Dutch claim were accepted it would have the effect of converting the plaintiffs from unsecured creditor to having a claim *in rem* against the assets of the defendant company in priority to the general creditors. Both Mocatta J. and the Court of Appeal, on the basis of the contractual stipulation entered between the two parties, upheld the claim of the Dutch suppliers. This enabled them to recover the foil.

One of the implications of the non-transfer of ownership is that: if the asset covered by the clause is one that escalates in value, it is the creditor/supplier who will benefit from the increase in value if the asset reverts back to him in the event of the default in payment. Moreover, even in the absence of such default, any increase in value of the object will benefit the seller as the buyer would have to continue paying the installments on the full value so escalated. Therefore, the increase in value implies that the creditor is given priority on previously unsecured values which are beyond the transaction which the ROT clause refers to. However, the supplier would not benefit from the increase in value if the parties agree to cap the amount payable in consideration for the asset under the clause.

However, the supplier availing of a ROT clause properly formulated may be deprived of the ownership of the goods in two circumstances:

- If the goods supplied have been converted into fixtures they are treated as being part of the land and will pass with the land. Article 308(f) of the Civil Code enshrines that any movable which is annexed to a tenement

\[216\] The contract provided: ‘the ownership of the material to be delivered by the seller will only be transferred to the purchaser when he has met the all that is owing to the seller, no matter on what grounds.’
permanently, to remain incorporated, shall become an immovable by nature. Therefore, the fixtures become part of the land. Hence the creditor who supplied goods, which were converted into fixtures, under a ROT clause will lose his right *in rem* over such assets supplied and therefore he becomes a normal creditor who has to queue up with the other unsecured creditors.

- If the goods under the ROT clause are sold by the buyer, before he fully pays the supplier, to a person in good faith then, according to article 558 of the Civil Code, this shall produce in favour of the third party the same effects as title. Hence the supplier will be divested from his title to the goods. However, article 559 provides that the goods may be recovered from by indemnifying the *bona fide* possessor if the goods were lost or robbed. This is also seen under English law by virtue of the operation of section 25 of the Sale of Goods Act 1979. Hence, by means of these provisions the company can, by selling the goods to a *bona fide* purchaser as a “buyer in possession”, pass good title even though the company itself lacked legal title at the time. This contrasts with the case *Carmelo Vella vs. Commissioned Gunner Steward R. Honour, R.N*\(^{217}\). Here the object in question was in the possession of the defendant under hire purchase. The latter sold the same object before the full price was satisfied. The court considered such sale as a sale of a *res aliena* and therefore considered the latter sale as null. The court did not go into whether the third party was in good faith or not.

### 3.2.2.1. Title Retention of Mixed Goods

This sub-title attempts to highlight the legal position in the situation where goods supplied on ROT clause are mixed with other goods.

Under article 580(1) of the Civil Code, where there is a mixture of goods belonging to separate parties, either of them may demand the separation if the person requesting separation did not give his assent to the commixture and the materials used can be

---

\(^{217}\) *First Hall Civil Court, 26th October, 1953*
separated without injury to such materials. However, if they cannot be so separated, the thing created by the commixture becomes the common property of the parties in proportion to the value of the materials belonging to each party prior to the commixture\textsuperscript{218}.

However, English case law shows that ROT clauses may provide for the reservation of title, not merely in the original goods delivered but also on the proceeds of sale of such goods or in products manufactured from such goods or in the proceeds of such products. Hence, the suppliers may make provision for the event of the goods being mixed or sold prior to the price being paid in full and therefore prior to the transfer of ownership. This serves to further protect the supplier. In the \textit{Romalpa} case\textsuperscript{219} the Court of Appeal held that when a seller supplies goods to a buyer under a retention of title clause and authorises the buyer to sell the goods under the condition that the latter accounts for the proceeds of sale, the supplier may, on the buyer’s insolvency, rely on the fiduciary relationship established and have an equitable right to trace those proceeds and prevent them from falling into the insolvent estate of the buyer. Hence, under this clause the seller is given a right \textit{in rem} over the proceeds and does not have to compete for a share in the buyer’s insolvency estate as the goods remain distinct from the insolvent estate. However, if there were no such contractual stipulation reserving title in the manufactured product or its proceeds, then there would be no fiduciary relationship between the seller and the buyer and the former would not be able to trace the new product or its proceeds\textsuperscript{220}.

In \textit{Re Peachdart} it was held that when retention of title clauses are made to retain title in new products or proceeds thereof, the court will construe such clauses as intending to vest legal ownership of the manufactured product in the hands of the buyer subject to a registrable charge in favour of the seller\textsuperscript{221}. Yet, according to Goff LJ in \textit{Clough

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{218} Civil Code, article 580(2).
\item \textsuperscript{219} (1976)
\item \textsuperscript{220} \textit{Borden (UK) Ltd v. Scottish Timber Ltd}. [1979] 3 WLR 672
\item \textsuperscript{221} [1984] Ch 131 466
\end{itemize}
\end{footnotesize}
Mill Ltd. Martin it is possible for the buyer and seller to agree which of them is to become owner of the manufactured product:

“I from my part can see nothing objectionable in an agreement between parties under which A, the owner of the goods, gives possession of those goods to B, at the same time conferring on B a power of sale and a power to consume the goods in manufacture, though A will remain the owner of the goods until they are either sold or consumed.”

3.2.2.2. ‘All-Monies’ Provision
According to V. Finch223 a particularly useful version of the retention of title clause, from a creditor’s point of view, is the ‘all-monies’ provisions. This provision ensures that the seller retains title over all products supplied to the seller until all debts owed to the seller on any ground are paid in full. The advantage of this provision is that it is not necessary to identify which goods from the supplied stock have been paid by the buyer as all the stock remains under the effect of the retention of title clause even though some of this stock has been paid.

The ‘all-monies’ provisions have the effect of keeping the goods which have been fully paid by the company being wound-up out of its estate. This will inevitably prejudice the company’s general body of creditors. This as the stocks which would have been paid by the company being wound-up would still not be considered to have entered its estate. Therefore such assets would not be available for distribution.

3.2.2.3. The Benefit of ROT224 Clauses
The supplier of goods is rarely in a position to require full payment of the asset on delivery to the buyer. A ROT clause is, above all, a type of security which originates from practice and is intended to provide the supplier with a means of retrieving unpaid goods from insolvent customers. If this practice were not available, suppliers would have to prove their debt in the liquidation process and thus only be paid a fraction of what is owed. As a consequence, suppliers would be more reluctant

---

222 [1985] 1 WLR 111, 116
224 Retention of title
to supply goods which would not be paid for. Therefore, a sale subject to a ROT clause may be considered as a financial facility in favour of the buyer as it allows the buyer to immediately use the goods or machinery by merely paying instalments on the full price.

**3.2.2.4. The Unfairness of the ROT Clauses**

As stated above, retention of title clauses do not have to be registered. The Cork Report held that this may be unfairly misleading to the unsecured creditors as they won’t have a clear indication of the insolvency risks when supplying goods on credit to a company or when lending money to such company\(^\text{225}\). The unsecured creditor would see an amount of assets in the possession of their debtor without knowing that such assets belong to his suppliers. What makes matters worse for the unsecured creditors is that corporate accounts routinely treat goods supplied under retention of title arrangements as purchases by the debtor company. The assets appear in the balance sheet and it is rare for auditors’ notes to mention that they are held under ROT clauses\(^\text{226}\). Hence, it can be said that the assets ‘remain invisible until they become important’\(^\text{227}\).

V. Finch regards ROT clauses as unfair as such devices are not equally available to all creditors. Suppliers of goods which are consumed on use such as fuels, paint, and food are unable to use ROT clauses. Also suppliers who engage in a series of ‘one-off’ transactions may find it far more difficult to impose ROT clauses on their debtors. Moreover, Finch opines that the unfairness seen above may be compounded by inequalities of bargaining power. Powerful creditors may be able to impose retention of title clauses on debtors whilst suppliers with less market clout may be unable to retain title on the goods they supply. The effect of this is that the creditors who are unable to use the ROT clauses would be in a situation where they ‘are loaded with the insolvency risks of the suppliers who are able to use such a bypassing

---

\(^{225}\) Cork Report, paras. 1631-65

\(^{226}\) C. Williams, ‘Retention of Title: Some Recent Developments’ (1991) 12 Co. Law. 54

\(^{227}\) Belcher and Beglan, ‘Jumping the Queue’, *Journal of business law*, 1997, p.17
device\textsuperscript{228}. Hence ROT arrangements may prove to be unfair as it shifts insolvency risks on those creditors who are new and weak in the market.

Notwithstanding the above ‘unfairness’ the Cork Report justified the retention of title clauses by saying that retention of title clauses are a contractual freedom which should not be restricted:

“… suppliers are entitled… to take steps to protect themselves and that it would be wrong to deny them the protection they seek.”\textsuperscript{229}

However, the Committee recommended that there should be a disclosure requirement along the lines of article 9 of the US Uniform Commercial Code. Thus, there should be: a disclosure of the names of the suppliers imposing retention of title clauses; descriptions of the types or classes of goods covered by the clauses; and the maximum amount that at any one time could be secured by the clauses\textsuperscript{230, 231}. It is useful noting that in France and Italy, like in the USA, ROT clauses require registration to be effective. However, the EC Directive 2000/35/EC\textsuperscript{232} does not require such registration. However, article 6.2 of the Directive leaves the door open to every Member State to provide for the possibility of this protection to creditors:

Member States may maintain or bring into force provisions which are more favourable to the creditor than the provisions necessary to comply with this Directive.

### 3.2.2.5. EU Law Provisions on ROT Clauses

By means of Directive 2000/35/EC, ROT is mentioned in EC legislation. Article 2.3 of the Directive reads:

Retention of title means the contractual agreement according to which the seller retains title to the goods in question until the price has been paid in full.

Moreover, Article 4 states:


\textsuperscript{229} Cork Report, paras. 1633-4

\textsuperscript{230} This latter requirement of disclosure illustrates that Cork considered that a duly registered retention of title clause should be limited to the price outstanding on the goods immediately contracted for and should not take the all-monies or all-liabilities form.

\textsuperscript{231} ibid, para. 1638

Member States shall provide in conformity with the applicable national provisions designated by private international law that the seller retains title to goods until they are fully paid for if a retention of title clause has been expressly agreed between the buyer and the seller before the delivery of the goods.

In practice, the EC legislators’ aim is not to regulate or even to harmonise a standard ROT clause. This seems to be impossible owing to the very different legal structure of sale contracts in various member states. However, their aim is to induce national legislators to actually guarantee its enforcement.

Moreover, EC Council Regulation 1346/2000\textsuperscript{233} also provides for ROT. This highlights the frequency of its use in today’s business world hence it underlines the need for specific legislation on the issue. Article 7 states:

The opening of insolvency proceedings against the purchaser of an asset shall not affect the seller’s rights based on a reservation of title where at the time of the opening of proceedings the asset is situated within the territory of a Member State other than the State of opening of proceedings.

3.2.2.6. Jus Retentionis

The right of suppliers emanating from ROT clauses is to be distinguished from \textit{jus retentionis}. The latter right is found in the following provisions of the Civil Code:

Article 1391: The seller is not bound to deliver the thing, if the buyer does not pay the price thereof, unless the seller has allowed the buyer time for payment.

Article 1392(2): Nor shall he be bound to make delivery if, since the sale, the buyer has become a bankrupt, or insolvent, or his condition has been so altered that the seller is in danger of losing the price.

The difference between the two devices is that whilst ROT presupposes that the ownership of the asset remains with the vendor until full payment and therefore the asset would not be available to the creditors of the buyer, \textit{jus retentionis} is based on the possession of the asset until payment. The latter implies that the ownership in the asset has already passed before full payment and therefore is exposed to creditors of the buyer. However, the supplier has a right to retain the asset until payment by the buyer.

\textsuperscript{233} On Insolvency Proceedings
Whilst, ROT clauses place the asset out of the reach of the creditors of the buyer, basing herself on article 1997(1) of the Civil Code\textsuperscript{234}, Tonia Huntingford contends in her thesis that \textit{jus retentionis} constitutes a right of preference over the price of the object bought:

\begin{quote}
“Thus, privileged and hypothcary creditors cannot rank before the ‘detentor’ where his rights of retention subsist. Since this right, or rather, the effects of this right subsist when the ‘detentor’ has been dispossessed of the thing by virtue of a garnishee order, it may well be said that the ‘detentor’ retains his right of preference over the price.”\textsuperscript{235}
\end{quote}

3.2.3. **Trusts**\textsuperscript{236}

If a sum is loaned by one company to another for a specific purpose and the borrowing company becomes insolvent, the lender will have little chance of recovering the full amount lent. This situation may be avoided if the lender forwards the money on trust.

3.2.3.1. **Background Provisions**

Article 3 of the Trusts and Trustees Act\textsuperscript{237} states that once a trust is created, a person will (trustee) hold as owner or will have vested in himself property under an obligation to deal with that property for the benefit of a person or persons (the beneficiaries). With the exception of a declaratory trust\textsuperscript{238}, a trust is created by the settlor who provides trust property or makes a disposition on trust or to a trust.

The trustee has full power and the duty to administer, employ or dispose of the trust property in accordance with the terms of the trust and any special duties imposed on the trustee by any law applicable thereto. He may sue and be sued in respect of the

\textsuperscript{234} Civil Code, article 1997(1): The provisions of this Title shall not affect the right of retention in cases in which such right is competent according to law.

\textsuperscript{235} Tonia Huntingford, LL.D., The Ranking of Creditors under Maltese Law, August 1977. p.13

\textsuperscript{236} Article 6A of the Trust and Trustees Act limits the scope to the said Act. In the context of this thesis paragraph (1)(v) of this article states that where a law of Malta contains provisions with regard the protection of creditors in matters of insolvency which cannot be derogated from by voluntary act, such law shall prevail over the terms of the trust if such trust is governed by Maltese Law. This, unless the Act or any other law relating to trusts specifies otherwise.

\textsuperscript{237} Ch. 331 of the Laws of Malta

\textsuperscript{238} A declaratory trust is a trust that is created unilaterally, whereby a person, already holding certain property, declares himself or herself to be a trustee of such property.
trust or otherwise act in all matters concerning the trust\textsuperscript{239}. Yet, although it may seem that the trustee has in relation to the trust property all the powers of a natural person having the absolute title to such property, this is clearly not the case as these powers have to be exercised in the interest of the beneficiaries in accordance with the terms of the trust\textsuperscript{240}.

Article 1124A of the Civil Code states that: trusts create fiduciary obligations on the trustee in favour of the beneficiary of the trust. It is thus the beneficiary who has a beneficial interest on the property under the trust\textsuperscript{241} and not the trustee or settlor of the trust. The beneficiary’s interest is personal to him in that his creditors, spouses, heirs or legatees have rights only to the extent of the beneficiary’s entitlements under the trusts and have no other rights in relation to the trust property or the trustee\textsuperscript{242}. Therefore, the creditors of the beneficiary may resort to the assets under the trust as long as the total amount of the debts contracted by the beneficiary does not exceed value of the assets under the said trust.

### 3.2.3.2. The Concept of a ‘Ring fenced Fund’

Trusts give rise to a ring fenced fund. This means that if money is lent to a company on trust, the property under the trust will remain separate from the personal property of the trustee. This implies that the debtor qua trustee does not hold the beneficial ownership of the assets under the trust. Hence, in the event of the insolvency of the trustee (borrower), his creditors will not have recourse to the assets held on trust.

The concept of a ring fenced fund is not only found in relation to trust law. It is also found in various laws affecting the financial services market. These serve as protection for the customers in the event of the insolvency of broker companies or of other intermediaries. By means of this concept, the assets held by the broker company

\textsuperscript{239} Trust and Trustees Act, article 3(3).
\textsuperscript{240} Ibid., article 24.
\textsuperscript{241} Ibid., article 9(1).
\textsuperscript{242} Ibid, article 9(2).
on behalf of their customers is considered separate from the company’s assets and hence, will not be subject to the claims of the broker company’s creditors.

3.2.3.2.1. ‘Ring Fenced Fund’ under the Civil Code

Article 1124A(b) of the Civil Code reads that trusts give rise to fiduciary obligations whenever the fiduciary:

holds, exercises control or powers of disposition over property for the benefit of other persons, including when he is vested with ownership of such property for such purpose;

Article 1124B of the same Code states that: although the fiduciary is vested with the ownership of the property and third parties may act in relation to the fiduciary as though he were absolute owner, such property is not subject to the claims or rights of action of his personal creditors, nor of his spouse or heirs at law.

3.2.3.2.2. ‘Ring Fenced Fund’ under the Trust and Trustees Act

The property constituting the trust is considered to be a separate and distinct fund from other property administered on other trusts or personally owned by the trustee\(^\text{243}\). The trust property will never enter the debtor’s estate and will therefore never enter the trustee’s personal estate and be available to his general body of creditors. In fact under article 21 (5) of the Trusts and Trustees Act, one of the duties of the trustee is to keep the trust property distinct and separate from their own property as well as from any other property held by him under any other trust or title, and separately identifiable from each other. However, the trustee may, if expressly permitted by the terms of the trust, or in any case where the trust property consists of fungible things, place and keep trust property in a common pool of identical assets or in a clients’ or common account. He may keep such assets in this way as long as his personal assets remain separate from those under the trust.

This concept of a ring fenced fund has the following legal effects\(^\text{244}\):

\(^{243}\) Ibid., article 3(2).
\(^{244}\) These legal effects extend to all fiduciary agreements.
(a) the personal creditors of the trustee shall have no recourse against the trust property;
(b) the trust property shall not form part of the trustee’s personal estate upon his insolvency or bankruptcy. 245

This ensures that if the trustee becomes bankrupt or insolvent, his creditors shall have no right or claim against the trust property except to the extent that the trustee himself has a claim against the trust property. 246.

The concept of separate patrimonies is important due to the fact that by means of article 32 of the Trusts and Trustees Act, the trustee may enter into transactions with third parties. Where in any such transaction or matter affecting a trust the trustee informs the third party that he is acting as trustee, a claim by such third party in relation to the transaction shall extend only to the trust property and not affect the personal property of the trustee. Hence, it is important for the creditors to know under what capacity the trustee is entering the transaction in order to know which estate is subject to eventual repercussions.

3.2.3.2.3. ‘Ring Fenced Fund’ under Specific Laws

These laws provide for protection to the customers of financial services companies who have their money held and administered by such companies. This money, although in the possession of such companies is considered to be a separate patrimony from its estate. Hence, it will never be available to their creditors in the event of their insolvency.

There are provisions under specific laws of Malta which compel companies or persons to hold money received from other persons in a separate account. These laws were enacted before the Trust and Trustees Act in order to create a ring fenced fund. This was in order to provide protection and certainty in the areas addressed.

245 Ibid, article 3(4).
246 Ibid., article 40A (2).
Article 19 of the Insurance Brokers and other Intermediaries Act\textsuperscript{247} provides that broker companies:

\ldots shall keep moneys held by it in a fiduciary capacity separate from its own moneys and shall, in respect of those moneys, maintain separate accounts in accordance with requirements determined by an insurance intermediaries directive made for the purposes of this article.

Moreover, Sub-article 2 of the same article clarifies that a person having a claim against the insurance broker company will not have access to the separate account held in a fiduciary capacity by the company:

No person shall have or obtain any recourse or right against moneys standing to the credit of the account referred to in subarticle (1) in respect of a claim or right against an enrolled company until all proper claims against those moneys have been satisfied.

The Investment Services Act (Control of Assets) Regulations\textsuperscript{248} also provides for the idea of a separate patrimony between the investment services company and its client. In fact article 3 holds that, the investment services company holding the assets of its customer in the course of rendering an investment service to such customer, shall do so solely for and on behalf of and in the interest of the customer. In fact the customer, whose assets are held under the control of a subject person\textsuperscript{249}, enjoys a right of ownership in such assets notwithstanding that they may be registered in the name and title of or are otherwise vested in the subject person\textsuperscript{250}. Therefore, the assets so held by the company, never enter the patrimony of such company and therefore never are available to its creditors. Sub-article 2 and 3 of the same article reinforces this:

\begin{enumerate}
\item[(2)] Notwithstanding anything stated in article 1894 of the Civil Code or in the agreement entered into between the subject person and the customer or the fact that a customer’s assets held under the control of a subject person are registered in the name and title of or are otherwise vested in the subject person, such assets \textit{shall be deemed to constitute a distinct patrimony, separate from that belonging to the subject person and from that of other customers} the assets of whom are also held under the control of the subject person.
\item[(3)] Except as expressly provided in the agreement entered into between the subject person and the customer and notwithstanding the provisions of the Civil Code, the control of assets belonging to a customer by a subject person shall not give or be deemed or construed to give to the subject person any rights over such assets nor shall it create any form of loan
\end{enumerate}

\textsuperscript{247} Ch. 404 of the Laws of Malta. \\
\textsuperscript{248} Subsidiary Legislation 370.05 \\
\textsuperscript{249} investment services company \\
\textsuperscript{250} Ibid, Article 4(1)
between the subject person and the customer and this notwithstanding the nature of the assets or the rights or obligations of the subject person in relation to the assets.

As already stated above, the concept of a distinct patrimony presupposes that the creditors of one patrimony do not have recourse to the other one. This is enunciated in article 5 of the Regulation:

The creditors of a subject person shall have no claim or right of action on or against the assets held under the control of the subject person for and on behalf of and in the interest of any customer and such assets shall not be affected in any manner by the provisions of laws and regulations in force regulating the insolvency or bankruptcy of the subject person.

Similarly, in relation to SICAVs, regulation 7 of the Companies Act (Investment Companies with Variable Share Capital) Regulations there is enunciated:

An umbrella or multi-class company may in its memorandum and articles of association elect to have the assets and liabilities of each sub-fund comprised in that company treated for all intents and purposes of law as a patrimony separate from the assets and liabilities of each other sub-fund of such company. Where an umbrella or multi-class company makes the election afore-mentioned the assets and liabilities of each sub-fund of that umbrella or multi-class company shall, for all intents and purposes of law be deemed to constitute a patrimony separate from the assets and liabilities of each other sub-fund of such a company.

3.2.3.3. The Relevance of Trusts in Corporate Insolvency

There may be situations where the settlor is also the beneficiary of the trust so created. This kind of trust is usually created in order to provide working capital to a company (the trustee) who is in turn to provide a service to the company constituting the trust. In this case, if the trustee were to become insolvent before the money under the trust is spent for the specific purpose it was constituted, then the money would return to the settlor. The logic behind this is: as the beneficiary has the beneficial interest on the property under the trust and the assets under the trust are distinct form the patrimony of the trustee, if a lender is placed in the position of beneficiary of a trust imposed on the company, then that lender has a claim in rem against the money held under the control of the subject person for and on behalf of and in the interest of any customer and such assets shall not be affected in any manner by the provisions of laws and regulations in force regulating the insolvency or bankruptcy of the subject person.

---

251 "SICAV" means an investment company with variable share capital duly licensed in terms of article 4 of the Investment Services Act;
252 Subsidiary Legislation 386.02
253 An umbrella or multi-class company is SICAV which in terms of its memorandum or articles of association it share capital is or is capable of being divided into different classes of shares, where each class of shares represents a distinct sub-fund of the company.
at issue to the exclusion of any other creditor of the trustee company claiming against its assets\textsuperscript{254}.

There are another two situations where trusts are of particular importance in the context of corporate insolvency:

- where funds are advanced for particular purposes; and
- where consumers make payments for goods and services in advance

\subsection*{3.2.3.3.1. Advances for Particular Purposes}

English case law delved into the question whether funds advanced directly to the company for a specific purpose, without a specific mention of the creation of a trust, would be considered to be held on trust.

In the case \textit{Barclays Bank Ltd. v. Quistclose Investments Ltd.}\textsuperscript{255} the company Rolls Razor Ltd. was in financial difficulties but declared a dividend on its shares. Quistclose, the defendant company loaned the latter company money solely for the purpose of paying its dividend. The sum was paid in a separate bank account with Barclays Bank with whom Rolls Razor was at the time overdrawn. Rolls Razor went into liquidation before the dividend was paid. Barclays claimed that it was entitled to set-off the funds received from Quistclose against the overdraft of Rolls Razor. The House of Lords however decided that the money had been received by the company on trust to pay the dividend and that it was the intention of both parties that such money would not become part of the general funds of the receiving company. Therefore, the House of Lords held that the money was held on trust for Quistclose and therefore was not available to Barclays to set off the overdraft.

The above case shows that if money is lent to a company for a specific purpose than the court may consider such money to be given on trust, even though there was no specific stipulation to that effect. If the borrower/trustee becomes insolvent without

\footnotesize{\textsuperscript{254} Milman and Durrant, Corporate Insolvency, 1\textsuperscript{st} Ed., 1987, Sweet & Maxwell p. 161
\textsuperscript{255} [1970] AC 567}
having spent the money which he was lent on the stipulated purpose, then such money cannot be taken by his creditors but must be returned to the lender. This arrangement contains an element of concern to the general body of creditors as trusts do not require registration nor a public notice in order for it to be created. They ‘may create an impression of commercial solidity so as to enable the borrower to continue trading and avoid insolvency, with the consequence that fresh liabilities to creditors will be probably incurred’\(^\text{256}\). Hence, potential creditors may be deceived as the trust will give the illusion that the estate is larger than it really is.

V. Finch\(^\text{257}\) opines that there are other considerations which hinder the effective and efficient protection of investors in routine cases of lending under this type of trust. These are:

- The debtor company may resist the request of the creditor to place funds at issue into a special account, to be used for a specific purpose, for a number of reasons which include administrative costs. These may be seen as excessive and unnecessary.
- If many other creditors insist on similar separate accounts the result may be the imposition of tight and inconvenient restraints on the uses to which the money can be put.
- The company who requires certain flexibility in their financing may feel that it’s not possible to designate specific purposes for its borrowing.
- The smaller/infrequent supplier of funds may not be in a good position and may not be able to calculate ways of arranging a trust which will reap them the advantages inherent in its use.

In V. Finch’s words:

“The widespread use of trust arrangements is likely to lead to inflexible regimes of financing that are not efficient with the end result being the worsening of the positions of unsecured creditors. An advice to the courts may be not to recognise trusts…where there is no express intention in the language used by the parties to establish a trust.”

\(^{257}\) Refer to V. Finch, Corporate Insolvency Law, 2002, Cambridge University Press, p. 475.
3.2.3.2. Consumer Prepayments
When consumers make payments in advance to companies for the supply of goods or services they run a considerable risk. If the company becomes insolvent before the goods or services are supplied, the consumers have no remedy except as unsecured creditors and therefore are unlikely to receive a substantial portion of their money back.

In the English case Re Kayford a mail order company entered financial difficulties. The company opened a separate ‘Customers’ Trust Deposit Account’ to deposit money received from customers of goods which had not been delivered. The money was to be withdrawn only on the delivery of the goods. However, initially the money was paid into a dormant deposit account in the company’s name and not in the separate account created. Only at a later stage was the name of the account altered.

When the mail order company entered liquidation proceedings Megarry J found sufficient evidence of an intention to create a trust:

“No doubt the general rule is that if you send money to a company for goods which are not delivered you are merely a creditor of the company unless a trust has been created. The sender may create a trust by using appropriate words when he sends the money … or the company may do it by taking suitable steps on or before receiving the money. If either is done the obligations in respect of the money are transformed from contract to property, from debt to trust.”

Megarry J here emphasised the need of the intention to form the trust. Without an indication of such intention the trust would not been deemed to have been created and thus the consumer prepayments would have been available to the general body of creditors on the company becoming insolvent.

Therefore, this type of trust requires that the consumer, on forwarding the money, manifests his intention to establish a trust, or the company supplying the goods must take actions to demonstrate such intention. Hence, this type of trust involves the

---

258 (1975)
259 (1975) 1 WLR 279 at 282
260 Certainty of intention is one of the pillars of trust law, together with certainty of subject matter and object.
settlor and the beneficiary being the same person\textsuperscript{261} ie. the consumer. V. Finch opines that most consumers will not be aware of the possibility of establishing this type of trust and therefore are unlikely to use the required forms of words when making purchases. Also, consumers may not occupy bargaining positions that allow them to insist on such arrangements. Moreover, trading companies have weak incentives to establish such trusts\textsuperscript{262}.

It could be argued that trusts do not provide the best route to consumer creditor protection. This as:

- Administrative costs for firms might be high if separate accounts and trusts were routinely employed\textsuperscript{263}. These costs will have a disproportionate effect on small new companies.
- Prepayments, in many cases, provide an essential part of the trader’s working capital\textsuperscript{264}. This means that firms have incentives to transfer the funds from special to general accounts before the contracts are fulfilled.
- Superior protections to consumer creditors could increase the incentives of other parties to take security and leave fewer assets available to unsecured creditors\textsuperscript{265}.

On fairness grounds this type of trust has the same effect as that discussed in 3.2.3.3.1. The firm’s general creditors are led to see a high level of economic activity whilst not realising that a proportion of this is funded out of consumer prepayments and that these assets will at no time enter the insolvency estate. They will therefore not be in a position to that a real picture of the affairs of the company.

\textsuperscript{261} As discussed in 3.2.3.3.
\textsuperscript{264} Cork Report, para. 1050
\textsuperscript{265} V. Finch, Corporate Insolvency Law, 2002, Cambridge University Press. p. 475
3.2.3.3. The Validity of such Trusts under Maltese Law

Due to the relatively recent enactment of the Trust and Trustees Act in Maltese law, the institute of trust is not so extensively used to cover situations where there is no specific stipulation for the creation of a trust. It would be interesting to know in what way the Maltese Courts would rule if similar circumstances as above were to come before them.

To this end, article 7(2) of the Trust and Trustees Act holds that assets held, acquired or received by a person for another on the basis of oral arrangements of a fiduciary nature shall be presumed to be a mandate unless there is evidence of an intention to create an oral trust. The mandatory holds the property subject to a fiduciary obligation and therefore such property is not subject to the claims or rights of action of his personal creditors or of his spouse or heirs at law as seen in 3.2.3.2.1. Therefore, in the event of his insolvency the assets would only be available to the creditors of the person for whom the assets were acquired.

However, if the court holds that the trust has been created, it shall still be subject to article 11 (2) of the Trust and Trustees Act:

Trusts shall fail if any court declares that their purpose or the terms of trust are not possible, or illegal, immoral or contrary to public policy, or otherwise tainted by error, fraud or violence, or any other reason which invalidates legal acts according to the laws of Malta.

Hence, even though the court may consider the trust to have been created, the trust may fail due to the purpose for which it was created. If does indeed fail, by means of sub-article 6 of the same article, the property as to which the trust has wholly or partially failed shall be held by the trustee in trust for the settlor absolutely, or if he is dead, for his heirs.

In accordance to article 303 of the Companies Act mentioned in 1.3.2.1., one of the reasons why a trust may fail is if it is constituted to give a fraudulent preference to the creditor who in such case would also be the settlor and the beneficiary.
3.2.3.4. Conclusion on Trusts

The Cork Committee held that property held by an insolvent company on trust for others does not pass to the liquidator representing the general body of the company’s creditors as the liquidator only takes on the ‘free assets’ of the insolvent company266. If a person lends money to a company which eventually becomes insolvent, that person would rank as an unsecured creditor with very little, or no, chance of recovering the amount lent. However, if the lender places the borrowing company in the position of a trustee, the situation would be radically different. Due to the concept of separate patrimonies the assets under the trust are separate from the personal patrimony of the trustee. Hence, if the trustee becomes insolvent, the money under trust would not be open to the personal creditors of the trustee. In this event the assets will revert back to the settlor. Therefore, just as the creditors who claim a reservation of title clause, those creditors who claim that the insolvent company is his trustee and not his debtor, are *prima facie* unsecured creditors who have a superior status over the assets under the trust as they have a claim *in rem* over them. It is thus possible for a prospective creditor to avoid *pari passu* distribution by keeping property out of the pool of assets available for distribution to the general body creditors of the debtor company by creating a trust.

---

266 Cork Report, para. 1042
Chapter 4. Alternatives to Pari Passu Distribution

4.1. To Achieve the Ideal Mode of Distribution

Vanessa Finch\textsuperscript{267} states that:

“the devices and processes that make up the regime for distribution should offer players in the marketplace a range of low-cost modes of protection against insolvency risks but they all should also avoid risks in ways that produce unfairness or inefficiency and should satisfy principles of accountability and transparency in seeking to ensure that both fairness and efficiency concerns are satisfied.”\textsuperscript{268}

She goes on to say that these above quoted goals may be achieved by offering and setting up a range of devices which are legally certain, identifiable and employable at minimal cost in order for all creditors to be able utilise.

Due to the fact that protection devices such as securities, retention of title and trusts are out of reach to vulnerable creditors, the above goals are very difficult to achieve.

Therefore, in order facilitate the attainment of these targets, Finch holds that the protections offered by insolvency law should be designed to protect the vulnerable creditors who bear the insolvency risks if left unprotected. In order to best be able to address their needs in the insolvency of their debtors, she identifies the various characteristics which make creditors vulnerable parties. These are:

- Creditors who cannot, at reasonable cost, secure preferential positions in distributions.
- Creditors who cannot, at reasonable cost, adjust terms and loan rates to reflect the risks they bear. Employees are a prime example of creditors who are ill-positioned to adjust their credit rates to take account of their risks. Also, as previously seen in the development of this thesis, some traders may be unable to adjust such rates when giving a loan or supplying goods because the costs of information collection are too high or the relevant data may not be

\textsuperscript{267} V. Finch, Corporate Insolvency Law: Principles and Perspectives, 2002, Cambridge University Press, p. 483
\textsuperscript{268} Ibid.
available to them. This too places them in a vulnerable position vis-à-vis other ‘robust’ creditors.

- Creditor who have a low capacity to absorb losses. This means that such creditors are unable to spread default of payment risks and are therefore more affected than other creditors when a debtor defaults in payment. Resilient traders tend to be those who have various amounts of different debtors. Hence, the default in payment of one of such debtors would not put the creditor concerned in dire straights. Whilst trade creditors usually have other sources of income, employees are rarely able to spread default risks and so are in highly vulnerable position.

In Finch’s eyes it is only by addressing the various possible shortcomings of vulnerable creditors will acceptable levels of efficiency, expertise, fairness and accountability could ever be achieved in the insolvency process. An interesting question would be whether pari passu distribution ensures the above in acceptable levels. In order to attempt to answer this question, before considering any alternatives to pari passu, its limitations in the insolvency process should be fleshed out.

4.2. Limitations of the Pari Passu Principle

4.2.1. Limitation in Scope

There are authors who are of the opinion that the role of pari passu has shrunk to insignificance as it is limited in scope. These authors criticize pari passu as it is a mode of distribution of the residual estate and does not cater for the distribution of the entire estate of the insolvent company. Therefore, by the time the pari passu principle comes into play it is substantially conditioned by the exceptions and bypassing devices discussed in chapters 2 and 3 respectively\textsuperscript{269}. These in themselves raise many issues of efficiency and fairness\textsuperscript{270} and reduce the role of pari passu as they introduce principles and priorities which override that of pari passu.


\textsuperscript{270} As has been seen, they are not equally available to the vulnerable creditors.
However, according to Finch, this in itself does not constitute a reason for abandoning *pari passu* as it still argued that it remains the most appropriate method of distributing the residual assets of the insolvent company. Other principles would produce significantly different, maybe even less acceptable, results for residual claimants.

### 4.2.2. Needs Clarity

A second limitation of *pari passu* is that it is not a totally clear principle. This is, once again, due to the multiplicity of possible exceptions and bypassing arrangements in law and practice. These are seen as creating a degree of confusion and uncertainty. A clarification of the rules governing the exceptions and bypassing devices may reduce uncertainties and costs incurred by creditors who seek to protect themselves from insolvency risks. In this way creditors would know exactly where they stand and therefore can take an informed decision as to the appropriate mode of action. However, this legal clarification may encourage further resort to the exceptions and bypassing devices. This will inevitably disadvantage those ordinary creditors who are not in a position to secure protections and will therefore be faced with a smaller residual estate to be distributed among themselves. This would occur as the stronger creditors would protect themselves at the expense of the weak/vulnerable creditors.

### 4.3. The Alternatives to the *Pari Passu* Mode of Distribution

A question which begs to be asked is: whether the array of exceptions and bypassing devices create such a degree of confusion and uncertainty that hinders the efficiency and fairness of the *pari passu* regime? And therefore, should a simpler, more rational and legally certain process be employed?

It is inevitable that when considering the above limitations to the *pari passu* principle the above questions come to the fore. As seen above, there are authors who advocate
that *pari passu* may not be the best way to distribute the residual estate of the insolvent company to the ordinary creditors.

The remainder of this chapter shall be concerned with the main alternatives to *pari passu* distribution of the residual estate. There will be particular focus on considerations of efficiency and fairness and on the question whether the route to better insolvency law lies through reforms to the operation of *pari passu* or through substituting another principle or method of distribution.

At this juncture it is of utmost importance to remind the reader that there is a common law principle that an agreement in conflict with the *pari passu* system of asset distribution is not permissible. This means that any private agreement to distribute the assets of the company in a different way to the *pari passu* system will be void. Therefore, it is not possible for the debtor to agree with a creditor that a different scheme of distribution shall apply. This point was made in *Re Jeavons, ex parte Mackay*271:

“A man is not allowed, by stipulation with a creditor, to provide for different distribution of his effects in the event of the bankruptcy from that which the law provides.”

This rule is best known in the context of its application in the *British Eagle*272 case, that is it will be contrary to public policy. Hence, the devices listed in the Chapters 2 and 3 of this thesis are the only ways in which a creditor can legally elude the *pari passu* scheme of distribution.

Apart from the possibility contemplated under article 291 of the Companies Act273, the position under Maltese law is similar to that of the UK. In that, there can be no other method of asset distribution of the residual estate of the insolvent company other than *pari passu*.

---

271 (1873) 8 Ch App 643
272 [1975] 1 WLR 758, HL
273 Briefly discussed in 2.2.5.
4.3.1. Debts Ranked Chronologically

An possible alternative to the \textit{pari passu} principle of distribution is that of satisfying the debts from the residual estate on a first-come-first-served basis. This means that the debts which were entered on the earliest date will be paid first. In order for this device to be efficient each debt entered by the debtor must be recorded and disclosed in order to give each creditor or potential creditor the possibility to assess the situation he would be in before entering any subsequent debt.

According to V. Finch the problem with this regime is that it does not address the problems raised by the exceptions and the bypassing mechanisms seen above. Moreover, this regime makes it difficult for a company who has entered troubled economic waters to raise funds since prospective creditors would know that arriving ‘late’ they would rank behind in the distributional order. This would lead to an increase in the resort to security, quasi-security and trust devices and transaction costs would accordingly balloon.\textsuperscript{274}

Hence, this alternative regime creates increased\textsuperscript{275} inefficiency and uncertainty for other prospective unsecured creditors who would need to assess their lending risks. This would entail a complex and time consuming analyses of the bypassing measures that have been used in relation to the company.

Besides being a system which allows those with greater resources and power to deprive poorer and weaker creditors of everything in their debtor’s insolvency, the first come first served system encourages the creditors to engage in duplicative and therefore wasteful monitoring of their debtor in order not to be left behind in any race to the pool. This adds uncertainty.\textsuperscript{276}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{274} V. Finch, ‘The Measures of Insolvency Law’(1997) 17 OJLS 227
\item \textsuperscript{275} vis-à-vis the \textit{pari passu} mode of distribution
\item \textsuperscript{276} V. Finch, ‘The Measures of Insolvency Law’(1997) 17 OJLS 227.
\end{itemize}
\end{footnotesize}
4.3.2. Debts Ranked Ethically

This regime would organise repayments from the insolvent company being wound-up on an ethical basis, according to the unsecured creditors’ needs. This utilitarian approach is exposed to the standard criticisms of utilitarianism. These are based on the impossibility to calculate the ‘needs’ of the unsecured creditors due to their subjective nature\textsuperscript{277}. Therefore, if the individual position or worth of a creditor is taken into account in distributing the residual estate, then that individual position will be difficult to assess in advance.

Hence, if this regime were to be applied predicting the positions in the repayment queue would be nearly impossible. This in turn would lead to high levels of uncertainty and therefore inefficiencies due to inability of creditors to assess present and future risks.

As a counter argument, \textit{pari passu} does itself admit of statutory protections to certain creditors on ethical grounds. This was seen in the case of preferential debtors such as employees. However, this does not give rise to the above inefficiencies and uncertainties. This as, preferential debtors such as employees are given a general protection as a group and are not on an individual basis, as the ethical ranking would require.

4.3.3. Debts Ranked According to Size

David Milman argues that small creditors should be paid at a higher rate of return then those ordinary unsecured creditors who are owed larger sums from the insolvent company in question. The basis for this reasoning is that small creditors are more vulnerable and deserve high levels of protection\textsuperscript{278}.

However, Finch describes Milman’s proposition as flawed in that the size of the loan cannot be correlated to the vulnerability of the creditor. Small creditors may be in fact less exposed to risk than medium or large lenders. This as they may be able to adjust their loan rates, may be more risk resilient and may be better informed or in a stronger negotiating position than larger creditors. Therefore, one may not generalise and consider all small lenders as more vulnerable.

4.3.4. Debts Ranked on Policy Grounds

This method of distribution involves paying different ordinary creditors at different rates on grounds of policy. However, according to V. Finch, this is not an alternative to the *pari passu* distribution but an alternative construction of the insolvent estate.

Just as the employees of the insolvency company are held to be preferential creditors on policy grounds, the consumer creditors are a clear example of who should be entitled to the same special treatment. This class of unsecured creditors might be entitled to higher rate of return when compared to trade creditors as the latter ‘should be more aware of the risks involved in extending credit to the company’ and because ‘bad debt insurance is increasingly available to trade creditors.’ Also, consumer creditors are said to suffer disproportionately on the debtor’s insolvency.

A counter argument to employing this method special treatment is that it mechanism would increase transaction costs. However, such increase in costs, according to D. Milman, “will be compensated by attendant improvements in fairness.”

As noted above many trade creditors may be more harshly affected by corporate insolvencies than the average consumer creditor. However, according to V. Finch this

---

282 Ibid.
283 Ibid.
depends on many factors such as the type of transaction involved, the pattern of risk spreading, the mode of payment, the market traditions, the levels of competition in the sector, the quality of information on supplies that is available and the rate of turnover of the business in the sector.

In deciding which group of creditors should be entitled to the protections, the same dilemma encountered whilst discussing the ethical regime in 4.3.2., comes to the fore. That is, it is impossible to generalize and form a well-found system of priorities which addresses everyone’s needs.

4.4. Conclusion

The contention that *pari passu* is not the best way to distribute the residual estate is not entirely correct. When compared to the alternative modes distribution, *pari passu* seems to remain the most appropriate method to distribute the residual estate of the insolvent company.

Indeed *pari passu* conduces to an orderly means of dealing with the unsecured creditors’ claims and involves lower distributional costs than other alternative processes such as ‘first come, first served’. This latter mode of distribution would involve expensive, individually funded races to assert rights against the insolvent company. Moreover it instigates creditors to enforce those rights with a speed likely to reduce the value of the estate available for distribution. Moreover, in *pari passu* the legal costs, uncertainties and delays are said to be kept low as there is no differentiation between the unsecured creditors’ claims. This avoids the need for courts to make difficult and procedurally expensive choices as, for example, would be involved were they to adopt other methods such as ‘distribution according to need’ or ‘inability to sustain losses’.
Conclusion

It seems that the primary attraction of the \textit{pari passu} principle is in its ability to provide for an orderly liquidation of the insolvent company. It prevents the ransacking of the estate of the insolvent company as it places the individual claims of each creditor is a prescribed order of priority. Goode states:

It is this principle of rateable distribution which marks off the rights of creditors in a winding-up from their pre-liquidation entitlements. Prior to winding-up each creditor is free to pursue whatever enforcement measures are open to him… The rule here, in the absence of an insolvency proceeding, is that the race goes to the swiftest … liquidation puts an end to the race. The principle first come first served gives way to that of orderly realisation of assets by the liquidator for the benefit of all unsecured creditors and distribution of the net proceeds \textit{pari passu}^{284}.

Once, the collectivity of the insolvency process is established, corporate insolvency law is faced with two important questions:

- How to stipulate which assets of the insolvent company will be available for distribution; and
- Whether the law should allow exceptions to be made to the \textit{pari passu} rule in the distributing those available assets.

Finch opines that the different angles from which of corporate insolvency law is viewed will produce different approaches to the distribution and construction of the insolvent estate^{285}.

If corporate insolvency law is viewed as being centrally concerned with maximising the assets available for distribution to creditors then the creditors’ rights in the liquidation process will be treated as being governed by prior non-insolvency entitlements. This means that what has been bargained for in advance will dictate asset distribution priorities in the subsequent liquidation. If on the other hand insolvency law is seen as having a redistribution role which allows prior private bargains to be adjusted in the public interest then the creditors’ rights in a

\footnotesize

liquidation will be influenced by a range of factors other than what had would have been bargained for outside the commencement of the winding-up process.

To ensure equitable distribution among creditors, corporate insolvency rejects what is seen as ‘the narrow creditor wealth maximising vision’ and espouses the ‘redistribution in the public interest’ philosophy. This is in effect the position of pari passu. This implies that:

- Exceptions to pari passu may be entertained, on their public interest merits; and also
- That in constructing the estate of the insolvent company which will be available for distribution, agreements entered prior to the winding-up of the insolvent company will be restricted in order not to hinder the principle of collectivity of pari passu distribution.

It is granted that the multiplicity of the exceptions and prior insolvency agreements allowed by statute may seem to create a degree of confusion and uncertainty in the distribution of the assets of the insolvent company. It is also conceded that these may hinder the application of the pari passu principle as they have the effect leaving a negligible amount of assets to be distributed among the ordinary creditors. However, bearing in mind the unconvincing alternatives discussed in chapter 4 of this thesis, the above criticisms\(^\text{286}\) should not be seen as cries calling to replace the pari passu principle.

On the contrary, the pari passu principle needs to be supported by the enactment of clear and comprehensive laws which delineate the exceptions and bypassing devices permitted at law. Only in this way will the efficiency and fairness of the pari passu principle and corporate insolvency law in general be guaranteed and maintained.

It is for this reason that an *ad hoc* insolvency legislation is required under Maltese law. The provisions in the Companies Act on insolvency, although provide for a workable structure, are still laconic when it comes to corporate insolvency. These need to be reinforced by more specific and modern provisions which curb the inefficiencies brought by legal uncertainty. To this end the UK Insolvency Act and Rules could serve as model laws.
### Appendix 1

<table>
<thead>
<tr>
<th>TYPE OF PREFERENCE</th>
<th>DESCRIPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Article 293 of the CA</td>
<td>Expenses incurred during winding-up</td>
</tr>
<tr>
<td>2. Special Privilege</td>
<td>Pledgee over the movable pledged</td>
</tr>
<tr>
<td>3. Ad hoc Privileges</td>
<td>EIRA/ Social Security privileges</td>
</tr>
<tr>
<td>4. Ad hoc Privilege</td>
<td>Income Tax privilege</td>
</tr>
<tr>
<td>5. General Privilege</td>
<td>Judicial Costs</td>
</tr>
<tr>
<td>6. General Privilege</td>
<td>Funeral Expenses</td>
</tr>
<tr>
<td>7. General Privilege</td>
<td>Death Bed Expenses</td>
</tr>
<tr>
<td>8. Special Privileges on movables</td>
<td>In favour of Hotel Keeper</td>
</tr>
<tr>
<td>9. General Privilege</td>
<td>Wages of Servants</td>
</tr>
<tr>
<td>11. Ad Hoc Privilege</td>
<td>VAT privilege</td>
</tr>
<tr>
<td>12. Special Privileges on movables</td>
<td>In favour of carrier of goods</td>
</tr>
<tr>
<td>13. Article 1439 of the Civil Code</td>
<td>Rights of the unpaid seller of goods</td>
</tr>
<tr>
<td>14. Special Privileges on movables</td>
<td>In favour of dominus/lessor</td>
</tr>
<tr>
<td>15. Special Privileges on movables</td>
<td>In favour of vendor/lender for purchase</td>
</tr>
<tr>
<td>16. Special Privileges on immovables</td>
<td>Article 2010 (a) to (e)</td>
</tr>
</tbody>
</table>
Bibliography:

- **Books**
  6. F. Rose, Restitution and Insolvency, 2000, LL.P.
  14. Palmers’ Corporate Insolvency I – Sweet & Maxwell
  15. Palmers’ Corporate Insolvency I – Sweet & Maxwell.
Theses:
2. Roberta Brincat, LL.D., Set-Off as a Mode of Extinction of Obligations, May 2005
3. Sharon May Bonnici, B.Accountancy (Hons.), Insolvency and Liquidation: the main issues, June 1999
4. Tonia Huntingford, LL.D., The Ranking of Creditors under Maltese Law, August 1977

• Articles
5. J. Spencer, The Commercial Reality of Reservation of Title Clauses, 1989 JBL 220, 221
7. Ogus and Rowley, Prepayments and Insolvency, (published by the United Kingdom Office of Fair Trading), 1984
9. R. Goode, The Death of Insolvency Law, (1980) 3 Co. Law 113

• Notes
1. Judge P. De Bono, Appunti di Lezioni sul Fallimento nel Diritto Maltese, seconda edizione riveduta, ampliata e corretta. 1907