A CRITICAL ANALYSIS OF THE EFFICACY OF THE CIVIL REMEDIES FOR FRAUDULENT AND WRONGFUL TRADING UNDER THE INSOLVENCY ACT, 2015

BY

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DECLARATION

I, MWANIA NZULA, do hereby declare that this is my original work and that it has not been submitted and is not being submitted for the award of a degree or any other academic credit in any other university.

Signed……………………………… Date…………………………………….

Mwania Nzula

This thesis has been submitted for examination with my approval as the University Supervisor

Signed……………………................... Date…………………………………….

Dr. Jackson Bett

DEDICATION

I dedicate this work to my guardian and godparent, Hon. Lady Justice Philomena M. Mwilu.

Everything I am-you and your unrelenting support made me.

ACKNOWLEDGEMENT

At the bottom of my heart lies much gratitude and thankfulness to Hon. Lady Justice Philomena M. Mwilu through whose generosity my fees for the entire Masters Programme was cleared. May our Good Lord perfect that which concerns her. I can no other answer but thanks, and thanks; and ever thanks.

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UK Insolvency Act 1986 Queen’s Printer

LIST OF ABBRAVIATIONS

ASIC- Australian Securities and Investment Commission

CEO- Chief Executive Officer

DPFB- Deposit Protection Fund Board

KACC- Kenya Anti-Corruption Commission

MSC- Mumias Sugar Company

USL- Uchumi Supermarkets Limited

NHC- National Housing Corporation

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ABSTRACT

The Insolvency Act 2015 provides for the civil remedies for fraudulent and wrongful trading. Although these remedies do not, so far, have any identifiable legal problem with respect to their implementation, they are likely to encounter enforcement challenges in future, going by the history of their implementation under the repealed Companies Act. The remedies under the repealed Companies Act were rarely invoked and it was difficult to establish liability under them. The study argues that the civil remedies provided under the repealed Companies Act were inherently ineffective, and that the legal challenges which dominated the implementation of the previous remedies under the repealed Act are likely to recur in the enforcement of these new remedies provided for under the Insolvency Act 2015. The study utilized a combination of doctrinal and comparative research methodologies to conduct an in-depth desk review on the implementation of these remedies in Kenya, and to investigate the best practices which Kenya can learn from UK and Australian insolvency regimes respectively.

The study reveals that the Kenyan courts adopted a complex and unstructured jurisprudence on the implementation of the remedy, the Kenyan provisions have a restricted class of potential applicants and a strict adherence to champerty rules, hindering the liquidator from accessing external funding for the claims. It also reveals that the UK has a more simplified way of determining a director's liability and UK courts have adjusted the interpretation of these remedies to meet the demands of 'rescue culture.' This notwithstanding, the UK regime has too been weighed down by the common law rules on champerty and maintenance. Australia is the most ideal jurisdiction from which Kenya can learn, considering its legislative clarity on the exact time when liability attaches. In addition, Australia has a broader list of potential applicants in a claim for insolvent trading, a unique way of embracing corporate culture and a very relaxed approach on the champerty rules.

CHAPTER ONE

INTRODUCTION

1.1 Introduction and Background of the Study

Fraudulent trading is any form of trading which has been employed or devised to defraud creditors.[1] It includes circumstances where corporate managers conduct the affairs of the company with an intent to defraud their creditors.[2] Wrongful trading, on the other hand, is the carrying on with the trading business of a corporate, when it has already occurred to the corporate managers that the corporate's insolvency is inevitable.[3] It occurs when corporate managers continue to trade when they are either actually aware that the company is ending to insolvency or when they ought to have been aware that the company was ending to insolvency.[4] It includes situations where company controllers keep trading on the assets of the company, when they are aware or should have been aware of the fact that the company had no reasonable prospects of avoiding insolvent liquidation.[5]

These two civil remedies are provided for under the Insolvency Act, 2015; section 505 provides for the remedy for fraudulent trading, while section 506 provides for the remedy for wrongful

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[1] Business Dictionary definition of 'fraudulent trading' <http://www.businessdictionary.com/definition/fraudulent-trading.html> Accessed on 5th August 2018.
[2] Real Business Rescue *Licensed Insolvency Practitioners,* 'The Difference Between Wrongful and Fraudulent Trading' <https://www.realbusinessrescue.co.uk/business-insolvency/difference-between-wrongful-fraudulent-trading> Accessed on 5th August 2018.
[3] Collins Dictionary <https://www.collinsdictionary.com/dictionary/english/wrongful-trading> Accessed on 4th August 2018.
[4] Real Business Rescue *Licensed Insolvency Practitioners,* 'The Difference Between Wrongful and Fraudulent Trading' <https://www.realbusinessrescue.co.uk/business-insolvency/difference-between-wrongful-fraudulent-trading> Accessed on 5th August 2018.
[5] Jon Mitchell, 'Wrongful Trading, Fraudulent Trading & Trading Whilst Insolvent' Thomas Westcott Business Recovery & Insolvency <http://www.thomaswestcottbri.co.uk/news/129-wrongful-trading-fraudulent-trading-trading-whilst-insolvent> Accessed on 4th August 2018.

trading. The remedy for fraudulent trading was previously provided for under section 323 of the Companies Act (Repealed).

Provisions proscribing fraudulent trading were first introduced in Kenya in 1962 by the repealed Companies Act.[6] Section 323 of the Act provided for a civil remedy for fraudulent trading, under which an implicated director was required to make financial contribution to the assets of the insolvent company. Fraudulent trading was described as carrying on the business of the company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose.[7] The claim could be instituted by the official receiver, the liquidator, any creditor or a contributory of the company against any persons who were knowingly parties to the carrying on of the business in the fraudulent manner.[8]

During the tenure of this repealed legislation, directors of several insolvent companies were implicated for fraudulent and irregular transactions but the law enforcers rarely invoked these remedies. Going by the facts of the various reports on these past instances of corporate mismanagement, it appears that invocation of section 323 was logically most appropriate and applicable to the circumstances. In material aspects, for instance, the conduct of the directors of Uchumi Supermarket Limited (USL) amounted to a kind of conduct which would prima facie be termed as fraudulent trading.[9] Instead, they were charged under the Penal Code.[10][11] In very few

[6] 1st January 1962 was the commencement date of the Companies Act, Cap 486 (Repealed).
[7] Companies Act, Cap 486 (Repealed) s 323 (1).
[8] Ibid.
[9] *Joseph Munyiri Munene v Attorney General & Another* [2010] eKLR, Petition Number 503 of 2009 para, 3. The directors sold the company's property at Kshs.147, 999, 000, to M/S Allgate Company Ltd and then leased back to Uchumi Supermarket at a monthly rent of 1,700,000. The directors did not do a prior independent valuation and they did not follow an open consultative process during both the selling and leasing of the property. And what was more, the buyer company was associated with the core suppliers of Uchumi Supermarkets Limited
[10] They were charged with conspiracy to defraud, contrary to section 317. An additional count was based on section 127, under which they were charged for breach of trust against the public.
[11] For instance, criminal case, *R v Chris Kirubi and 13 others* (No. 900 of 2008).

occasions, the law enforcers invoked section 323 but they were eventually unsuccessful in establishing liability for fraudulent trading.[12]

In May 2006, USL was declared insolvent. It was not immediately clear as to what was the main cause of its insolvency, but there were speculations that it had gone under thanks to insider trading[13] and manipulation of its shares.[14] On 13th June 2006, a ministerial task force was constituted. Its aim was multi-ford; to look at all the aspects culminating in the collapse of the supermarket chain, to investigate the role of the directors in the debacle and, with the aid of Kenya Anti-Corruption Commission (KACC), to establish whether there had been any fraudulent activities associated with the decline and the collapse of the supermarket chain.[15]

Later, on 20th June 2006, the findings of the task force were presented to parliament.[16]The report attributed the collapse of the company to fraudulent transactions by the management board. It identified a particular transaction which involved a fraudulent sale of the company's parcel of land.[17] Consequently, upon the recommendation of the Director of Criminal Investigations, all the members of the Board of Directors who had approved the sale of the company's property were

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[12] *Ajay Shah v Deposit Protection Fund Board as Liquidator of Trust Bank Limited (In Liquidation)* [2016] eKLR, Civil Appeal no. 158 of 2013.
O. M. Da Costa Luis (The Liquidator for Nzaa Kuu Cement Co. Ltd v Christopher M. Musau [2013] eKLR, Winding up Cause No. 42 of 1993.

[13] Insider trading is a civil wrong committed where corporate directors use sensitive and confidential corporate information in their possession to make investment decisions, with a view to either make profits or avoid losses and particularly when such information is not available to the public. Even though Insider trading is distinct from fraudulent trading, the two have a unique relationship characterized by possible overlaps. For instance, insider trading will amount to fraudulent trading if done with an intent to defraud the creditors of the company or creditors of any other person. On a closer look, all forms of insider trading amount to fraudulent trading. This is so, going by the wording of the remedy for fraudulent trading which states that fraudulent trading can be committed even when a company is run for 'any fraudulent purpose.' Given that a director who commits insider trading does so fraudulently, it goes without saying that a charge for fraudulent trading can in some occasions substitute a charge for insider trading. It is on this ground that the USL's insider trading incident has been used in this study.

[14] Kenya National Assembly Official Record (Hansard), 13 June 2006 p.1284.

[15] Ibid, pp. 1284-1286.

[16] Kenya National Assembly Official Record (Hansard), 20 June 2006 p. 1437.

[17] Benson Wambugu, 'Corporate PS lists reasons for Uchumi collapse before Nairobi Court' *Business Daily* (Nairobi, 14 March 2011). It reported that, on the night before the company doors were closed, shares worth Kshs. 22 million were off-loaded on the stock market.

charged with the offence of conspiracy to defraud and breach of trust[18] in the criminal case, *R v Chris Kirubi*.[19] However, the accused persons were later acquitted for lack of sufficient evidence to sustain a conviction.[20] Consequently, no one has ever been held liable for the irregular sale.

The collapse of USL was a monumental problem to the people of Kenya.[21] There was a well-deeply-felt attitude that USL going under was a pain to a national brand.[22] By 2006, it was the largest locally-owned supermarket chain in Kenya. It was the main support system for small-scale farmers and local manufacturers. In addition, it created direct employment for more than 1000 Kenyans, eventually growing to be seen as a symbol of Kenyan local enterprise.[23] Upon its collapse, the fate of 1000 former USL workers was unknown. Indeed, they were given Kshs. 20 000 each, having worked for the company since the 1970s.[24]

This is not the first instance where implicated directors have not been prosecuted. In March 2015, a departmental committee, which had been constituted to investigate on the challenges ailing the sugar industry in Kenya, presented a comprehensive report to the parliament.[25] It established that several directors had been involved in fraudulent activities which had eventually caused the insolvency of Mumias Sugar Company (MSC). The report collaborated with an earlier study which had attributed the company's huge loss of funds to its directors' fraudulent trading.[26] Until the date of this study, none of the implicated directors has been successfully found liable. Such was also

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[18] *Joseph Munyiri Munene v Attorney General & Another* [2010] eKLR. Petition 503 of 2009 at the High Court of Kenya at Nairobi.
[19] *R v Christopher John Kirubi and 13 others* (No. 900 of 2008).
[20] Ibid.
[21] Kenya National Assembly Official Report (Hansard) 13th June 2006 p. 1279.
[22] Kenya National Assembly Official Report (Hansard) 6th July 2006 p. 1894.
[23] Ibid, p. 1280.
[24] Ibid, p. 1286.
[25] Government of Kenya (2015) *Report of the Departmental Committee on Agriculture, Livestock and Co-operatives on the Crisis Facing the Sugar Industry in Kenya* (Clerks Chambers).
[26] Ibid, p. 22.

the case for the collapsed Trust Bank Limited where although its directors' conduct apparently demonstrated the epitome of fraud and violation of fiduciary duties, none of the directors has ever been held liable for the misconduct to the date of this thesis.

On 18th September 1998, Trust Bank Limited was placed under statutory management. The insolvency of the bank and its subsequent liquidation in 2001 could be justifiably associated with the particular role played by its directors. Two executive directors of the bank had a joint account with the bank. Just two days before the bank was placed under statutory management, the two directors irregularly overdrew the joint account to a sum of Kshs. 241, 442,375.80.[27] First, the joint account had not been officially opened in the Bank books. The account had no account opening document to support it and it did not have authorized signatories. And what was more was that the bank did not hold any security for the repayment of the loan and there was no application to the Bank by account holders for any loan or overdraft facility.[28]

Subsequently, Deposit Protection Fund Board (DPFB) instituted civil proceedings against the directors. DPFB sought to impose civil liability by invoking a civil remedy for fraudulent trading,

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[27] *Ajay Shah v Deposit Protection Fund Board as Liquidator of Trust Bank Limited (In Liquidation)* [2016] eKLR Civil Appeal No. 158 of 2013.

[28] *Ajay Shah v Deposit Protection Fund Board as Liquidator of Trust Bank Limited (In Liquidation)* [2016] eKLR Civil Appeal No. 158 of 2013. The facts of the case. Two executive directors of Trust Bank Limited incorporated a company in the name of Trust Capital Services Limited. The company 'opened' three accounts with the Bank. On 16th September 1998, the account of Trust Capital Services Limited company was overdrawn to a sum of Kshs. 241, 442,375.80. The amount was withdrawn through 24 banker's cheques. The Bank was placed under statutory management by the Central Bank on 18th September 1998. A Scheme of Agreement was made on 25th May 1999. In the Scheme, the directors admitted owing insider loans to Trust Bank Limited, expressly admitting that they owed money to the Bank. However, on 6th May 1999, a direct payment in form of credit deposits totaling Kshs. 96, 500, 000 has been paid to Trust Bank Limited by Trust Capital Services Limited. Further, by 30th June 1999, cheques amounting to 146, 687,402.45 were dishonored by Trust Bank Ltd, reversed and they were never paid, as the Bank had went into Statutory Management. The Bank ceased trading on 21st September 1999 and went into liquidation on 16th August 2001. A liquidator was appointed on 31st August 2001. The liquidator did some investigations between 2008 and 2010 and established fraud. It emerged that the debt was in fact not a loan transaction, but a fraud practiced on the Bank by the two directors. First, the account had not been officially opened in the Bank books. The other account had no account opening document to support it, there were no company resolution from Trust Capital Services Limited to open the account and the Bank did not have authorized signatories to the account. And what was more, the bank did not hold any security for the repayment of the loan. In addition, there was no application to the Bank by Trust Capital Services Ltd for any loan or overdraft facility.

which had been provided for under section 323 of the Companies Act, Cap 486 (Repealed).[29] Although the High Court found that the directors were liable for the loss of the amount, the High Court's decision was short lived after the Court of Appeal later overruled the judgment. In the end, the bank went under and depositors lost their lifelong savings without a soul on earth caring. This was a great setback for depositors, especially the Asian community, who had waged a long and often frustrated battle to get back the billions of shillings they lost in what was once Kenya's third largest bank.[30]

Fraudulent transactions by directors have been identified as one of the main factors leading to insolvency of Kenyan parastatals.[31] In August 2001, a committee revealed how directors of various parastatals had looted public funds through fraudulent transactions.[32] For instance, the National Housing Corporation (NHC) was declared insolvent due to fraudulent transactions and reckless trading by the directors. A section of directors initiated a major project in contravention of public procurement rules and without the approval of the board.[33]

The insolvency of these public companies is significantly detrimental to the Kenyan economy. Before its collapse, the now ailing sugar industry supported, directly or indirectly, approximately six million Kenyans, which represented about 16% of the entire national population[34]. Further, it was a reliable contributor to the Kenyan economy. It generated foreign exchange to the tune of

[29] Sam Kiplagat, 'Former Trust Bank directors on the spot for loss of Sh 1.5billion' *Daily Nation* (2 May 2010).
[30] George Ngigi, 'Trust Bank directors ordered to pay depositors Sh 1.5 billion' *Business Daily* (2 June 2013).
[31] Kiarie Mwaura, 'The Failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya.' (2007) *Fordham International Law Journal*.
[32] See Catherine Gicheru, 'MPs Watchdog Finds More State Looting' *Daily Nation* (16 August 2001).
[33] Kiarie Mwaura, (n 31) p.58.
[34] Government of Kenya, (2014) *Report of the Departmental Committee on Agriculture, Livestock and Co-operatives on the crisis facing the sugar industry in Kenya* p. 10.

$250 million, which translated into about 7.5 per cent of the national GDP.[35] And what was more was that the collapse adversely affected the economies of Rift Valley, Nyanza, and the western regions.[36] Besides, the inefficiency losses in the sector, the insolvency of MSC has caused heavy budgetary burdens to the tax-payer, especially in form of bail-outs. In 2014 alone, MSC received a bail out of 3.14 Billion.[37]

It still remains unknown how the enactment of the Insolvency Act 2015 has improved and will improve the implementation and the efficacy of the two remedies. Nonetheless, it is worth noting that the Insolvency Act has not altered the structure of the previous enabling provisions in terms of their wording. The repealed section 323 was, in a very identical manner, replicated under section 505 of the Insolvency Act 2015. Section 505 provides for a civil remedy for fraudulent trading, under which an implicated director is liable to making financial contribution to the assets of the troubled company.[38]Although there has been an intention to make amendments to the Insolvency Act 2015 and the Insolvency Regulations 2016, sections 505 and 506 are not subjects of the proposed amendments.[39]

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[35] Atieno Yvonne, 'Corporate Governance Problems facing Kenyan Parastatals: A case study of the Sugar industry.' (MBA Thesis, Bonn University 2009).

[36] Government of Kenya, (n 34) p. 10.

[37] Shaban Makokha, 'Mumias Sugar to get Sh 3bn more in bailout' *Daily Nation* (9 May 2017) <https://www.nation.co.ke/news/1056-3920316-2rlfsfz/index.html> Accessed on 7th August 2018. In 2015, the company received Ksh 2 billion from the Government of Kenya for its restructuring plan. See Mumias Sugar Press Release (2015): *Receipt of Kshs 1.1 billion advance on 2nd bailout tranche from the government of the Republic of Kenya*. <http://www.mumias-sugar.com/images/Press-Release.pdf> (Accessed on 24th March 2018).

[38] Insolvency Act 2015, s 505.

[39] The Insolvency (Amendment) Bill, 2017. <https://www.icpsk.com/membership/e-library/finish/9-cs-practioners-corner/1787-the-insolvency-amendment-bill-2017> (Accessed on 24th March 2018).

1.3 Statement of the Problem

The Insolvency Act 2015 provides for the civil remedies for fraudulent and wrongful trading. Although these remedies do not, so far, have any identifiable legal problem with respect to their implementation, they are likely to encounter enforcement challenges in future, going by the history of their implementation under the repealed Companies Act. The legal challenges which dominated the implementation of the previous remedies under the repealed Act are likely to recur in the enforcement of these new remedies because the two regimes share identical wording of the enabling provisions.

During the tenure of the repealed Companies Act, parliamentary committees and taskforce reports attributed insolvency of Kenyan publicly listed companies to fraudulent dealings by management boards. However, law enforcers rarely invoked the provisions proscribing fraudulent trading. Instead, they utilized alternative mechanisms especially by instituting criminal prosecutions under section 317 of the Penal code, which provides for an offence of conspiracy to defraud. For the exceptional cases-in-point where the remedy for fraudulent trading was invoked, it was difficult for the liquidator to establish liability under the provisions.

This study seeks to investigate why the civil remedy for fraudulent trading was underutilized and why it was almost impossible for the law enforcers to secure a conviction under the same repealed provisions. The study will investigate these two objectives considering that the substance of the provisions has remained the same, and hence a rebuttable presumption that the same identified challenges will logically recur during the implementation of the new remedies provided under the Insolvency Act 2015. It will investigate the problem with the view to suggest necessary amendments on section 505 and 506 of the Insolvency Act 2015, which will effectively address fraudulent managerial conduct within companies in Kenya.

1.4 Objectives of the Research

1. To examine the law enforcers' preference of invoking other alternative legislative provisions over section 323 of the repealed Companies Act.
2. To examine the legal challenges which were faced by the liquidators whenever they sought to establish a director's liability under section 323 of the repealed Companies Act.
3. To investigate on the comparative parallels that can be drawn from South Africa, Australia and United Kingdom in relation to the structure of their insolvent trading provisions and their judicial treatment.
4. To propose the necessary amendment/reforms to section 505 and 506 of the Kenyan Insolvency Act 2015 in relation to civil remedies for fraudulent and wrongful trading.

1.5 Research Questions

1. What legal challenges did the liquidator face whenever he sought establish a director's liability under section 323 of the repealed Companies Act?
2. What are the comparative parallels that can be drawn from Australia and the United Kingdom in relation to the structure of their insolvent trading provisions and their judicial treatment?
3. What are the necessary amendment/reforms to section 505 and 506 of the Kenyan Insolvency Act 2015 in relation to civil remedies for insolvent trading?

1.6 Theoretical Framework

1.6.1 Introduction

The theoretical underpinning of this study is based on two theories; Agency theory of financial management and the Positivism theory of jurisprudence. The agency theory makes the fundamental assumption that in every firm, there is an inherent and constant conflict of interest between the managers of a corporate entity and its owners. The theory advocates for different mechanisms of solving these agency problems and aligning the interests of the agent with those of the principal. The positivism theory believes that the law is posited somewhere, there must be separation between law and morality, and the judges do not have a role in rule making. The study utilizes these theories in the insolvency context with a view to protect and promote the rights of unsecured creditors during insolvency. The researcher has utilized them to illuminate the discourse on how to apportion rights and duties to directors with respect to proscribing wrongful trading and fraudulent trading.

1.6.2 The Agency Theory

The agency theory assumes a two-tier form of corporate control comprised of corporate shareholders and corporate management. These two players establish a principal-agent relationship whereby the principal is the shareholders, who hire the corporate managers to run the company on their behalf.[40] The theory operates under the basic assumption that a company's chief goal is to optimize its market value and therefore the directors should achieve this aim by maximizing shareholders' wealth. Against this background, the theory assumes that the company's goal to

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[40] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure '(1976) Vol. 3 (4) *Journal of Financial Economics*.
<http://uclafinance.typepad.com/main/files/jensen_76.pdf> Accessed on 24th April 2018.

maximize its market value is incompatible with the interests of its controllers, who will ordinarily champion their personal interests, to the detriment of the corporate owners.

This incongruity of interests occasions agency conflicts and problems, which are more pronounced in publicly owned companies, where there is a separation of corporate control and corporate ownership. These interest conflicts are of two main types: conflicts between shareholders and the directors and conflicts between shareholders and creditors.[41] Kim and Nofsinger have contributed to this theory by suggesting two solutions to solving these agency problems: The use of managerial incentives and the use of managerial monitoring.[42] They propound that agency problems could be solved by utilization of managerial incentives, made to tie the wealth of the directors to the wealth of shareholders, thereby aligning the interests of the directors with those of the shareholders.[43] In addition, the theory also recognizes conflicts between creditors and directors.[44]

Its proponents also believe that the agency problems can be mitigated by utilizing various markets of corporate control. Some of the markets for corporate control are, take-over threats, insolvency, the market for shares, product competition and director liability. There are recognizable developments in the concept of director liability, as a market of corporate control. The limited liability principle of a company has direct impact on the agency conflicts between creditors and directors as argued by Jensen. The director liability mechanism imposes liability, either civil liability or criminal liability or both, to directors found guilty of deliberate mismanagement.

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[41] Ibid.

[42] Kenneth Kim and John Nofsinger, *Corporate Governance* (2nd Edition, Washington State University 2007).

[43] Magdalena Jerzemowska, 'The Main Agency Problems and Their Consequences' (2006) Vol.1 *Acta economica Pragensia* pp. 9-17.
< https://www.vse.cz/polek/download.php?jnl=aop&pdf=73.pdf> Accessed on 24th April 2018. For instance, companies can solve agency problems by granting shares to the directors as part of their compensation. On the second solution, he suggests the use of managerial monitoring as a mechanism for monitoring the managers' behavior.

[44] Damodaran argues that these conflicts manifest themselves in three ways: conflicts on investment decisions, conflicts in determining how to finance the projects and conflicts on how much to pay out as dividends.

Damodaran[45] argues that the liability of managers should be better defined, directors should be personally responsible for losses incurred by creditors and they should be punished for continuing to trade in circumstances where the company's insolvency is expected.[46] He argues that the upshot of imposing liability on directors is two-fold: to poster the trust of creditors towards the directors and to guarantee the protection of their interests. He submits that the directors may avoid personal responsibility by demonstrating that they took all the necessary steps to minimize losses to the creditors.

In line with the tenets of this theory, insolvency law has devised three ways through which it can protect the welfare of unsecured creditors: payment to creditors in accordance with Jackson's creditors' bargain model, considering reorganizing the company through voluntary administration and imposing personal liability on the directors.[47] The objective of the third recovery method, which is the main subject of this study, is two-fold: deter undesirable conduct and offer a measure of compensation if deterrence is unsuccessful.[48]This study will utilize the agency theory to analyze the extent to which the Kenyan insolvency laws are efficient, in deterring undesirable conduct by directors and in providing, where the deterrence is in vain, a measure of compensation to unsecured creditors.

1.6.3 The positivism Theory

Proponents of the positivist theory of jurisprudence argue that the subject matter of law is human-made law, created by a political sovereign and imposed on political inferiors. The theory propounds that law is a social fact, which can be ascertained through a systematic process rather

[45] Damodaran A, *Corporate Finance* (John Wiley, 1997) p. 34.
[46] Ibid.
[47] Anderson H, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia' (2009) Vol. 27 (8) *Company and Securities Law Journal* p. 2.
[48] Ibid, p. 9.

than a group of principles derived from the forces beyond the political sovereign. The theory believes that law derives its legitimacy from its conformity with the legal system in which it has been enacted, rather than from its conformity with the principles of natural law and morality.[49] The theory places more premium on the conformity of the law with the grund norm. Against this background, its proponents argue that the law must be followed and recognized as such, purely on the basis that it has been enacted and posited as such irrespective of its moral content. In a summary, the theory conceives law as what it is rather than what it ought to be.[50]

The origins and the initial development of the theory were influenced by the works of Bentham and those of John Austin. The ideas of the theory were scattered until the theory gained some form of structure in the late eighteenth century. The theory did not have a concrete form until John Austin made his most celebrated contribution when he articulately distinguished the proper subject of law from other social conventions which could be easily confused with law.[51] John Austin's work and contribution to the theory were greatly influenced by the works of Hume and Bentham, both of whom had expressed their dissatisfactions with the common law. The duo had previously observed that the common law practice did not have a systematic manner of adjudicating legal disputes and they argued that this situation had created a fertile ground for corruption and arbitrary court decisions.[52] Austin argued that these challenges could only be solved by drawing a separation between law and morality.

[49] Brian Leiter, 'Positivism, Formalism, Realism' (1999) Vol. 99 *Columbia Law Review* pp. 1138-43.
[50] Daniel Gebrie and Hassen Mohamed, '*Ethiopian Justice and Legal Research Institute Teaching Material on Jurisprudence*' (2008) p. 46.
[51] Jonathan Brett Chambers, 'Legal Positivism: An Analysis' (2011) Vol. 79 *Undergraduate Honors Thesis* p. 15.
[52] Pragalbh Bhardwaj and Rishi Raj, 'Legal Positivism: An analysis of Austin and Bentham' Vol. 1 (6) *International Journal of Law and Legal Jurisprudence Studies* pp. 4-10.

The theory has since undergone significant developments. John Austin made the most valuable contribution.[53] He made a clear distinction between positive law and positive morality. According to John Austin, law is that which has been enacted by a political superior for the governance of his political inferiors. On the other hand, he argues that positive morality is those rules set by persons, other than political superiors, for the guidance of persons over whom they have influence. Austin argued that the positive law is the proper law, which should be recognised as such, and the study of law should only be concerned with the positive law.[54]

His acknowledged contribution notwithstanding, John Austin has been criticized. His criticism can be summed up in three main points of criticism. One, it has been argued that laws as are known today are not like orders backed by threats. Although laws like criminal laws resemble orders backed by sanctions, such a character does not exist in other laws like the law on the writing of wills and the laws on creating a contract. In addition, he has been criticized for assuming that the sovereign is the only source of law.[55] This has been viewed as not been live to the role of the courts in the creation of common law and those created by administrative bodies. Austin's concept that the sovereign is not bound to obey anyone has also been challenged. Critics argue that in the contemporary legal systems, the powers of the parliament are far from unlimited, both by the constitution and the doctrine of separation of powers.[56]

The concept of law as was advocated by John was further advanced by H LA Hart in his main work, *The Concept of Law*. His point of entry was by arguing that John Austin's analysis is limited

[53] He defined law as a command of the sovereign enforced by sanction.
[54]Anthony Townsend Kronman, 'Hart, Austin and the Concept of Legal Sanctions' (1975) Vol. 84 *The Yale Law Journal* p. 584.
[55] Wilfrid E. Rumble, 'Legal Positivism of John Austin and the Realist Movement in American Jurisprudence' (1981) Vol. 66 (5) *Cornell Law Review* pp. 986-91.
[56] Daniel (n 50) pp. 60-62.

and primitive. His main contribution and advancement of Austin's concept of law was achieved by making a crucial distinction between primary and secondary rules. He described primary rules as those that govern primitive society particularly on with the view to ensure social coexistence within the members of the society, especially criminal laws.[57] On the other hand, he described secondary rules as those rules which stipulate how primary rules are made, how they come into force and how they can be amended. Secondary rules comprised of rules of recognition, rules of change and rules of adjudication.[58]

The theory was further advanced by Hans Kelsen who advocated for a pure theory of law. Kelsen argued that the laws derive their validity from their conformity with the grund norm, which is the basic norm on which all the laws in the legal system are based. He placed more premium on the unity of a particular legal system, and order, through placing all the laws in any particular system in some sort of hierarchy.[59]

Taken wholesomely, positivism underscores two main values which can be termed as indispensable in any civilized legal system. The first value goes to the root of protection and promotion of human rights against violation by the state and private citizens. The mere fact that the law is written and posited somewhere means that the citizens are well informed of their rights, and the government is promoting the recognition and the protection of those rights. And what is more is the certainty which comes with the written laws.[60] In a positivist society, the citizens have the privilege to order their conduct accordingly, and the courts are strictly prevented from making

[57] Robert S. Summers, 'Professor H.L.A. Hart's Concept of Law' (1963) *Cornell Law Faculty Publications* pp. 1348-54.
[58] Anthony Townsend Kronman, (n 54) p. 586.
[59] Kendra Frew, 'Hans Kelsen's Theory and the key to his normativist dimension' Vol. 4 *The Western Australian Jurist* p. 285-320.
[60] Weatherburn Don and Findlay Mark, 'Positivism, Empiricism and Criminology Theory' (1985) Vol. 5 (2) *Research Collection of School of Law* p. 197.

laws since the proponents argue that judges should decide cases strictly in accordance with the law.[61]

In the Kenyan context, the positivist jurisprudence calls for rational, reasonable and critical thinking on the institutions of parliament and the judiciary. This theory has a big sway in the Insolvency context, especially when advocating for the enactment of clear rules on insolvency, which will be go a long way in ensuring optimal recognition and protection of the rights of both the creditors and the directors of a company approaching insolvency. In majoritarian circumstances, the judges and the legislatures have a duty to ensure that their exercise of their respective roles is channeled to securing certainty and predictability in the entire insolvency regime.

Bentham argues that in their mandate of interpretation, the judges should be guided by the written laws and must do so within the strict confines set by the legislature. In this regard, judges should dissociate themselves from going ahead of the parliament and in case of an apparent deficiency with the insolvency laws; their recourse is restricted to signaling the parliament. The resultant certainty is very useful in the insolvency context, since it provides a clear apportionment of duties and rights amongst the key players in the insolvency regime: the creditors, the directors and the insolvency practitioners. The study utilizes this theory to cement the concept of apportioning rights and liabilities to company directors in the event of insolvency. It advocates for clear stipulation of these duties and rights, which will eventually enable the directors to order their conduct with certainty.

[61] Daniel, (n 50) p. 47. They argue that the integrity of the law can only be maintained through a neutral and objective judiciary that is not guided by subjective notions of equity.

1.7 Hypotheses

This study proceeds on the hypothesis that the civil remedies for fraudulent trading and wrongful trading, provided for under sections 505 and 506 of the Insolvency Act 2015 respectively, are inherently ineffective.

1.8 The Scope of the Study

The study is limited to civil remedies for fraudulent trading and wrongful trading in Kenya. In particular, the study will analyze these two remedies as they were or as they are provided for under the previous Companies Act, Cap 486 (repealed), and the Insolvency Act 2015. It does not consider the criminal offences in anticipation of liquidation which were previously provided for under the repealed Companies Act. Further, it will consider neither the criminal remedies for fraudulent trading nor the criminal offences in anticipation of liquidation, which is currently provided for under the Insolvency Act 2015. In addition, the study is limited to undesirable managerial instances which occurred under the previous insolvency regime, before the Insolvency Act 2015 came into force.

1.9 Justifications of the Study

Globalization and the establishment of global markets have necessitated revolutionary reforms on national insolvency regimes, which in many aspects do not offer optimal guarantee to international investors and creditors in the event of insolvency. Due to the eternal pressure being imposed on individual states by Breton Institutions and influential international players, national governments have now made such reforms a major legislative agenda.[62]Such an agenda has been well acknowledged and adopted by the Kenyan Government. Under the Economic Pillar of the Kenya

[62] Too Chepkemoi, 'A comparative Analysis of Corporate Insolvency Laws: Which is the best option for Kenya?'(PhD Thesis, Nottingham Trent University 2015) p. 1.

Vision 2030, the Government of Kenya has planned to establish Kenya as a regional financial hub, by positioning her as a competitive player in global financial arena. It recognizes that one of the three pre-requisites to establishing successful financial markets is an effective regulatory framework.[63]

The contribution of this research is of great public interest. First, it is instrumental to policy makers as they draft and formulate Kenyan laws in pursuit of integrating Kenya with the rest of the world. Second, it is useful to judges and administrative authorities, especially when adjudicating on a matter touching on either the interpretation or the scope of any remedy for insolvent trading provided for under the Insolvency Act 2015. For the judges, the study will strive to come up with the optimal interpretation of the provisions and the corresponding evidential thresholds necessary for establishing a directors' liability under the provisions in light of global best practices in the pursuit of establishing a globally competitive insolvency regime.

1.10 Research Methodology

The research will take a qualitative approach, majorly the desk review method. It will seek to analyze the Companies Act, 2015 and the Insolvency Act, 2015. It will also revisit and analyze the previous Companies Act, Cap 486 (Repealed). It will review Government Reports, Government Policies and Subsidiary Legislation. On secondary sources of information, the study will review Text Books, Journals articles, and conference papers and reports.

The research will also be based on a comparative study of Kenya, Australia and the United Kingdom. South Africa is arguably the most advanced African country in terms of legal

[63] Government of Kenya, '*Kenya Vision 2030: A Globally Competitive and Prosperous Kenya*' (Government Printer 2007) p. 90. <https://www.researchictafrica.net/countries/kenya/Kenya_Vision_2030_-_2007.pdf> (Accessed on 24th April 2018).

developments while there is a general agreement that UK has the best and the most advanced insolvency globally. Additionally, the Kenyan Insolvency Act 2015 has borrowed heavily from the UK Insolvency Act 1986. Given then the UK Act has been in force for a period 32 years, the UK courts' jurisprudence emanating from this 1986 Act is very instrumental in understanding the interpretation, the scope and the implementation of the provisions providing for remedies for insolvent trading.

1.11 Literature Review

While as there is substantial literature on the efficacy of an insolvency regime, there is relatively scarce literature on the efficiency of the civil remedies for fraudulent and wrongful trading. Internationally, a few have written on the effectiveness of these remedies.

Farrar, J.H[64] discusses the efficiency of the remedies for insolvent trading in two jurisdictions; Australia and New Zealand. He analyses the Australian remedy for insolvent trading, which imposes both civil and criminal liability on a director who fails to prevent insolvent trading.[65] Further, he analyses the New Zealand remedy for reckless trading, which imposes upon a director the duty to prevent reckless trading. He analyzes the provision creating the remedy, its components and the manner in which it is being implemented. He argues that the provisions creating the remedies, though well intentioned, are ineffective due to two reasons; the provisions overstretch the concept of piercing the corporate veil and they were inconsistently enforced.

[64] Farrar J. H, 'Director's Duties and Corporate Governance in Troubled Companies' (2001) Vol. 6 *Canter Law Review* pp. 99-108.

[65] He discusses the components of the provision creating the remedy, and what constituted its contravention and the defenses which are available to the accused director.

Henry Skudra[66] investigates the effectiveness of the remedy for fraudulent trading and wrongful trading in the UK. His analysis features three distinct remedies for insolvent trading in the UK: civil remedy for fraudulent trading and civil remedy for wrongful trading under sections 213 and 214 of the Insolvency Act respectively and criminal remedy for fraudulent trading under section 993 of the Companies Act, 2006. In essence, he examines the efficacy of the criminal remedy under the Companies Act, in comparison with the two civil remedies provided for under the Insolvency Act 1986. He submits that the criminal remedy for fraudulent trading is a more effective tool of preventing illicit trading in a company approaching insolvency, and it offers a real alternative to the civil remedy for fraudulent trading.[67]

Ian Fletcher[68] analyses the efficacy of both the civil remedy for fraudulent trading and wrongful trading in the UK. He argues that the civil remedy for fraudulent trading has not achieved its optimal utility for various reasons associated with the requirement to proof the respondent directors had 'intent to defraud.' He argues that the main challenge is the practical difficulty of demonstrating the requisite intention to defraud on the basis of such evidence as is available. In addition to these challenges, Ian argues that the situation has been aggravated by the role of the UK courts, which have been inconsistent in formulating the exact conduct which should be deemed as fraudulent and in interpreting the underlying concept of fraud itself, which are to be applied in claims on fraudulent trading.[69]

With respect to the remedy for wrongful trading, Ian argues that the remedy was purposely introduced as a compliment to the civil remedy for fraudulent trading and in response to the

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[66] Henry Skudra, *Fraudulent trading as a creditor's remedy- time for a rethink*? (2013) *Amicus Curiae* pp. 11-17.
[67] Ibid, p. 17.
[68] Ian F. Fletcher, *The law of Insolvency* (4th Edition, Sweet & Maxwell 2009) p. 850.
[69] Ibid, pp. 852-3.

inherent challenges, which had made it almost impossible for a liquidator to establish liability for fraudulent trading. However, he argues that the remedy has not been efficient for several reasons. The main challenge is funding the liquidator' claim as he has limited access to finances from the insolvent company. He argues that a UK liquidator can neither sell the claim to a third party nor assign a share of the fruits for external financing due to the legal basis of the remedy and the constraints of the law of champerty. Further, he argues that claims for wrongful trading are subject to a degree of uncertainty as to their ultimate outcome.[70]

Roy Goode[71] critics the efficacy of the civil remedy for fraudulent trading in the UK. In material respects, he collaborates Ian's criticism, particularly on the requirement to proof that the directors had intent to defraud. He argues that the liquidator's high burden of proof in establishing fraud to the criminal standard of proof proved a serious deterrent to the institution of proceedings. He further argues that this particular burden of proof has made the statutory provisions on the civil remedy for fraudulent trading became, although not quite, a dead letter.[72]

Regionally, there is no literature on the effectiveness of an insolvency regime. In Kenya, despite the observable collapse and liquidation of many companies, there is no substantial debate on the effectiveness of the Kenyan insolvency regime, leave alone the effectiveness of the insolvent trading provisions.

E.A. Otieno[73] wrote on the effectiveness of Kenyan corporate insolvency regime. The writer begins by highlighting the essentials of an efficient insolvency system. She discusses the four main essentials of an efficient insolvency regime which are derived from the philosophical foundations

[70] Ibid, pp. 856-61.
[71] Roy Goode, *Principles of Corporate Insolvency Law* (4th Edition, Sweet & Maxwell, 2011)
[72] Ibid, p. 663.
[73] Otieno-Arwa Eunice, 'Corporate Insolvency Systems in Kenya: A case for reform' (LL.M Thesis 2005, University of Nairobi, 2005)

of insolvency law; the prevention function, the rehabilitative function, the distributive function and the punitive function. About the philosophy of punishment, the writer submits that an insolvency regime should be punitive, by bringing to book those found guilty of mismanagement. According to the study, the insolvency regime was ineffective, as it did not strictly conform to the above mentioned philosophies of insolvency.[74] However, the findings are very general and the study did not examine the implementation of the both section 318 and 323 of the Companies Act Cap 486 (repealed).

The writer proposes an insolvency regime which can provide remedy for insolvency offences committed during the pendency of the insolvency proceedings such as fraudulent preference and disposal of property. He recommends an effective insolvency system which should be in a position to punish fraudulent, careless or negligent conduct that leads to insolvency.[75]However, substantial changes have since occurred to the Kenyan insolvency regime. In fact, the Insolvency Act, 2015 and the Companies Act, 2015 have incorporated all the recommendations proposed by the study.

1.12 Chapter Breakdown

This study is comprised of five chapters.

The first chapter has outlined the agenda of the study. It begins with a background of the study, followed by a statement of the problem, which will articulate the specific legal problem under study. This has been followed by an elaborate literature review, which will demonstrate the gap in the literature. Next is a comprehensive theoretical framework, the foundation upon which the study

[74] Ibid, pp. 8-9.
[75] Ibid, p. 9.

rests. Further, the chapter has an outline of the objectives of the study and its hypothesis, the basic assumptions upon which the study is taken. The chapter has concluded with a discussion on the methodology which will be adopted by the study.

The second chapter features the conceptual framework of the civil remedy for fraudulent and wrongful trading. It offers elaborate definitions and descriptions of the concepts of fraudulent and wrongful trading. It further analyses the underlying assumptions and rationales of the two remedies. In addition, the chapter describes the historical development of the two remedies both in the UK and in Kenya, and their current structure. The chapter seeks to uncover the trend which has been demonstrated by the developments in this area of law, and the objectives behind the amendments and legislative developments.

The third chapter will investigate the challenges which were faced for invoking section 323 of the Companies Act Cap 486 (repealed), with a view to understand why law enforcers were forgoing invoking the provisions. It will investigate the structure of the repealed provisions and how their architecture could have been the main challenge to their efficiency. The chapter will consider whether the identified challenges, if any, were debated upon in the process of amending the Companies Act Cap 486. The third chapter will investigate Kenyan judicial approach and its treatment of section 323 of the Companies Act Cap 486 (repealed), with a view to understand why it was almost impossible to establish a director's liability under the two repealed provisions. It will investigate how Kenyan courts construed the repealed provisions and establish whether such judicial treatment could have been a disincentive to invoke the repealed provisions.

The fourth chapter will investigate the structure and the architecture of insolvent trading provisions in Australia and United Kingdom. First, it will justify the choice of the two jurisdictions and the relevance of each in the Kenyan Context. Additionally, it will investigate the judicial treatment

and interpretation of the insolvent trading provisions in these two jurisdictions. This will be in a bid to identify any good practice; which Kenya can emulate.

The fifth chapter will contain a summary of findings of the study and the conclusion taken by the study. Alongside this, it will recommend the necessary amendments to sections 505 and 506 of the Kenyan Insolvency Act 2015.

CHAPTER TWO

THE REMEDIES FOR WRONGFUL AND FRAUDULENT TRADING

2.1 Introduction

This chapter features the conceptual framework of the civil remedy for fraudulent trading and wrongful trading. It offers elaborate definitions and descriptions of the concept of fraudulent trading and wrongful trading. Further, it has analyzed the underlying assumptions and rationales for these two remedies. This is followed by a brief history on the development of the two remedies in the UK and in Kenya, and their current structure in both jurisdictions. In addition, the chapter has briefly discussed criminal remedies provided for under the Insolvency Act, which also have the ultimate effect of regulating the conduct of the directors of an insolvent company, but which are not the subject of this thesis.

2.2 Definition of concepts

2.2.1 Fraudulent trading

There is no one unanimous definition of the term 'fraudulent trading.' The term 'fraudulent' has been defined as acting with or having the intent to deceive.[76] Elsewhere, it has been defined as any conduct involving bad faith and deceitfulness, lack of honesty, or moral depravity.[77] Also, the term 'Fraudulent trading' has been defined as any form of trading which has been employed or devised to defraud creditors.[78] It has also been defined to include circumstances where corporate managers

[76] Collins English Dictionary (6th Edition, HarperCollins Publishers 2006) p. 614.
[77] Black's Law Dictionary (8th Edition, West Publishing Co. 2004) p. 687.
[78] Business Dictionary definition of 'fraudulent trading' <http://www.businessdictionary.com/definition/fraudulent-trading.html> Accessed on 5th August 2018.

intentionally conducts its affairs in a manner that defrauds their creditors.[79] Nonetheless, all these definitions converge at the idea that fraudulent trading involves actual knowledge and real intent of deceiving the company creditors.

2.2.2 Wrongful Trading

There is great controversy on the definition of the term 'wrongful trading,' and scholars have described it differently. The Collins' Dictionary defines the term 'wrongful' as unjust or illegal.[80] The Black's Dictionary defines it as an act characterized by unfairness or injustice.[81] The Collins dictionary defines the term 'wrongful trading' to include the situations where the corporate managers continue carrying on the trading business of the corporate, when it has already occurred to them that the corporate's insolvency is inevitable.[82] It has also been thought of as 'irresponsible trading' and mismanagement of an insolvent company.[83] The Black's Law Dictionary defines it as when a firm is allowed to continue trading when a reasonable person can see insolvency.[84] In essence, these definitions point towards a breach of a duty through careless and reckless conduct, by directors of an insolvent company.

Notwithstanding these various definitions of 'wrongful trading,' it is apparent that it is a negligence-based remedy. This negligence-based conception has been conspicuously pointed out by legal scholars. Legal practitioners argue that a company engages in wrongful trading when its corporate managers continue to trade when they are either actually aware that the company is

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[79] Real Business Rescue *Licensed Insolvency Practitioners,* 'The Difference Between Wrongful and Fraudulent Trading' <https://www.realbusinessrescue.co.uk/business-insolvency/difference-between-wrongful-fraudulent-trading> Accessed on 5th August 2018.

[80] Collins, (n 76) p. 1889.

[81] Black's (n 77) p. 1644.

[82] Collins Dictionary <https://www.collinsdictionary.com/dictionary/english/wrongful-trading> Accessed on 4th August 2018.

[83] Company Debt, 'Wrongful trading vs Fraudulent Trading: What are they?'<https://www.companydebt.com/faqs/what-is-wrongful-trading/> Accessed on 4th August 2018.

[84] The Law Dictionary (Featuring Black's Law Dictionary Free Online Dictionary 2nd Edition).

ending to insolvency or when they ought to have been aware that the company was ending to insolvency.[85] Mitchell has defined wrongful trading as when company controllers keep trading on the assets of the company, when they are aware or should have been aware of the fact that the company had no reasonable prospects of avoiding insolvent liquidation.[86] The remedy for wrongful trading employs an objective test, namely, that of the ordinary, reasonable man, to determine whether with all the available evidence, the company had reasonable prospects of meeting its liability. It also uses the objective test to determine if, with all the available evidence, the company directors should have realized that the company had no reasonable prospects of honouring its debts.[87]

The Kenyan legislative framework has adopted a functional definition of both the terms: 'fraudulent trading' and 'wrongful trading.' Although the Insolvency Act does not specifically define these terms, it offers a description of when it can be said that these civil wrongs have been committed. Fraudulent trading occurs where the 'business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose.'[88] On the other hand, wrongful trading occurs where a director of a company carries on the company's business when he 'knew or ought to have known that there was no reasonable prospect that the company would avoid being placed in insolvent liquidation.'[89]

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[85] Real Business Rescue *Licensed Insolvency Practitioners,* 'The Difference Between Wrongful and Fraudulent Trading' <https://www.realbusinessrescue.co.uk/business-insolvency/difference-between-wrongful-fraudulent-trading> Accessed on 5th August 2018.
[86] Jon Mitchell, 'Wrongful Trading, Fraudulent Trading & Trading Whilst Insolvent' Thomas Westcott Business Recovery & Insolvency <http://www.thomaswestcottbri.co.uk/news/129-wrongful-trading-fraudulent-trading-trading-whilst-insolvent> Accessed on 4th August 2018.
[87] Roy Goode, (n 71) p. 663.
[88] Companies Act 1948 and The Insolvency Act 2015 s 505.
[89] Insolvency Act 2015 s 506.

2.2.3 Indicators of wrongful trading

The act of wrongful trading has different formations and manifestations. A company can carry out wrongful trading if its controllers continue with the trading business of the company despite a clear indication from its financial statements, that the entity cannot generate profits.[90] Alternatively, it might occur when the corporate entity is approaching insolvency although it is yet to wind up. In these particular circumstances, it will occur if the directors invest in excessively risky ventures hoping to escape the impending financial troubles, but being aware that the creditors will bear the additional loss, should the gamble turn out to be unsuccessful.[91] Others have opined that a corporate entity will be engaging in wrongful trading where the entity incurs liabilities but without reasonable prospect that it will meet the liabilities.[92]

2.3 The History of the evolution and development of fraudulent trading in the UK

The introduction and evolution of the civil remedy for fraudulent trading can be traced in the UK. The remedy was first introduced into English law in the 'Companies Act 1928' which was enacted in line with the recommendations of the '1926 Company Law Reform Committee,' popularly known as Greene Committee.[93] Before the introduction of this provision, company controllers used to order for goods on credit in order to crystalize their existing floating charge with the company, when the controller knew that the entity would not honour such liability. Such illicit trading gave

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[90] Paul Davies and Sarah Worthington, *Gower & Davies' Principles of Modern Company Law* (9th Edition, Sweet & Maxwell 2012) p. 235.
[91] Ibid, p. 230.
[92] Roy Goode, (n 71) p. 663.
[93] Maria Elena, 'Fraudulent and Wrongful Trading-Case study of a Judicial Appreciation' (Master's Thesis International Business Law, University of Van Tilburg 2012) p. 14.

the controller an upper hand in the appointment of receiver over the charge. The recommendation for the introduction of this remedy was designed to combat this practice.[94]

The Committee's understanding on the concept of fraudulent trading was very clear and articulate. It recommended that the Companies Act be amended to provide for a civil remedy for fraudulent trading. The remedy would be applicable where the controllers of the company had carried the business of the company with the intention of defrauding its creditors.[95] The remedy would only be invoked in circumstances where a company was being would up and it would be available to a liquidator, a creditor and a contributory. The provision would empower the court to make a declaratory order stating the extent of liability being imposed on the director, and any other order as the court deemed fit and appropriate.[96]

These recommendations were reflected in subsequent UK legislations, particularly Companies Act 1928. The Act provided for a remedy which was more or less an equivalent of today's remedy for fraudulent trading.[97] The wording of the particular provision which provided for the remedy remained substantially untouched until the UK 1986 insolvency reforms came by. However, few minor amendments did occur particularly in 1929 and in 1945. In 1929, section 75 of the 1928 Act, which provided for the remedy, was moved to section 275 of the consolidated Companies Act of 1929.[98] The Act provided for both civil and criminal remedies for fraudulent trading and the remedy could be instituted by any creditor, a liquidator, a contributory or the official receiver. In

[94] Greene Committee Report on Company Law Amendment, Cmnd 2657 (1926), para 61-62. See Edward & Hugo, p. 694.
[95] Paul Omar, 'Directors' Liability in Insolvency: The Position in the United Kingdom' *The International Insolvency Institute* pp. 2-5.
[96] Andrew Keay, 'Fraudulent Trading: The Intent to Defraud Element' (2006) Vol. 35 *Common Law World Review* p. 122.
[97] UK Companies Act 1928 s 75.
[98] Andrew Keay, (n 96) p. 122.

1945, the Cohen Committee saw the relocation of the section[99] and the expansion of the class of potential respondents to include persons who were parties to the illicit trading.[100]

The final and the most advanced developments on the remedy for fraudulent trading occurred in 1986 after the Cork Committee.[101] The significance of the committee was two-fold: it was responsible for the development of the remedy for fraudulent trading and the introduction of the civil remedy for wrongful trading. On one hand, the 1986 insolvency reforms simplified and split up the remedy for fraudulent trading; the criminal version of the remedy was kept in the Companies Act[102] while the civil version of the remedy was placed within the Insolvency Act 1986.[103] On the other hand, the Act introduced the civil remedy for wrongful trading. This development was in line with the recommendations of the Cork Committee, which had recommended a radical extension of the remedy for fraudulent trading. The Committee had recommended a civil remedy for situations where company directors traded recklessly or negligently thereby increasing creditor losses, in circumstances where there were little prospects of the company's recovery of the losses.[104]

2.4 Introduction and Evolution of wrongful trading in the UK

The introduction and development of the remedy was attributed to the inadequacy of the remedy for fraudulent trading. The elements of proofing fraudulent trading rendered it almost impossible for the liquidator to successfully establish and impose personal liability for fraudulent trading.[105]

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[99] Section 275 was moved to section 332 of the Companies Act of 1948.
[100] Andrew Keay, (n 96) p. 123.
[101] See, *Insolvency Law and Practice: Report of the Review Committee*, (Chairman, Sir Kenneth Cork), Cmnd 8558 (1982) (hereinafter 'Cork Report').
[102] UK Companies Act 1985 s 485.
[103] Maria Elena, (n 93) p. 15.
[104] Richard Williams, 'What can we expect to gain from reforming the insolvent trading remedy?' (2015) Vol. 78 (1) *The Modern Law Review* p. 2.
[105] Ian Fletcher, (n 68) p. 856.

For instance, one of the important ingredients for establishing the claim was to proof that the respondents had carried on the business of the company with intent to defraud. Establishing 'fraudulent intent' to the criminal standard of proof was a serious challenge to the liquidator, and it deterred him from instituting the proceedings. Some legal writers have argued that this high evidential burden imposed on the liquidator almost rendered the provisions almost a dead letter.[106]With such difficulties, there was the need for an alternative civil remedy, which would cure all the legal challenges which were inherent with the remedy for fraudulent trading.

Essentially, the remedy for wrongful trading was intended and designed to serve as a complement to the remedy for fraudulent trading, rather than to render it redundant and meaningless. In fact, the Cork Committee recommended that the remedy for fraudulent trading be supplemented by the introduction of a new remedy, under which liability for wrongful trading would be established, but without the need to establish dishonesty and whose proof will require a lesser burden of proof; on a balance of probabilities.[107] The idea of complimenting each is even apparent, going by the way their enabling provisions go hand in hand. Both in the UK and in Kenya, these two provisions follow each other in the respective statutes.

The civil remedy for wrongful trading was first introduced in the UK in 1986, following the recommendations of the Cork Committee. The remedy has been, to a large extent a real complement to the remedy for fraudulent trading. Establishing liability under this remedy requires a lesser burden of proof than that required under the remedy for fraudulent trading.[108] The remedy for wrongful trading applies to directors contemplating an overly risky investment strategy- but

[106] Roy Goode, (n 71) p. 663.
[107] Richard Schulte, 'Wrongful Trading: An Impotent Remedy?' (1996) Vol. 4 (1) *Journal of Financial Crime* pp. 38-46.
[108] Edward Bailey and Hugo Groves, *Corporate Insolvency Law and Practice* (3rd Edition, Butterworth's 2007) p. 693.

without fraud or at least provable fraud.[109] While as the remedy for fraudulent trading applies a subjective test, the remedy for wrongful trading utilizes an objective test to ascertain liability, by assessing the actions of the director in question against the actions which a reasonable director in the similar circumstances would have taken.[110][111] In essence, it is a negligence-based remedy.

2.5 The rationale for the remedy for wrongful and fraudulent trading

The utility of the remedy for fraudulent trading is well acknowledged in the company law literature. Its relevance emanates at the intersection of two well-known principles of company law: The principle of limited liability and that of separate personality.[112] The remedy works under the basic assumption that these two company law doctrines might encourage corporate controllers to defraud their creditors since a creditor's claim is limited to the assets of the company.[113] Essentially, the remedy for fraudulent trading has been viewed as a powerful tool to redress the balance between the two company law doctrines.

The duo civil remedies seek to address the risk that company controllers might take excessive risks at the cost of the creditors. They minimize losses to the creditors by proscribing trading while the companies are almost sliding into insolvency and encouraging the directors to closely monitor the financial positions of their companies.[114] Further, they are tools of creditor protection in the

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[109] Paul Davies and Sarah Worthington, (n 90) p. 230.
[110] Richard Schulte, 'Wrongful Trading: An Impotent Remedy?' (1996) Vol. 4 (1) *Journal of Financial Crime* pp. 38-46.
[111] Edward Bailey and Hugo Groves, (108) p. 698.
[112] Simphiwe Phungula, 'Liability of Liability of Directors for Reckless and Fraudulent Trading: The Continuance of S424 (1) of The Companies Act 61 Of 1973 Together with The Coming into Force of S22 and S77 (3) (B) Of The Companies Act 71 Of 2008' <https://researchspace.ukzn.ac.za/bitstream/handle/10413/12138/Phungula%20_Simphiwe_2013.pdf?sequence=1&isAllowed=y> Accessed on 18th August 2018.
[113] Paul Davies and Sarah Worthington, (n 90) p. 227.
[114] Andrew Keay and Michael Murray, 'Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia' (2005) Vol 14. *INSOL International Insolvency Review* p. 34.

vicinity of insolvency. In addition, the Cork committee conceived the civil remedy for wrongful trading as an effective tool of achieving a healthy balance between the promotion of enterprise growth and discouraging gross irresponsibility.[115]

Despite their eminent utility as a creditor protection mechanism, the two civil remedies have been equally criticized as having the consequence of making directors excessively risk-adverse. Critics of these two remedies have argued that imposing personal liability on the company directors will occasion early closures of companies and premature entry into administration procedures or liquidation.[116] Further, critics are worried that imposing personal liability might occasion the closure of viable businesses, which have realistic chances of redeeming themselves from the financial difficulties and eventually resume normal business life, a situation which has wider benefits to the society, the economy and the stakeholders.[117] In addition, it has been argued that they may deter qualified people from becoming managers while at the same time prevent a company from investing in risky but profitable business ventures.[118] However, these criticisms are not well grounded enough to counter their utility as external mechanism of corporate governance.

2.6 The relationship between the two remedies

The two remedies have different areas of scope and application. The remedy for fraudulent trading is concerned with the propriety or otherwise, of incurring new liabilities, and the main issue worth attention under this remedy is whether or not there is a genuine belief that the company has

[115] Vanessa Finch and David Milman, *Corporate Insolvency Law: Perspectives and Principles* (3rd Edition, Cambridge University Press, 2017) p. 602.
[116] Preetha S, 'The Fraudulent Trading Offence: Need for A Relook' (2011) Vol. 4 *National University of Juridical Sciences Law Review* p. 238.
[117] Hans C. Hirt, 'The Wrongful Trading Remedy in UK Law: Classification, Application and Practical Significance' (2004) Vol 1 *European Company and Financial Law Review* p. 84.
[118] Preetha S, (n 116) p. 238.

reasonable prospects of discharging the incurred liabilities as and when the liabilities fall due.[119] On the other hand, the remedy for wrongful trading focuses on whether there were any reasonable prospects that the company would avoid insolvency proceedings.[120] The major difference between the two remedies is that the remedy for fraudulent trading imposes liability for directors who recklessly continue trading at a time when there are no reasonable prospects that the company could avoid going into insolvent liquidation.[121]

These two remedies have a complex relationship between themselves. On one hand, they demonstrate a picture of an overlap and intertwine. There is a great likelihood that the two civil wrongs will be coexisting and overlapping in any scenario where fraudulent trading has occurred. In these circumstances of overlap, the liquidator is more likely to invoke the remedy for wrongful trading, thanks to its lower standard of proof. it is more likely that the remedies will overlap in any case where fraudulent trading has occurred.[122] On the other hand, they color a picture of two distinct entities which can exist independent of the other. For instance, while as the remedy for wrongful trading can be established where the business of the company has been carried on in a reckless and negligent manner, without the proof of fraud, establishing a claim under the remedy for fraudulent trading necessitates the proof of the fraudulent intent.[123]

Furthermore, the remedy for fraudulent trading is unique in several aspects. Key of its uniqueness is on its scope which is wider than that of the remedy for wrongful trading making the remedy for

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[119] Anderson Hamish, 'An introduction to Corporate Insolvency Law' (2016) Vol. 8 *The Plymouth Law & Criminal Justice Review* p. 38.
[120] Gareth Rigby, 'Directors' concerns: Facing insolvency and wrongful trading' *Mourant Guide* (January 2017) <https://www.mourant.com/file-library/media---2017/2017-guides/directors--concerns---facing-insolvency-and-wrongful-trading.pdf> Accessed on 14th August 2018.
[121] Hans C. Hirt, 'The wrongful Trading remedy in UK Law: Classification, Application and Practical Significance' (2004) *European Company and Financial Law Review* p. 85.
[122] Anderson Hamish, 'An introduction to Corporate Insolvency Law' (2016) Vol. 8 The Plymouth Law & Criminal Justice Reviewp. 38.
[123] Gareth Rigby (n 120).

useful to the office-order.[124] For instance, while as the respondents in a claim for wrongful trading are restricted to are restricted to the directors of the company, the class of the potential respondents in the claim for fraudulent trading is much wider as it includes any person who was party to the fraudulent trading. More importantly, the remedy for fraudulent trading ensures more protection for a wider group of persons. While as the remedy for wrongful trading seeks to protect the welfare of the creditors of the particular company, the remedy for fraudulent trading is designed to ensure protection of both the creditors of the particular company and the creditors of other companies. In addition, the remedy for fraudulent trading prohibits the directors from conducting the business of the company for fraudulent purposes like engaging in tax evasion.[125] As a result, it can be argued that the introduction of wrongful trading did not make fraudulent trading redundant.

2.8 Remedies under the Kenyan Insolvency Act, 2015

2.8.1 Fraudulent trading

The Kenyan legislative framework has provided for a civil remedy for fraudulent trading, under which liable directors are mandated to make financial contributions to the assets of the company. The current provisions under the Insolvency Act[126] are virtually identical to the previous provision which existed under the Companies Act (Repealed).[127] Under both provisions, the liquidator was vested with powers to invoke the remedy by obtaining a court order, declaring the personal liability of the liable director and the extent of their liability. These powers were excisable where the directors of the company had carried on its business either for fraudulent purpose or with intentions to defraud their creditors or creditors of another person.[128]

[124] Richard Schulte (n 104).
[125] Anderson Hamish, (n 116) p. 39.
[126] Insolvency Act 2015, s 506.
[127] Companies Act Cap 486 (Repealed) s 323.
[128] Insolvency Act 2015, s 505 (1) (a).

The scope of the Kenyan remedy for fraudulent trading is relatively wide, since it has a civil version and a criminal version of the remedy. is viewed both as a criminal offence, and as a civil wrong. The Companies Act deals with fraudulent trading as a criminal offence, although the wording of the offence is very identical to the wording of the civil remedy under the Insolvency Act. The offence is committed where directors carry on a company's business for fraudulent purpose, or while intending to defraud either their creditors or those of another person.[129] Somehow, this criminal offence complements the civil remedy under the Insolvency Act. Institution of criminal proceedings for the criminal remedy is not under any pre-conditions, unlike the invocation of the civil remedy under the Insolvency Act. For instance, the company need not be under liquidation.[130]

The civil remedy for fraudulent trading was first introduced into Kenyan legal framework in 1962 under section 323 of the Companies Act (Repealed).[131] Essentially, the provision imposed civil liability for any person who took part in fraudulent trading of a company. The remedy was available where the corporate controllers carried the business of a company with intent to defraud either their creditors or a creditor of another person or even when they conducted the business for a fraudulent purpose. The remedy could be invoked by a creditor, a liquidator or an official receiver.[132] The respondents in the claim for this remedy included anyone who had taken part in

[129] Companies Act 2015, s 1002.
[130] Companies Act 2015 s 1002 (2).
[131] The Companies Act, Cap 486 (Repealed) s. 323.
[132] Section 323 (a) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

the fraudulent trading; whether an insider or an outsider. The ultimate order was discretional and the court could impose liability as it felt fit and appropriate.

2.8.2 Wrongful Trading

The Insolvency Act has incorporated major developments in the area of directors' liability, as it provides for both the remedy for fraudulent trading and the remedy for wrongful trading. Unlike the previous Companies Act, the Insolvency Act has introduced and made elaborate provisions on the remedy for wrongful trading.[133] In many respects, this particular legislative development is a legal transplantation from the UK. The Kenyan provision providing for the remedy is virtually identical with its UK counterpart.[134]

The remedy for wrongful trading was first introduced in Kenya in 2015, through the Insolvency Act 2015. The remedy is applicable to companies that are in insolvent liquidation under the balance sheet test of insolvency.[135] The court might require the responsible directors to make financial contributions to the assets of company.[136] The respondents have a statutory defence where they can demonstrate that they took positive steps, which a reasonable director in similar circumstances would have taken, to minimize loss to the creditors.[137] The remedy has a wider class of potential

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[133] Insolvency Act, 2015 s 506.
[134] UK Insolvency Act 1986, s 214; Insolvency Act, 2015 s 506.
[135] Insolvency Act 2015, s 506 (2) (a). According to the Act, a company is in insolvent liquidation if, at the time the liquidation commences, its assets are insufficient for the payment of its debts and other liabilities and the expenses of the liquidation.
[136] Insolvency Act 2015, s 505 (2).
[137] Insolvency Act 2015, s 506 (6). The section provides, (3) If, in the course of the liquidation of a company, it appears to the liquidator that a person to whom this section applies knew or ought to have known that there was no reasonable prospect that the company would avoid being placed in insolvent liquidation, the liquidator may make an application to the Court for an order under subsection (5).
(5) On the hearing of an application made under subsection (3), the Court may make an order declaring the respondent to be liable to make such contribution (if any) to the company's assets as the Court considers appropriate, but only if it is satisfied that, at the relevant time, the respondent knew or ought to have known that there was no reasonable prospect that the company would avoid being placed in insolvent liquidation.
(6) However, the Court may not make such an order if satisfied that the respondent took such steps to avoid potential loss to the company's creditors as the respondent ought reasonably to have taken, assuming that the respondent knew that there was no reasonable prospect of the company avoiding going into solvent liquidation

respondents as it includes all the key officers of the particular company, such as a manager, a chief executive officer, a secretary and a director.[138]

2.8.3 Other Remedies not under study

Alongside these two civil remedies, the Kenyan insolvency regime employs other remedies, majorly criminal sanctions, whose purpose is to streamline the liquidation process by ensuring cooperation of the company directors with the liquidator. Such criminal remedies were previously provided for under the previous regime as offences committed immediately before the commencement of a winding up or during the winding up of a company.[139] These criminal offences have been reproduced under the Insolvency Act, 2015. It is an offence to commit a fraudulent act in anticipation of liquidation[140] and it also proscribes transactions to defraud creditors of company in liquidation.[141] Further, the Act criminalizes several kinds of misconduct committed during the liquidation process.[142]

And what is more, the Act has provided for criminal offences with respect to transactions done before and during the liquidation of the company. For instance, the Act prohibits the conduct of any transaction which is designed to defraud the creditors of the company in liquidation.[143] It is also an offence to engage in fraudulent acts in anticipation of liquidation. The scope of this offence is wide as it covers concealment of the company's assets, removal of the company's assets from jurisdiction, destruction of company documents relation to its property, making of false entries and

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[138] Insolvency Act 2015, s 2.

[139] The Companies Act (repealed) s 318 (1) (b), it was an offence not to deliver to the liquidator any property of the company in the director's custody. Under s 318 (1) (c), it was an offence to fail to deliver company books, documents and papers. Under s 318 (1) (d), criminalized concealment of any company property from the liquidator.

[140] Insolvency Act 2015, s 498. Division 10. On Offences relating to conduct before and during liquidation and criminal proceedings relating to those offences.

[141] Insolvency Act 2015, s 499.

[142] Insolvency Act 2015, s 500.

[143] Insolvency Act 2015, s 499.

alterations on documents relating company's property among others.[144] The nature and the objective of these offences are to prohibit interference with the liquidation process and ensure smooth running of the process.

2.9 Conclusion

In conclusion, there is no one unanimous definition of the term 'fraudulent trading' and 'wrongful trading.' However, various definitions converge at some point. For fraudulent trading, it is agreed that it involves actual knowledge and real intent of deceiving the company creditors. For wrongful trading, there is a general agreement that it is a negligence-based remedy which employs the objective test, that of the ordinary reasonable man. The Insolvency Act has adopted a functional definition of both terms, by offering a description of when it can be said that these civil wrongs have been committed.

The introduction and evolution of the civil remedy for fraudulent trading can be traced in the UK. The introduction and development of the remedy for wrongful trading in the UK was attributed to the inadequacy of the remedy for fraudulent trading. Essentially, the remedy for wrongful trading was intended and designed to serve as a complement to the remedy for fraudulent trading, rather than to render it redundant and meaningless. Although the utility of the two remedies is well acknowledged in the company law literature, they have been equally criticized for making directors unduly risk-adverse. The two remedies have a complex relationship between themselves. On one hand, they paint a picture of an overlap and intertwine. On the other hand, they appear as two distinct entities which can exist independent of the other.

[144] Insolvency Act 2015, s 498 (2).

CHAPTER THREE

THE IMPLEMENTATION OF THE CIVIL REMEDY FOR FRAUDULENT TRADING UNDER THE INSOLVENCY ACT, 2015

3.1 Introduction

This chapter analyses the implementation of the civil remedies for fraudulent and wrongful trading under the Insolvency Act 2015. Given that these remedies are relatively new and there are very little developments on their implementation, the chapter juxtaposes their prospective implementation with the implementation of the previous remedies under the Companies Act (Repealed). The chapter analyses the implementation of the previous remedy with a view to appreciate the challenges which might recur in the implementation of the remedies under the Insolvency Act. This approach is buttressed by the overwhelming similarities between the previous and the current remedies, characterized by identical wordings of the enabling provisions.

The chapter is divided into the following parts. Part one has dealt with the structure and architecture of the provisions which provided the remedy. This is followed by an examination of the judicial interpretation accorded by the courts. This part has discussed various sub-titles which include; how the courts handled the proof of 'fraudulent intent' and the burden of proof requirement, and the basic requirements for establishing a claim under the provisions. The next part has investigated how the courts treated Section 323-based claim with respect to the Limitation of Periods. It has also discussed the events leading to its amendment and any relevant deliberations on its reform. The last part has provided a conclusion in which the researcher has summarized on the efficacy of the remedy.

3.2 The structure and architecture of the Fraudulent Trading Provision

The remedy for fraudulent trading was provided for under the Companies Act (Repealed).[145] The provision was relatively clear on its manner of enforcement, and the conditions pre-requisite to its invocation. First, the company had to be in the process of winding up.[146] Second, the provision has a specified list of potential plaintiffs. Claims under this provision could be brought by either; official receiver, a creditor or a liquidator.[147] Third, the provision provided the nature of the consequential court order. The order was discretional, and it would cover all or any of the company's debts as the court would direct. What was more, the provision applied where the directors of the company had carried its business with the intention of defrauding their creditors. The provision had a broad and an unspecified scope of potential defendants since the defendants included all persons who had participated in the fraudulent trading.

[145] Companies Act Cap 486 (Repealed) s 323. The section provided that (a) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

[146] *In omnia Fertilizer (Kenya) Ltd v Peter Francis Rukahu Kinya & 3 others* (2006) eKLR, Civil Case 480 0f 2004. The matter was dismissed for lack of jurisdiction. The suit had been commenced by a plaint under the Civil Procedure Rules. In effect, it called upon the court to exercise its Ordinary Civil Jurisdiction and not its winding up jurisdiction under section 323 of the Companies Act. No para.

[147] *Edward Ndungu & 9 others v Patch Osodo* (2006) eKLR, Winging up Cause 7 of 1997. The applicants had no *locus stand*i to apply for the remedy under section 323. They were neither the official receiver, nor were they the liquidator nor contributories of the company. They also could not establish that they were creditors of the company.

3.3 Implementation and enforcement of the remedy

3.3.1 Judicial Interpretation of the remedy

3.3.1.1 The Remedy and the concept of a company's separate personality

Kenyan courts interpreted the provision in conformity with the established principles of company law. They interpreted it as an exception to the concept of a company's separate personality. In *Ultimate Laboratories v Tasha Bioservice*, it was held that section 323 was among the many circumstances in which the fundamental principle of incorporation may be disregarded, lifted, or pierced.[148] This view was upheld in many other subsequent cases.[149] The court in *John Gikandu Magondu v Charles Gaituri*, held that engaging in fraudulent trading under section 323 was a statutory instance of unveiling a corporate veil.[150] Further, it was accepted that a director would incur personal responsibility for participating in fraudulent trading.[151]

3.3.1.2 The manner of instituting a section 323-based claim

Kenyan courts adopted a complex and unstructured jurisprudence on the manner of instituting a claim under section 323. The law provided section 323 as a stand-alone provision, which would sustain a claim without having to be read together with other provisions. However, the courts were divided on the particular provisions on which to base the claim. On the one end, some courts interpreted the section as sufficient provision to base the claim. On the other end, some courts held the view that the section had to be read together with other provisions to sustain a claim for

[148] *Ultimate Laboratories Vs Tasha Bio service Limited* Nairobi H.C.C.C No. 1287 of 2000.
[149] *In Re Matter of Adopt-A-Light Ltd* (2014) eKLR, para 8. See also *Post Bank Credit Limited (In Liquidation) v Nyamangu Holdings Limited* (2015) eKLR para 12. And *Francis Gichuhi Kamau & another v Kenya Railways Staff Retirement Benefits Scheme* (2016) eKLR para 10.
[150] *John Gikandu Magondu v Charles Gaituri Ndei & another* (2014) eKLR. Miscellaneous Civil Case 113 of 2013.
[151] *The Deposit Protection Fund Board*, para, 31. See also *O.M. Da Costa Luis*, para 12.

fraudulent trading. In *O.M Da Costa* case, the application was brought under the provisions of section 323, 324 and 325 of the Act.[152]

The practice of basing a 323-based claim on several other provisions was prejudicial to the efficacy of the remedy. Basing the claim on several sections adversely affected the liquidator's chances of making a successful claim. Such an incidence raised the threshold of establishing liability. The court in *O.M Da Costa* applied this test, holding that the liquidator had to establish two elements. First, he had to establish that the directors of the company had carried its business with intentions to defraud their creditors; and second, the liquidator had to establish that the respondent director had either misapplied the company's property, or he had retained such property unlawfully, or the director was guilty for breach of his fiduciary duties and trust to the company.[153]

With respect, the court in *O.M Da Costa* misapplied and misinterpreted the law on the application of the provision. The claim contemplated under section 323 was very distinct from the claim contemplated under section 324. While section 323 dealt with fraudulent trading, section 324 dealt with instances where the court could assess damages against delinquent directors. Unlike the 323-based claim which specifically dealt with instances where the company controllers carried its business with the intention to defraud their creditors, the 324-based claim was a very general claim. The scope of the 324-based claim extended to any of the following four circumstances; where the respondent director had been guilty of breach of his fiduciary duties to the company, where the

[152] *O. M. Da Costa Luis (The Liquidator for Nzaa Kuu Cement Co. Ltd v Christopher M. Musau* [2013] eKLR, Winding Up Cause 42 of 1993; para, 10.

[153] Companies Act, Cap 486 (repealed) s 324. Liability would attach to a director if the director retained or become liable or accountable for any money or property of the company, or been guilty of any misfeasance or breach of trust in relation to the company.

director had misapplied the company's property, where the director had unlawfully retained the company's property or where the director had become liable for the company's assets.[154]

3.3.1.3 Proof of 'Fraudulent intent'

Kenyan courts had no structured jurisprudence on the interpretation of the term 'fraudulent intent.' Such absurd position was demonstrated in the case of *O. M. Da Costa*. Even though the court held that the liquidator did not demonstrate that the respondent directors had carried the business of the company with the intention to defraud their creditors, the court did not sufficiently demonstrate how it had arrived at the conclusion and above all it did not analyze the real meaning of the term 'fraudulent intent.'[155] And what was more was how the court went on its own target and considered irrelevant factors which had no bearing on the issue at hand. For instance, the court was concerned about the personal relationship between the applicant and the respondent director, pointing that the two had scant respect for each other, and the application had been filed after inordinate delay which serves little purpose other than irritate.[156]

With respect, the court in *D. M. Costa* misapplied the law and it fundamentally arrived at the wrong conclusion on the interpretation of the remedy for fraudulent trading. The court overwhelmingly relied on irrelevant precedent, a UK case, which had no bearing to the case at hand. The UK's case *Re Hawkes Hill Publishing Co. Ltd (In Liquidation) Ward v Perks* [157] concerned a case of wrongful trading and not fraudulent trading as the Court in *D. M. Costa* mistook. Therefore, the *Court in D.M Costa* was totally wrong when it applied the test of wrongful trading to establish whether the

[154] Companies Act, Cap 486 s 324.
[155] O. M. Da Costa Luis (The Liquidator for Nzaa Kuu Cement Co. Ltd v Christopher M. Musau [2013] eKLR, Winding Up Cause 42 of 1993; para, 10.
[156] *O. D M. Casta*, para 14.
[157] *Re Hawkes Hill Publishing Co. Ltd (In Liquidation) Ward v Perks & Another* (2007) EWHC 3073 Ch. The case particularly interpreted the term 'the prospect of avoiding insolvent liquidation' as an element of establishing wrongful trading.

respondents were liable for fraudulent trading. In fact, the court sought to answer the following three questions; whether the respondent had acted reasonably, whether the respondent knew or ought to have known that the company would become insolvent and whether the respondent had taken steps to mitigate any loss which had been incurred. These three questions are the core elements of establishing liability for wrongful trading.[158]

The necessity of defining the term 'intent to defraud' has not caught the attention of Kenyan Courts. The High Court in the *DPFB case* did not interpret the term, despite its holding that the directors had engaged in fraudulent trading. Similarly, the High court in both the *D.M Costa* and the *Ajay I. Shah v DPFB*[159] cases squandered the opportunity to interpret the term.[160]

3.3.1.4 Burden of Proof

A liquidator's claim brought under section 323 required a unique burden of proof, different from the standard of mere balance of probabilities required in civil claims. This special burden of proof was attributed to the requirement of establishing fraud. In *Mutsongar v Nyati*, it was held that allegations of fraud must be strictly proved and they require a high degree of probability, which is something more than a mere balance of probabilities.[161] This holding has since been upheld by more recent cases. In *Njuwangu Holdings Ltd v Langata Kpa*, the court held that the standard of proving fraud in civil cases is much higher than the usual civil standard based on a balance of probability but not beyond the criminal standard of beyond a reasonable doubt.[162] The uniqueness

[158] *D. M. Costa*, para 14.
[159] *Ajay I. Shah v Deposit Protection Fund Board as Liquidator of Trust Bank Limited & Praful Shah* [2014] eKLR
[160] Other cases include *Edward Ndungu & 9 others v Patch Osodo* (2006) eKLR, Winging up Cause 7 of 1997.
[161] *Mutsongar v Nyati* (1984) KLR 425.
[162] *Njuwangu Holdings Ltd v Langata Kpa Nairobi & 5 others* (2014) eKLR.

of the standard of proof is premised on the fact that an allegation of fraud is a serious indictment against a party to whom it is made.

3.3.2 The position of a 323-based claim with respect to Limitation of Actions

3.3.2.1 The rules governing the limitation of period on claims by a liquidator

The 323-based claim did not have a special limitation period hence it was subject to the general rules and principles governing limitation of periods. Essentially, the claim had the same limitation period as it would have if the claim was brought by the company.[163] In this regard, courts held that the section neither created a new cause of action nor created new rights because the cause of action is a cause of action that inheres in the company.[164] Further, it has been held that the section provided only a summary and efficient remedy in respect of rights that existed and accrued to the company prior to it being placed in liquidation.[165] As a result, the mere fact that a company's claim is time barred consequently means that the liquidator's institution of the same claim is as well time barred.

Entry into liquidation and the appointment of a liquidator had no bearing on the computation of the limitation period. It did not start neither on the entry into liquidation nor on the appointment of the liquidator. Instead, the computation of the limitation period started to run on the day the cause of action arose. The commencement of the winding up only gave the liquidator the legal capacity to institute proceedings in his own name.[166] It neither extended nor revived any limitation period nor did it exclude the duration of winding up from computation of the limitation period.[167]

[163] *Ajah Shah* (n 28) para 65. The court in Appeal held that in substance, the claimant remained the company, and this conception would not be altered by the fact that the claim was brought by the liquidator. Consequently, a claim under the section did not have a limitation period distinct from that applicable to the underlying claim.
[164] *Ajah Shah* (n 28) para, 66.
[165] *Ibid*, para, 60.
[166] *Ibid*, para, 63.
[167] *Ibid.*

This position is based on principle. The nature of the claim is merely procedural because it only grants the company an alternative way of seeking compensation from a director who has breached his duties.[168]

There was certainty and a general agreement among the courts that 323-based claims had a limitation period of six years. This position was based on the provisions of the Limitation of Actions Act. The nature of the provision contemplates that the claims should fall under the category of actions to recover a sum recoverable under a written law. Such claims have a limitation period of 6 years, and the period starts to run from the date on which the cause of action accrued.[169] Courts specifically held that the computation started the day the cause of action arose in favor of the company.[170] This rule was applied in *Ajay Shah v Deposit Protection Fund Board,*[171] where the Court held that the matter was time barred. The cause of action arose on 16th September 1998, when the overdrafts were made, and the claim was commenced in 2010, more than 6 years later.[172]

This certainty on the computation of limitation period notwithstanding, the courts were willing to adopt a flexible approach in determining the limitation period for 323-based claims. In some instances, especially where there was fraud, the courts demonstrated the interest to suspend the computation of the period to the date of the fraud discovery. This interpretation was in line with the written law, which stipulated that the limitation period for claims based on fraud started to run when the plaintiff discovers the fraud.[173] Such was the case in *Ayah Shah*, where the court was

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[168] *Ibid*, para, 58.
[169] The Limitation of Actions Act, s 4 (1) (d).
[170] *Ajah Shah* (n 28) para 65.
[171] *Ajay Shah v Deposit Protection Fund as Liquidator of Trust Bank Limited (In Liquidation)* (2016) eKLR, Civil case Numbers 158of 2013.
[172] *Ibid*, para 65.
[173] The Limitation of Actions Act, s 26 (a).

willing to suspend the limitation period. The alleged fraud had been concealed and the liquidator only discovered the fraud some years later after the expiry of the six years.

3.3.2.2 The suspension of the statute of limitation under section 323

The jurisprudence from the Kenyan courts on the application of the fraud exception was unstructured and intermittent. The courts were uncertain on the particular facts which would justify the application of the exception. This played out in the case of *Ayah Shah*, where the court took two extreme ends of the spectrum. On the one end, the court did not identify fraud from either the facts of the case or the liquidator's submissions. This meant that the limitation period was to be determined as per the general rule. On the other end, the court appeared to admit that fraud had been established. This meant the claim was subject to the exception on the computation of the limitation period and hence the limitation period would be suspended until the time when the discovery was made.

On the one end, the fraud exception did not apply hence the liquidator's claim was time barred. According to the court, the liquidator had discovered the cause of action in 2001, when he was appointed. It reasoned that the Scheme, dated 25th May 1999, had all the relevant and material information to institute a claim under section 323.[174] The court did not see fraud on the part of the directors, given that the directors had even admitted the debt. In the absence of fraud, the court held that the computation of the limitation period did not qualify for the exceptional rule applicable in cases involving fraud. As a result, the court found that time started running from 25th May 1999,

[174] The directors had participated in the making of the scheme of agreement, in which they had admitted that they owed some insider loans to the company.

and it expired after six years. Given that the claim was instituted in 3rd March 2010, the court concluded that the claim was long time, time-barred.[175]

Be that as it may be, the ruling in *Ayah Shah* is open to serious criticism. A particular point of criticism is on how the court arrived at its finding that the directors had not fraudulently concealed crucial information. With respect, the court ignored or otherwise assumed the argument by the liquidator. According to the liquidator, the information in the Scheme of Arrangement was not enough to establish a cause of action. The directors had just admitted owing insider loans to Trust Bank Limited.[176] However, later the liquidator later came to discover that in fact, the admitted 'insider loans' were not loans in the first place.[177] In essence, the directors had fraudulently concealed facts giving rise to the cause of action. The court's failure recognize such crucial facts was fatal to the liquidator's claim, given the computation of the limitation period of the claim could not be granted the special exception on fraud cases.

On the other end, however, the court simultaneously reached a very different conclusion on its findings on the presence of fraud on the part of the directors. The court was reluctantly persuaded that the liquidator had discovered some fraud and it was willing to suspend the statute of limitation to the date of discovering the fraud.[178] Such a finding was a major step on the efficacy of the

[175] *Ajah Shah*, (n 28) para 80.
[176] *Ibid*, para 5.
[177] Following some investigations between 2008 and 2010, the liquidator established that in deed fraud had been practiced on the company. It emerged that the debt was in fact not a loan transaction, but a fraud practiced on the Bank by the two directors. First, the account had not been officially opened in the Bank books. The other account had no account opening document to support it, there were no company resolution from Trust Capital Services Limited to open the account and the Bank did not have authorized signatories to the account. And what was more, the bank did not hold any security for the repayment of the loan. In addition, there was no application to the Bank by Trust Capital Services Ltd for any loan or overdraft facility.
[178] Ajah Shah (n 28), para 66.

remedy, considering that the liquidators are likely to discover the fraud aspect way late since their appointment into the office.

However, the fraud exception had a nominal utility especially in the context of section 323-based claims. Its insignificance was occasioned by certain prerequisites which the liquidator had to proof, and which were by their nature hard to establish. The liquidator had to pinpoint the exact date on which the discovery of fraud was made, from which the computation of the limitation would be based. This made it almost impossible for the liquidator to get the suspension of the limitation period for 323-based claims. Such was the case in Ayah, where the liquidator could not rely on this exception, as he could not give a specific date or event when he made the discovery. The court held that the date from which computation of the limitation period is to start cannot be a date in flux and fluidity; it cannot be an open-ended date in continuum.[179] Arguably, the court was giving with one hand, and taking with the other.

The court in the *Deposit Protection Fund Board* appears to have made the right interpretation of the section. This is so considering its position on the interpretation of the issue of limitation of actions. The two courts were in agreement that the claim was not time barred, and a cause of action in fraud allegations accrues from the time when the fraud is discovered.[180] However, with due respect, the Court of Appeal seemed to have made an absurd decision particularly by maintaining that the liquidator had to pinpoint the specific date of discovering the fraud.

[179] *Ibid*.
[180] *The Deposit Protection Fund Board as Liquidator of Trust Bank Limited (in Liquidation) v Vajah & Another* (2013) eKLR; Miscellaneous Civil Application 294 of 2010, para 22.

3.4 The assessment of its enforcement and implementation

3.4.1 The successes in the instituting claims under section 323

The civil remedy for fraudulent previously provided for under the Companies Act (Repealed) did not live to its goal and objective. There were few cases brought under the provision, all of which were lost either on first trial or on appeal. The greatest achievement by this section was reached in 2013, in the case of *The Deposit Protection Fund Board (DFF) as Liquidator of Trust Bank Limited (in Liquidation) v Vajah*[181] where the liquidator successfully made a claim under section 323. However, the achievement was short-lived as the holding was successfully appealed at the Court of Appeal in *Ajay Shah v Deposit Protection Fund Board as Liquidator of Trust Bank Limited (In Liquidation)*.[182]

The civil remedy for fraudulent trading had a limited scope, owing to the specific circumstances under which it would be invoked. Its application was limited to cases where the company was in the course of being wound up, and this condition rendered the remedy irrelevant as a tool of corporate governance. It prevented the invocation of the remedy where the directors were engaging in fraudulent transactions but the company was still operating. This explains why the provisions were never invoked to remedy the fraudulent trading at Mumias Sugar Company and Uchumi Supermarkets Limited. The two never went into winding up thanks to government bailouts.[183]

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[181] Ibid, para 24.

[182] *Ajay Shah v Deposit Protection Fund Board as Liquidator of Trust Bank Limited (In Liquidation)* [2016] eKLR Civil Appeal No. 158 of 2013.

[183] Kwama Kenneth (2015, July 7) 'Past beneficiaries of state bailout funds' Standard Digital. Also <http://www.standardmedia.co.ke/business/article/2000168256/past-beneficiaries-of-state-bailout-funds> Accessed on 7th August 2018. On July 15, 2006, the government advanced a bailout of 675 million after which the company resumed operations. See also Jackline Wanjiku Mwangi, 'Critical review of the legal framework for financial bailouts of public companies in Kenya' (LLM Thesis, University of Nairobi, 2017) p. 4. The company was financed to the tune of 407 Million in 2009.

Consequently, unless and until a company went into liquidation, nobody had the *locus standi* to invoke the section and hence there was no opportunity to pursue the 323-based remedy.

3.5 The nature of the civil remedy for fraudulent trading under the Insolvency Act 2015

A civil remedy for fraudulent trading has been provided for under the Insolvency Act. The current remedy is fundamentally similar to the previous remedy. The section has an identical wording with section 323 of the repealed Companies Act. It reads; '*If in the course of the liquidation of the company, the liquidator forms the view that a business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose…*'[184] In addition, the consequential court order is a discretional one, guided by what the court deems fair and reasonable. Further, the provision has a broad and unrestricted class of potential defendants. Defendants are any persons who participated in the fraudulent trading of the company.[185]

However, the remedy under the Insolvency Act is also different from the previous remedy in a number of respects. Among the differences is the significant reduction of the number of potential plaintiffs under the two legislations. The current remedy has a more restricted list of potential plaintiffs. In fact, the claim can be made exclusively by the liquidator.[186] This may be contrasted with the previous remedy where there was a wider scope of plaintiffs. The remedy under the previous law could be invoked by several key participants in the life of the company; a liquidator, a contributory, a creditor or the official receiver.[187]

[184] Insolvency Act, 2015 s 505.
[185] Insolvency Act, 2015 s 505 (1) (b).
[186] Insolvency Act, s 505 (1).
[187] Companies Act 1948, s 323 (a).

3.6 Wrongful Trading

The desire to analyze the efficacy of the newly introduced remedy for wrongful trading in Kenya is well founded both on principle and logic. This analysis informed by the conspicuous literature in insolvency law, which suggests that any discourse on the remedy for wrongful trading has become almost inseparable from mentioning the remedy for fraudulent trading. Although this remedy has just been introduced in Kenya, there is much to discuss about it. Though the remedy has been implemented in other jurisdictions like the UK and Australia, its efficacy in these jurisdictions has been under heavy criticism and its enforcement and implementation has encountered serious legal challenges. Against this back ground, it is crucial to dissect the structure of the Kenyan provisions with a view to unearth whether they are immune and susceptible to the legal challenges being faced in the two jurisdictions; UK and Australia.

The remedy is founded on comprehensive provisions which stipulate the conditions of attaching liability and the defenses available to the respondent director. It applies to companies which have gone into insolvent liquidation, and the respondents are those persons who were officers of the company before it commenced the liquidation process. This civil wrong is committed when the respondent trades while they knew or ought to have known that there was no reasonable prospect that the company would avoid being placed in insolvent liquidation. The respondent has a defence if he can demonstrate that he took positive steps to minimize losses to the creditors. The steps in question are those which the respondent director should have taken had he known that the company had no reasonable prospect of avoiding going into solvent liquidation.[188]

[188] Insolvency Act, 2015 s 506.

Upon establishing liability, the court can make several orders. One of them is a contribution order, in which the respondent director is declared liable to make financial contribution to the assets of the company as the court considers appropriate. In addition, the court has powers to disqualify the respondent director from being a director of a limited corporate entity in future. Furthermore, it may disqualify the respondent from being a liquidator, as administrator, a provisional liquidator or a supervisor of a voluntary arrangement of a company or limited liability partnership.[189] The duration of all these disqualification orders is discretional and may go up to fifteen years.

The implementation of the remedy is fundamentally limited considering the limited class of potential applicants in a claim for wrongful trading. The liquidator has the sole privilege to invoke this remedy. Effectively, other groups of persons such as an administrator, a receiver and creditors of the company have no *locus standi* to initiate these particular proceedings. On the other hand, the remedy has a relatively wide class of potential respondents, which includes key participants in the management of the company; the company directors, the secretaries, the company CEO, and managers in the company.[190] However, the definition of the word 'director' is somehow limited as it does not encompass both shadow and former directors.[191]

3.7 Conclusion

To a great extent, the civil remedy for fraudulent trading did not live to its goal and objective thanks to several factors. Kenyan courts adopted a complex and unstructured jurisprudence on the manner of instituting a claim under section 323. Further, the courts had no structured jurisprudence on the interpretation of the term 'fraudulent intent.' In fact, the necessity of interpreting the term 'intent to defraud' did not get any attention from the Kenyan courts. In addition, a liquidator's

[189] Insolvency Act 2015 ss 506 (5-8).
[190] Insolvency Act 2015 s 2.
[191] Insolvency Act 2015 s 506 (1) (b).

claim brought under section 323 required a unique burden of proof, different from the standard of mere balance of probabilities required in civil claims. However, it was a challenge for the liquidators to achieve this particular burden of proof. Lastly, its efficacy was also affected by the strict interpretation of the rules on limitation of actions.

Although the remedy for wrongful trading has just been introduced in Kenya in 2015, there is much to discuss about it on its future in the Kenyan context. Despite the fact that the remedy has been implemented in other jurisdictions like the UK and Australia, its efficacy in these jurisdictions has been under heavy criticism and its enforcement and implementation has encountered serious legal challenges. Against this back ground, it is crucial to dissect the structure of the Kenyan provisions with a view to unearth whether they are immune and susceptible to the legal challenges being faced in the two jurisdictions; UK and Australia.

CHAPTER FOUR

COMPARATIVE ANALYSIS OF REMEDIES FOR FRAUDULENT AND WRONGFUL TRADING IN THE UNITED KINGDOM AND AUSTRALIA

4.1 Introduction

This chapter has investigated the comparative parallels that can be drawn from Australia and United Kingdom with respect to the implementation of their civil remedies for both fraudulent and wrongful trading. The chapter has two main parts. The first part has discussed the implementation of the remedy for fraudulent trading under the two jurisdictions and the second part has discussed the implementation of the remedy for wrongful trading. At the beginning of each part, the researcher has provided a justification for the choice of the jurisdiction under investigation. Finally, the researcher has concluded the chapter with a summary of the issues arising from the investigation.

4.2 THE REMEDY FOR FRAUDULENT TRADING IN THE UNITED KINGDOM

4.2.1 The suitability of the UK regime for this study

The UK is the most appropriate jurisdiction for comparative analysis on the implementation of the remedy for fraudulent trading. Both the previous remedy under the Companies Act (repealed) and the current remedy under the Insolvency Act take after the UK provision on many aspects. The three statutes have a similar wording. Under the UK Act, liability for fraudulent trading attaches if the respondent carries on the business of the company with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose.[192] Further, the remedies

[192] UK Insolvency Act s 213 (1). The Kenyan provision, (Companies Act Cap 486 (Repealed) s 323 provided '*If in the course of the winding up of a company it appears that any business of the company has been carried on with intent*

have similar pre-conditions for their invocation. Under the three statutes, the remedy can only be invoked where the company is being would up.[193]

The provision proscribing fraudulent trading under the Insolvency Act is more similar to the UK's provision than it was the case before the insolvency reforms of 2015. The previous Companies Act had a broader class of potential plaintiffs which included the liquidator, the official receiver, a creditor and a contributory of the company. The Insolvency Act has significantly reduced the class of potential plaintiffs, taking the same position to that of UK. Under the two jurisdictions, the remedy can only be instituted by the liquidator.[194] Further, the consequential orders are of the same nature. The orders and the amount of contributions are discretional.[195]

4.2.2 The implementation of the Remedy for Fraudulent trading in the UK

4.2.2.0 The elements of establishing a claim for fraudulent trading

4.2.2.1 The proof of fraudulent intent

The requirements for establishing liability under the UK provision are fairly straightforward. The liquidator had to satisfy three elements.[196] First, the liquidator has to demonstrate that the respondent directors had carried the business of the company with the intention of defrauding their creditors. Two, the liquidator has to proof that the respondent director participated in the fraudulent

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to defraud creditors of the company or creditors of any other person or for any fraudulent purpose.' The Insolvency Act 2015 s 505) provides that '*If—(a) in the course of the liquidation of the company, the liquidator forms the view that a business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose*;'.

[193] UK Insolvency Act s 213 (1). The Kenyan provision has the same condition.

[194] This is the same position in the UK. (Insolvency Act 1986 s 213).

[195] Insolvency Act 1986 s 213, and Insolvency Act 2015 s 505.

[196] However, some legal writers hold a contrary view. (Edward Bailey and Hugo Groves, p. 694.) They opine that the liquidator has to proof two elements: The carrying on of business with an intent to defraud, and the respondent was knowingly party to the carrying on of such business.

trading. Three, the liquidator had to proof that the respondent director took part in the fraudulent trading knowingly.[197] The burden of proof of these elements is on the liquidator. The liquidator has to establish the alleged fraudulent misfeasance and the fact that a company director is involved does not change this.[198]

UK courts have a structured and a concrete jurisprudence on the interpretation of the phrase 'intent to defraud,' as an element of establishing liability under the remedy. The liquidator has to show '*actual dishonesty involving, according to current notions of fair trading among commercial men, real moral blame*.'[199] This means that the directors have deliberately carried on the business of the company while they are certainly sure that they are trading purely at the expense of the creditors and being fully aware that the creditors will not be paid.[200] The courts have simplified this requirement by outlining the facts and circumstances the proof of which it will be presumed that the director had intent to defraud. The presumption will be made if '*a company continues to carry on business and to incur debts at a time when there is, to the knowledge of the directors, no reasonable prospect of the creditors ever receiving payment of those debts*.'[201]

Nevertheless, the proof of the 'intent to defraud' is problematic in many aspects. The element has more intricate requirements, which borders a charge for a criminal offence. It requires actual dishonesty on the part of the respondents and the dishonesty conduct may be deducted from either a single transaction or a chain of transactions.[202] The dishonesty is satisfied when directors incur

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[197] Roy Goode, *Principles of Corporate Insolvency Law* (4th Edition, Sweet & Maxwell, 2011) p. 658. This was established in Re Bank of Credit and Commercial International SA, Morris v State Bank of India [2003] B.C.C. 735, per Potter J. at [11].
[198] *Mullarkey & Ors v Broad & Another* High Court (Ch) Bristol District Registry Case no 38 2007.
[199] *Re Patrick and Lyon Ltd* (1933) Ch 786.
[200] Edward Bailey and Hugo Groves (n 108) p. 696.
[201] Paul Davies and Sarah Worthington, *Gower & Davies' Principles of Modern Company Law* (9th Edition, Sweet & Maxwell 2012) p. 229.
[202] Edward Bailey and Hugo Groves (n 108) p. 695.

liabilities, at a time when they are certain sure that the debts will not be repaid or at a time when there is a substantial and unreasonable risk that the debts will not be paid. Further, an application for the remedy must detail the alleged fraud with particularity.[203] The liquidator was obliged to establish some element of deliberate dishonesty rather than the fact that a party is simply prejudiced by the action.[204]

Further, the proof of the third element is the most problematic. Proofing that the defendant '*took part with knowledge*' places a very high burden on the liquidator. The element requires actual knowledge and the liquidator has to prove subjective moral blame. It cannot be inferred merely because they ought to have realized there was no prospect of repayment.[205] This high burden of proof has had serious repercussions on the efficacy of the remedy for fraudulent trading. It prevented the remedy from being used except in the most extreme circumstances.[206]

The legal challenges of establishing the three elements have adversely affected the utility of the remedy as a tool of corporate governance. The most fatal challenges are associated with defining the scope of 'intent to defraud,' as a crucial element attaching liability. The UK courts have had a challenge with formulating the test of fraudulent conduct and the underlying concept of fraud itself.[207] The practical difficulty of demonstrating the requisite intention to defraud on the basis of such evidence as is available is always a challenge.[208]These legal challenges have sparked a low

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[203] Henry Skudra (n 66) p. 13.
[204] Martha Maher & James Forsyth, 'Fraudulent Trading-An under-used remedy' *Guildhall Chambers* p. 3. <http://www.guildhallchambers.co.uk/files/FraudulentTrading_AnUnder-usedRemedy_MM&JamesForsyth.pdf> Accessed on 18th August 2018.
[205] Paul Davies and Sarah Worthington (n 90) pp. 229-230.
[206] Pavlos Neofytou Kourtellos, 'Cyprus Insolvency Law; the concept of Fraudulent Trading' *P.N.Kourtellos & Associates LLC* p. 2. <https://www.kourtelaw.com/uc/wp-content/uploads/2014/02/Cyprus-Insolvency-Law-the-concept-of-Fraudulent-Trading.pdf> Accessed on 18th August 2018.
[207] Ian Fletcher, *The Law of Insolvency* (4th Edition, Sweet & Maxwell, 2009) p. 852.
[208] Cameron Scott, 'Financial Crime Update' (2013) *Butterworths Journal of International Banking and Financial Law* p. 2.

opinion on the potential of the remedy as a tool for corporate governance with some legal scholars being skeptical that proceedings brought under either version of the remedy for fraudulent trading can be successful.[209]

4.2.2.2 The scope of the remedy

The UK remedy has a wider scope than the Kenyan remedy, especially with respects to the class of potential respondents. Unlike the Kenyan remedy whose potential respondents were exclusively company directors, the UK remedy has a broader class of potential respondents. UK courts have interpreted the remedy to capture other persons who need not be directors of the troubled company. In the UK, liability for fraudulent trading may also be imposed on complete outsiders, provided they knowingly took part in the fraudulent trading of the company.[210]

4.3 THE REMEDY FOR WRONGFUL TRADING IN THE UNITED KINGDOM

4.3.1 The suitability of the UK Insolvency regime in this research

The UK is the most favorite jurisdiction to offer a comparative analysis on the implementation of the remedy for wrongful trading. The Kenyan provision proscribing wrongful trading is similar with the UK's provision in many aspects. The two provisions have identical wordings.[211] Further, the provisions have an identical class of potential plaintiffs. The revocation of the provisions is a preserve for the liquidator.[212] In addition, they have similar pre-conditions for their invocation. In

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<http://www.23es.com/wp-content/uploads/2014/04/JIBFL-Financial-Crime-Update-August-2013.pdf> Accessed on 18th August 2018.

[209] Ian Fletcher (n 68) p. 853.

[210] Roy Goode, (n 71) p. 659. This principle was established in *Re Gerald Cooper (Chemicals) Ltd* [1978] Ch. 262.

[211] UK Insolvency Act, s 214 (2) (b) provides 'If in the course of the winging up of a company it appears that…. at some time before the commencement of the winding up of the company, that person new or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. The Kenyan Insolvency Act section 506 provides 'if, in the course of the liquidation of a company, it appears to the liquidator that [the] person knew or ought to have known that there was no reasonable prospect that the company would avoid being placed in insolvent liquidation.'

[212] Insolvency Act 2015 s 506 (3) and UK Insolvency Act 1986 s 214 (1).

both jurisdictions, the company must have gone into insolvent liquidation.[213] Furthermore, defendants in a claim for wrongful trading under the two jurisdictions have similar defenses. To a greater extent, the two provisions have an identical wording of the defence.[214]

Notwithstanding all these apparent similarities, there are few differences between the two provisions. One point of contrast is on the class of potential respondents in a claim of wrongful trading. Under the UK provision, the respondent must be a director of the company.[215] Under the Kenyan provision, the class of the potential respondents is broader in scope since it includes the CEO of the company, secretaries, managers and directors of the company.[216] However, these differences are not so significant that they can negate the magnitude of the shared features. Arguably, they have marginal influence on the invocation and implementation of the remedy.

4.3.2 The Introduction of the remedy for wrongful trading in the UK

The remedy for wrongful trading was introduced in the UK in 1986, by the 1985-1986 insolvency reforms which were influenced by the Cork Committee of 1982. The introduction of the remedy was long overdue. Before its introduction, a previous law reform committee had recommendation its introduction. In 1962, the Jenkins Committee unsuccessfully suggested the introduction of a remedy for 'reckless trading.'[217] In 1982, exactly twenty years after the Jenkins Committee, the

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[213] UK Insolvency Act 1986 s 214 (2) (a); Insolvency Act 2015 s 506 (1) (a).
[214] UK Insolvency Act 1986 s 214 (3) provides that the defendant will have a defence if 'that person took every step with a view to minimizing the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken. Kenyan Insolvency Act 2015 s 506 (6) provides that the defendant will have a defence if'…the respondent took such steps to avoid potential loss to the company's creditors as the respondent ought reasonably to have taken, assuming the respondent knew that there was no reasonable prospect of the company avoiding going into solvent liquidation.'
[215] UK Insolvency Act 1986 s 214 (2) (c).
[216] Insolvency Act 2015 s 506 (1) (b).
[217] UK Board of Trade (1962) Report of the Company Law Committee Cmnd. 1749 para 85 b (iii). (The Jenkins Committee). The Committee was chaired by Lord Jenkins.
<https://www.takeovers.gov.au/content/Resources/other_resources/downloads/jenkins_committee_v2.pdf>
Accessed on 18th August 2018.

Cork Committee successfully recommended the introduction of the same remedy, but under the name of 'wrongful trading.'[218] The remedy was designed to complement the remedy for fraudulent trading, which had lost its utility as a mechanism of enforcing desired managerial conduct.

4.3.3 Successes in the Implementation of the remedy in the UK

4.3.3.1 A robust and an all-around approach on the remedy in the UK

UK courts have a structured jurisprudence on the interpretation of the provisions proscribing wrongful trading. The emerging jurisprudence indicates that the liquidator has to establish two elements. First, the liquidator has to establish that at some time before the commencement of the winding-up, the respondent knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.[219] Second, the liquidator has to establish that the respondent had been a director or a shadow director of the company at the time when the probability of the company's eventual insolvency was or ought to have been known.[220] The onus is on the liquidator to establish the two elements.[221]

These two requirements for establishing a director's liability have attracted less controversy. Academic commentators have simplified these requirements by breaking them down into two basic questions which the court has to answer, both on an objective basis. The first question is '*Should the director have realized there was no reasonable prospect of the company avoiding insolvent liquidation?*' The second one is, '*Did the director take all the steps he or she ought to have taken to minimize the loss to the company's creditors, especially, no doubt, by seeking to*

[218] Richard Williams, (n 104) p. 2.
[219] Ian Fletcher, (n 68) p. 857; Roy Goode, (n 71) p. 666.
[220] Ibid, (n 68) p. 857.
[221] Roy Goode, (n 71) p. 671.

have the company cease trading?'[222] Claims based on this remedy has a limitation period of six years, and time starts running from the date of the winding-up order or alternatively, from the date of the resolution.[223]

The UK courts have a sophisticated way of determining a director's liability. They employ a combination of an objective and a subjective test in determining whether there was a 'reasonable prospect' that the company would avoid going into insolvent liquidation. Under the objective test, the actions of the respondent director are measured against that of a reasonably diligent person having both the both the general knowledge, skill and experience that could reasonably be expected of a person carrying out the same functions as are carried out by that director for that company.[224] As for the subjective test, the respondent director will be measured based on the general knowledge, skill and experience that that particular director possesses.[225]

The UK has a more elaborate and a comprehensive provision on how to establish a director's liability. It specifies the method of ascertaining the facts which a director ought to know, the conclusions which he ought to reach and the steps which he ought to take. The provision employs both the subjective and objective test to determine a director's liability. Under the objective test, the court must measure the defendant against a reasonably diligent director in his position.[226] For

[222] Paul Davies and Sarah Worthington (n 90) p. 231.
[223] Edward Bailey and Hugo Groves (n 108) p. 698.
[224] D Konstantinov, 'Wrongful trading: Comparative Approach (England and Wales, Russia and USA)' (2015) Vol. 2 (1) *BRICS Law Journal* p. 16.
[225] Edward Bailey and Hugo Groves (n 108) p. 702.
[226] UK Insolvency Act s 214 (4) (a). The court will must consider matters which would be known or ascertained or reached or taken by a reasonably diligent person having both; the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company,

the subjective test, the court will judge the defendant on the basis of his knowledge, skill and experience.[227] There are no such breakdowns under the Kenyan provision.

In addition, the UK has a broader scope of attaching liability for wrongful trading, as the threshold of liability being imposed on UK directors appears to be more flexible in scope since it is not limited to mere incurring of debts.[228] In the UK, a director can be found liable even where the director has not incurred further debts. Equally, a UK director might not be found liable even where the director has incurred further debts.[229] Ideally, the UK provisions on wrongful trading include a broader range of conduct, since there is a greater variety of activities which might occasion liability. For instance, liability will attach on directors when they sell the assets of the company at an undervalue or even when the board pays excessive remuneration to their directors or even when the board decides to do nothing to minimize the loss to the creditors.[230]Such an extensive concept of attaching liability is the most appropriate for the dynamic contemporary corporate world.

To a great extent, the UK concept of wrongful trading is a more efficient tool of corporate governance than the Kenyan concept of wrongful trading. First, the UK's two tests of establishing liability for wrongful trading are significant. The subjective test is an effective tool of attaching liability on experienced directors who can otherwise not be found liable under the objective test.[231] Hence, a director who is well-qualified and with significant experience cannot escape liability simply by demonstrating that a reasonable director would not have concluded that insolvent

[227] UK Insolvency Act s 214 (4) (b). The court will consider the general knowledge, skill and experience that that director has

[228] Andrew Keay and Michael Murray, 'Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia' (2005) Vol. 14 *INSOL International Insolvency Review* p. 39.

[229] *Ibid*, p. 34

[230] S. Griffin, *Personal Liability an d Disqualification of Company Directors* (Oxford, Hart Publishing, 1999) p. 64

[231] UK Insolvency Act 1986 s 214(4).

liquidation was inevitable, if a person with his or her credentials would have seen insolvent liquidation coming.[232]

4.3.3.2 The Defence to Wrongful Trading

UK courts have adopted a literal interpretation of a statutory defence available to a respondent in a claim for wrongful trading. The respondent has to establish that he took every step he ought to have taken to minimize the potential loss to creditors and therefore the onus of proof, in relation to the question of whether proper steps were taken to minimize loss to creditors lies with him.[233] However, the nature and the scope of the statutory defence have been criticized. Most criticisms have been based on the uncertainty on what actions need be taken to achieve the defense. There remains significant unanswered questions especially on the exact conduct and the kind of actions required to demonstrate that the directors took 'every step' to minimise losses to the creditors.[234]

To a great extent, the UK approach to the defences is less generous as the defence is ambiguous and somehow almost impossible to establish. It has been argued that the use of the phrase 'every step' can be said to be too mean because a strict interpretation of the phrase could raise the bar too high for a defendant to establish the defence, making it almost impossible for a deserving director to acquire its protection.[235] For companies which have gone into insolvent liquidation, some scholars have argued that a director, who had taken some positive steps to minimise the loss to the creditors, could nevertheless be liable, due to the possibility that the director did not take 'every possible step' otherwise the company would not have gone into insolvent liquidation.[236] This absurd situation is made worse by the vague wording of the term 'every step' which has not been

[232] Andrew and Michael (n 228) p. 36.
[233] Roy Goode (n 71) pp. 667-71.
[234] Andrew and Michael (n 228) p. 55.
[235] *Ibid*, p. 45.
[236] *Ibid*.

defined in the statute and hence it is likely that the interpretation of this section will be guided by the unique facts of each case. Further, the section does not provide for special and exceptional circumstances where a director might be unable to carry out these steps especially where the director is ill or overseas.

4.3.3.3 Burden of proof

There is a general agreement amongst UK courts on the evidential burdens of proof in a claim for wrongful trading. Basically, the burden is shared between the liquidator and the respondent director. The liquidator initiates the proceedings and bears the burden to proof the two elements of the claim.[237]The liquidator has to establish the two elements on a balance of probabilities.[238] If the liquidator succeeds in discharging his burden, the burden will shift to the respondent director to mount a defence. The respondent director has the burden of demonstrating that he took every step with a view to minimize potential loss to the creditors of the company as the director ought to have taken.[239]

4.3.3.4 The date of discovery

Besides establishing the two elements of the claim, the liquidator has to meet an additional requirement pertaining 'the date of discovery'. This is the time at which 'deemed knowledge' was first acquired. He has to identify the 'relevant date or time' when the respondent director should have been aware that there was no reasonable prospect that the company would avoid going into insolvent liquidation.[240] Although the statute uses a very general phrase on the time of deemed

[237] First, he has to establish that the respondent director, at some time prior to the commencement of winding up, knew or ought to have concluded that there was no reasonable prospect of the company avoiding an insolvent liquidation. Second, he has to establish that the respondent was a director of the company.
[238] Andrew and Michael (n 228) p. 49.
[239] Ibid, p. 50.
[240] Vanessa Finch and David Milman, (n 115) p. 602.

knowledge,[241] determining the particular date or time is indispensable. First, a director's liability for wrongful trading cannot be based on acts or omissions committed before that time.[242] Second, it is the exact moment when the duty to take the steps to minimize the potential loss accrues to the director.[243]

The exact point at which liability attaches in the UK is surrounded by ambiguity and vagueness. It is the date when the respondent director knew or ought to have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation.[244]Satisfying this requirement on the 'date of discovery' has been problematic for liquidators. Courts and liquidators encounter much difficulties, when ascertaining the exact date when the 'wrongful trading' began. Normally, in the evidence supporting the claim, more than one date would be relied upon as the beginning of the wrongful trading, as the court may not accept the single date asserted by the liquidator; and it would be dangerous to leave the pleading of alternative dates to trial.[245] This requirement has proved to be a great hindrance, impairing the utility and the efficacy of the remedy for wrongful trading.

However, UK courts have adopted a flexible approach on the interpretation of the date or time of the deemed knowledge. This approach is a new development which represents a radical shift from the previous jurisprudence. Older cases required a liquidator to identify and establish the exact time. However, this is no more and the courts have instead adopted a more generous approach.[246]

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[241] Insolvency Act 1986 s 214 (2)(b). The Act uses the phrase 'at some time before the commencement of the winding up of the company.'
[242] Roy Goode, (n 71) p. 671.
[243] Ibid, p. 670.
[244] Andrew and Michael (n 228), p. 37. *See* Edward, p. 701. *See* Rubin v Gunner (2004) EWHC 316 (Ch), and *Re Sherborne Associates Ltd* (1995) BCC 40.
[245] Edward Hugo (n 108) p. 701. *Look Rubin v Gunner* (2004) EWHC 316 (Ch), and *Re Sherborne Associates Ltd* (1995) BCC 40.
[246] Roy Goode (n 71) p. 670.

This change of approach has been justified, primarily on grounds of fairness to the respondent director. It has been argued that in the real world, it is not very easy to establish the exact date when a director ought to have concluded that an insolvent liquidation was inevitable, just as it is almost impossible to establish the exact date when a company becomes insolvent.[247]

4.3.3.4 Rescue Culture

The UK law is more appropriate and friendly to the concept of corporate rescue and restructuring arrangements. The UK regime offers their directors a greater leeway in determining the fate of their companies, without the risk of being personally liable. For instance, UK directors are not prohibited from incurring further debts.[248] Ideally, the fact that the insolvency of a company is looming does not prevent the directors from incurring more debts, provided there are some prospects, even if negligible, that the company would avoid insolvent liquidation.[249] To a great extent, this generous approach allows the directors to continue with trading when a company is facing difficult financial times. This position empowers the directors to adopt a long term agenda on how they can trade out of the financial crisis, even if the company is already insolvent, provided there is reasonable prospects that the company might recover.[250]

UK courts have adopted a robust interpretation of the remedy, with a view to promote 'corporate rescue.' Recent courts have adjusted the section to the theme of 'rescue culture' either by postponing the point at which they conclude the directors ought to have realized the company had no realizable prospect of avoiding insolvent liquidation or by taking a broad view of the

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[247] Ibid.
[248] Andrew and Michael (n 228) p. 36.
[249] N. Coburn, *Insolvent Trading: A Practical Guide* (2nd edn, Law Book Co, 2003) p. 37.
[250] VCS Yeo and JLS Lin, 'Insolvent trading—a comparative and economic approach' (1999) Vol. 10 *Australian Journal of Corporate Law* pp. 220–221.

appropriate actions of the directors in such a case.[251] In *The Rod Gunner Organisation Ltd, Re,*[252] the court suspended its finding of 'no reasonable prospect' for the first six months after the company become insolvent, on the grounds that the directors thought an outside investor was going to come in with substantial funding.[253] Such an approach was also adopted in a later case; *Continental Assurance Co of London Plc*.[254]

The concept of promoting corporate rescue in the context of interpreting the provisions proscribing wrongful trading has been fairly justified. Fundamentally, UK courts are hesitant to second-guess the commercial decisions of the directors. They have recognized that directors are usually confronted with difficult circumstances from where they are required to make tough decisions which might turn out not in their favour.[255] In recognition to this precarious position, UK judges are aware of the risks of judging the conduct of the directors on the basis of hindsight. It has been remarked that a director who ceases to trade and opts for liquidation even before giving it a second trial might be stigmatized as being coward.[256] On the basis of these grounds, UK courts are sometimes reluctant to impose liability on directors, where the respondent director(s) had some reasonable hope that some external factor would come to their aid.

The adoption of this restructuring culture is appropriate and in touch with the commercial realities. With such an approach, UK directors have the autonomy to adopt a long-term agenda on the recovery which might include engaging in some more risky but profitable ventures. With such a

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[251] Paul Davies and Sarah Worthington (n 90) p. 235.
[252] *The Rod Gunner Organisation Ltd, Re,* [2004] 1 B.C.L.C 110.
[253] Paul Davies and Sarah Worthington (n 90) p. 235.
[254] *Continental Assurance Co of London Plc* (No.4), Re [2007] 2 B.C.L.C. 287. The court refused to find 'no reasonable prospect' during a period of some six months in which the directors commissioned a report as to the company's solvency and decided to continue trading on the basis of the report received, until it later became clear that the company was in fact insolvent. (Paul and Sarah, p. 236).
[255] Vanessa Finch and David Milman, (n 115) p. 602.
[256] Paul Davies and Sarah Worthington (n 90) p. 236.

regime in place, the UK directors can continue trading even when the company is insolvent, and they have sufficient flexibility to enable them carefully juggle the competing interests of the company, its creditors and the stakeholders.[257] However, the UK directors have not lived up to this task. Most UK directors have failed to sufficiently undertake the juggling task, due to their inability to appreciate and handle the complex challenges which come with insolvency.[258] These difficulties could be attributed to the directors' lack of experience and expertise on matters of insolvency and the knowhow on how to balance the ever competing interests.

4.3.5 Challenges on the effectiveness of the remedy

The effectiveness of the UK remedy has come under serious criticism from both the academia and the judiciary. There is a general agreement that the remedy has not lived to its expectations. Some legal scholars have associated its inefficacy with the insignificant number of cases reported under this remedy. Between 1986 and 2013, only 29 applications were made out of which just 11 were successfully prosecuted.[259] Similarly, other scholars have argued that the insignificant number of reported cases reveals the inefficacy of the remedy.[260] As a result, it has been felt that the remedy has failed to fulfill its main objective as an external mechanism of corporate control. As such, it has been termed as inefficient in deterring directors from engaging in illicit trading in financially troubled companies.[261]

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[257] Douglas Hawthorn, 'Continued trading while insolvent is not necessarily wrongful trading' *Michelmores* (October 10 2017) <https://www.michelmores.com/news-views/news/insolvency-act-wrongful-trading> Accessed on 18th August 2018.
[258] Andrew and Michael, (n 228) p. 41.
[259] Vanessa Finch, David Milman *Corporate Insolvency Law: Perspectives and Principles* (3rd Edition, Cambridge University Press, 2017) p. 601. See Paul and Sarah (n 90) p. 236. (The two hold the same opinion that litigation under the section is sparse and there are few reported cases).
[260] Hans C. Hirt, 'The Wrongful Trading Remedy in UK Law: Classification, Application and Practical Significance' (2004) Vol 1 European Company and Financial Law Review p. 102.
[261] Hans C. Hirt, 'The Wrongful Trading Remedy in UK Law: Classification, Application and Practical Significance' (2004) Vol 1 *European Company and Financial Law Review* p. 102.

The ineffectiveness of the UK remedy for wrongful trading has been broadly attributed to two main factors: Internal factors, which are associated with the technical wording of the provision and external factors, which are associated with legal doctrines and common law principles. The internal factors encompass two key elements of establishing liability. The first challenge is encountered when determining the exact time when one can say that a company has no reasonable prospect of avoiding going into insolvent liquidation.[262] The second challenge is encountered when determining the various types of actions which go to demonstrate that a director had taken 'every step' to minimize losses to creditors.[263] The external factors encompass the common law doctrines, especially the ancient champerty rule, which has, for the longest time, limited the extent to which a liquidator can secure external funding for a wrongful-trading action.[264]

In addition, the UK provisions on wrongful trading have a restricted list of potential applicants. The cause can exclusively be invoked by the liquidator, at the exclusion of other persons like creditors, the administrators and receivers. This exclusion of the creditors from the list of potential applicants has been criticized. The creditors do not have an opportunity to invoke this remedy, particularly where the liquidator has failed or is unwilling to institute the claim.[265] Further, it has been opined that the liquidator may not effectively balance the public functions of insolvency since his main concern is to ensure maximum recovery for the creditors, leaving unattended the interests of other stakeholders like the government and the employees of the company.[266]

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[262] Adrian Walters, 'Wrongful trading: two recent cases' (2001) *Insolvency Lawyer* p. 4.

[263] Rebecca Jarvis, 'Topical issues: How effective is the wrongful trading legislation in holding rogue directors to account?' *Linklaters* (May 2016) p. 3. <https://lpscdn.linklaters.com/-/media/files/linklaters/pdf/mkt/london/gc6805_rogue_directors_bafs_final_a_screen.ashx?rev=8bdff673-e267-41d7-81b3-f89af822f5d4&la=en&hash=4FEA1BA53BFFF7A821A0E55116093A91C617623D> Accessed on 18th August 2018.

[264] John Armour and Adrian Waters, 'Funding liquidation: a functional view' (2006) *Law Quarterly Review* p. 11.

[265] UK Insolvency Act, s 214 (1).

[266] Andrew and Michael, (n 228) p. 44.

4.3.5.1 Liquidator's Funding

The challenge of funding wrongful trading actions is the most acknowledged challenge and has attracted most attention. The section places the litigation in the hands of the liquidator, who does not have access to any public funds to support any litigation he or she may propose to bring.[267] Many legal writers have argued that this challenge has watered down the utility of the remedy. The challenge has disempowered wrongful trading as a strong force for directorial accountability.[268]

Funding the liquidator's claim is a more real challenge, considering the financial position of the company. Given that the company is insolvent, the liquidator has difficult considerations to make on how to fund the claim. If the insolvent company does have some realizable assets, the liquidator may consider using those to fund the litigation in order to swell the amount available for distribution to the creditors.[269] However, most liquidators do not choose this avenue for justifiable reasons. They are unwilling to risk the company's already inadequate assets on litigation unless there is a very strong chance of success.[270] Further, they refrain from taking proceedings because it is uncertain as to whether they will be liable for an adverse costs order and they might not be able to secure some sort of financial cover.[271]

And what is more, the UK liquidator has limited chances of acquiring external funding for a wrongful trading claim. In ordinarily suits and actions by a liquidator, the liquidator has several external sources of funding which include; funding for the litigation from a floating charge holder, selling the claim to a third party, obtaining funding for the claim by assigning some part of the

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[267] Paul Davies and Sarah Worthington (n 90) p. 236.
[268] Vanessa Finch and David Milman, (n 115) p. 602.
[269] Paul Davies and Sarah Worthington, (n 90) p. 236.
[270] Gregorian and Butler, ''Liquidators litigation expenses, funding arrangements and the amendment to rule 4.218'' (2004) Vol. 20 *Insolvency Law & Practice* p. 151.
[271] Johnn Armour and Adrian Waters (n 264) pp. 1-3. (The two argue that before embarking on the litigation, the liquidator must evaluate the prospects of success and consider the implications of an adverse outcome).

fruits of the litigation to a third party and calling for indemnities from creditors in relation to costs. Even though there are a variety of exploitable options, these options are somehow unsuitable and unavailable to the liquidator, particularly on actions for wrongful trading. Their unsuitability is premised on either legal restriction on their use or the nominal incentives which they offer to the external funders.

A UK liquidator cannot acquire external funding by selling the wrongful trading action. The liquidator in the UK is not permitted to sell the action. Although the liquidator typically acts in the company's name, the powers under section 213 and 214 are statutory powers given specifically to the liquidator.[272]The liquidator cannot sell the 214 claim under the general power to dispose of the company's assets, because the right to claim under the section is vested in the liquidator personally, not in the company.[273]

Assigning some part of the fruits of the litigation is not a suitable option. Although assigning has been permitted in the UK,[274] it does not offer enticing incentives to the funder. The assignment is allowed on the condition that the liquidator retains control of the litigation. Such a condition is premised on the special status of the liquidator in the judicial system. The liquidator is an officer of the court and cannot relieve himself of the duty owed to the court in relation to the litigation by assigning control over it to the funder. This condition makes funding in exchange for a share of the proceeds considerably less attractive from the funder's point of view.[275]

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[272] See also Paul Davies and Sarah Worthington, *Gower & Davies' Principles of Modern Company Law* (9th Edition, Sweet & Maxwell 2012) p. 1284. See also Andrew and Michael, (n 228) p. 49. (They similarly argue that the powers under section 214 are granted to the liquidator personally by legislation).
[273] Paul Davies and Sarah Worthington (n 90) p. 237.
[274] Australia 1986 Act s. 246ZD.This was the law until the reforms of 2015.The 2015 reforms gave the office holder an express statutory right to assign a wrongful or fraudulent trading claim (or the proceeds of such an action).
[275] Paul Davies and Sarah Worthington, (n 90) p. 237.

Obtaining funding from the secured creditors is not a practical alternative. It is unsuitable as it does not offer any incentives to the secured creditors. The proceeds of 213 and 214 claims go to benefit the unsecured creditors, not the holders of a floating charge.[276] Alternatively, the liquidator can seek indemnity from the creditors in relation to costs. However, this option is not mostly used. Creditors are not always keen, or able, to provide such indemnities.[277] In essence, the liquidator has limited avenues of protecting himself. The liquidator can claim their own expenses of bringing the claim from company funds, ranking with the liquidation costs and expenses. However, the liquidator must not engage in the litigation without creditor approval.[278]

4.3.5.2 Determining the amount of contribution

The determination of the amount of contribution upon the establishment of liability is purely a court's affair. The court *may* declare that that person is liable to make such contribution (if any) to the company's assets as the court thinks proper.[279] UK courts have come up with a formula of calculating the amount of contribution. They have held that the amount of compensation to be ordered is the amount by which the deficiency of the company has increased between two particular dates.[280] The first date is the date when the respondent director knew or ought to have known that insolvent liquidation was inevitable, and the second date is the date of the start of the liquidation.[281]

UK courts do not have a concrete jurisprudence on the awarding of a contribution order, upon establishing a director's liability for wrongful trading. And what is more, is the wide discretional

[276] Ibid.
[277] A Keay, ''Pursuing the Resolution of the Funding Problem in Insolvency Litigation'' [2002] *Insolvency Lawyer* p. 90.
[278] Insolvency Act 1986, Schedule 4, cl 3A.
[279] UK Insolvency Act, 1986 s 214 (1).
[280] Andrew and Michael, (n 228) p. 42.
[281] *Re Produce Marketing Consortium Ltd* (1989) 5 BCC 569.

powers granted to the judges in deciding the amount to be awarded. In fact, the judges are not obliged to make the contribution order, even if the directors have actually engaged in wrongful trading.[282] Further, although the courts have held that the amount of compensation to be ordered is the amount by which the deficiency of the company has increased between two particular dates,[283] the determination of the date *when the respondent knew or ought to have known that the insolvent liquidation was inevitable* is purely at the courts discretion, and it's open to radical adjustments especially when interpreted with the view to promote corporate rescue. This uncertainty on the amount of contribution has made it difficult for a liquidator to gauge the likely award of the court.[284]

UK courts are divided as to the nature, role and the purpose of the remedy for wrongful trading. On one hand, some judicial approaches treat it as compensatory while on the other hand others have treated it as penal. In *Re Produce Marketing Consortium*, the court treated the remedy as 'primarily compensatory rather than penal.' This interpretation has been contradicted by more recent cases which held that the remedy is penal. In *Re Sherborne Associates Ltd*, the judges saw the remedy not so much as a civil remedy to raise standards among directors and to compensate creditors, but as a way to punish directors whose actions are seen as immoral.[285] This uncertainty has adversely affected the efficacy of the remedy.

To an extent, UK courts have gone before the parliament with respect to exercising their discretion under the provision prescribing wrongful trading. To some extent, they have usurped the powers of the legislature by considering irrelevant factors, which were never contemplated by the

[282] UK Insolvency Act 1986, s 214 (1).
[283] The first date is the date when the respondent director knew or ought to have known that insolvent liquidation was inevitable, and the second date is the date of the start of the liquidation.
[284] Re Produce Marketing Consortium Ltd (1989) 5 BCC 569.
[285] Vanessa Finch and David Milman, (n 115) p. 602.

legislature. Such usurpation is evident when the courts are determining the amount to be awarded in the contribution order. Some courts have considered the culpability of the director, so that naïve and honest directors are treated with leniency and reckless directors are treated with little sympathy.[286] This approach has been fairly criticized. It has been submitted that the intention behind the remedy is to provide financial compensation to the creditors and not to penalise the directors.[287] In line with this, it has been rightly argued that a determination on the damages to be awarded in the compensation order should be solely guided by the ultimate loss suffered by the creditors and not the director's state of mind.[288]

4.3.5.3 The Impact of the Enforcement Challenges

The culmination of these legal challenges has occasioned a low opinion on the utility of the remedy. It has been argued that the essential objective of the remedy in the UK would be better achieved by section 993 of the Companies Act 2006.[289] Further, these challenges have arguably proved to be a hindrance to the liquidator, who has a number of difficult considerations to make. In the alternative, liquidators have decided to go for other alternative proceedings, which have relatively less complexities. In most instances, they find it easier to establish a claim for misfeasance, a claim based on preference of creditors or a claim for an undervalue transaction, instead of confronting the complex proceedings for a wrongful trading claim.[290]

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[286] A. Walters, ''Wrongful Trading: Two Recent Cases'' [2001] *Insolvency Lawyer* p. 211.

[287] VCS Yeo and JLS Lin, 'Insolvent trading—a comparative and economic approach' (1999) Vol. 10 *Australian Journal of Corporate Law* pp. 220–221.

[288] Andrew and Michael (n 228), p. 43.

[289] S Preetha, 'The Fraudulent Trading Offence: Need for A Relook' (2011) Vol. 4 *National University of Juridical Sciences Law Review* p. 232. See also Henry Skudra, p. 17. Section 993 of the UK Companies Act 2006 provide for the offence of fraudulent trading.

[290] Vanessa Finch and David Milman, (n 115) p. 601.

4.3.6 Conclusion on the efficacy of the remedy for Wrongful Trading in UK

The ineffectiveness of the UK remedy for wrongful trading has been attributed to several legal factors. These factors range from those inherent by virtue of the technical structure of the proscribing provisions, to those occasioned by the capability of the law enforcers to prosecute wrongful trading claims. In particular, they include challenges on the funding of the liquidator's claim, the amorphous judicial interpretation of the remedy, the conflicting judicial treatment and interpretation of the nature of the remedy, the uncertainty surrounding the determination of the amount of contribution payable upon being found liable and the restrictive pre-conditions of instituting the claim.

In addition to these factors, the scope of the remedy is fairly limited to certain conditions. These limitations are premised on the class of potential plaintiffs and the circumstances for its invocation. The right to make application to the court for an order under the provision is limited to the liquidator and may only be exercised in cases where the company has gone into insolvent liquidation. These limitations do not empower the creditors of the troubled companies, who ordinarily have a legitimate interest in the affairs of their debtor.

4.4 INSOLVENT TRADING IN AUSTRALIA

4.4.1 The suitability of the choice for Australia

In addition to the UK, the Australian insolvency regime is the other most preferable jurisdiction, which can possibly offer good practices from which Kenya can draw lessons. In many respects, the Australian Insolvency regime has similar attributes with the Kenyan insolvency regime. Both regimes provide for the wrongful trading in two versions; as a criminal offence and as a civil wrong. In addition, they provide for defenses available to directors liable for these civil wrongs.

And what is more, Australia has a very unique and progressive jurisprudence on insolvency, as it has been widely acknowledged in the academia world.

4.4.2 An analysis of the Implementation and Enforcement of the remedy

The Australian approach to insolvent trading is very basic. Essentially, it imposes a duty on the directors to prevent insolvent trading. Its simplicity is demonstrated by the clear provisions which outline the conditions for invoking the remedy and the exact point in time when liability for insolvent trading accrues. The applicant has to establish three elements. First, the applicant must establish that the respondent was a director of the company at the time it incurred the debt. Second, the applicant must demonstrate that the company was insolvent when it incurred the debt, or it became insolvent upon incurring the debt. Lastly, the plaintiff must demonstrate that the debt was incurred at a when the director the director had a reasonable ground to suspect that the company was insolvent or it would become insolvent upon incurring the debt.[291]

The Australian approach epitomizes legislative clarity, considering its detailed specificity on the exact time when a company debt is deemed to have been incurred. In fact, the Act has an operative table for the purposes of this particular section. The table contains two columns; 2 and 3.[292] If a company takes action set out in column 2 of the table, it incurs a debt at the time set out in column 3.[293] For instance when a company pays a dividend, the debt is incurred when the dividend is paid or, if the company has a constitution that provides for the declaration of dividends, when the dividend is declared.[294] In addition, when the company redeems redeemable preference shares that

[291] Australia Corporations Act s 588G (1) (a-d).
[292] Paul James, (n 318) p. 6.
[293] Australia Corporations Act s 588G (1A).
[294] Point one, on the operative table.

are redeemable at its option, a debt is incurred when the company exercises the option.[295] Therefore, the Australian law provides very exact guidelines on the time when liability attaches.

The Australian approach has certainty on the amount of compensation awardable by the court. They have a simplified formula for determining the amount of damages payable. The amount to be recovered should be equal to the loss or damage suffered by the company as a result of the insolvent trading.[296] This clarity is fundamental for the liquidator, and the creditors, as it informs them of the likely court award, which is not subject to the courts discretion.

To a great extent, the wording of the Australian provisions has produced great certainty for Australian directors on their rights, duties and responsibilities. The Australian remedy is way much clear and definite as to when liability will arise and it reflects the actual recommendations of the Cork Committee[297] which had proposed liability for incurring of debts. An Australian director has a clear duty: a duty to prevent the occurrence of insolvent trading. As such, the law grants the director a very limited scope to exercise any discretion since the director has no option than to cease trading.[298] As a result of this clarity, Australian directors can order their conduct accordingly, since they can easily predict the legal effect of their actions during insolvency. The Australian position has been appraised since it adopts a relatively conservative approach to insolvency assessments which in return made directors more proactive in the monitoring of the company's financial position.[299]

[295] Point five, on the operative table.
[296] Australia Corporations Act s 588M (2).
[297] UK Insolvency Law and Practice: Report of the Review Committee, (Chairman, Sir Kenneth Cork), Cmnd 8558 (1982) para 61.
[298] A. Hicks, 'Advising on Wrongful Trading: Part 1' (1993) 14 *Company Lawyer* p. 17.
[299] Andrew and Michael (n 228) p. 37.

Australia has a broader list of potential applicants for a claim for insolvent trading. Such a claim can be instituted by the liquidators, creditors, receivers, administrators and the Australian Securities and Investments Commission (ASIC).[300] And what is more is that the law has provided a comprehensive framework to ensure that the creditors do not abuse this privilege. Creditors will exercise these powers where the liquidator has not made any application. They can utilize these powers through two alternative ways. Under the first one, the creditor has to seek the liquidator's consent.[301] Under the second way, the creditors are required to notify the liquidator that they intent to institute civil proceeding against a particular director. This notice can only be given after six months since the commencement of the winding up process. The liquidator is required to respond to the notice within three months of the notice, by giving the requested notice or stating his reasons why he considers that the creditors should not institute the proceedings.[302]

In addition, the Australian position offers optimal protection to the creditors. The law has adopted a very severe view on illicit trading as since the directors of an insolvent company are prohibited from incurring any debt for as long as the company remains insolvent. To a great extent, this restrictive approach may serve to provide some clear protection to creditors.[303] Further, the recovery of compensation for loss can be initiated whether or not the director has been convicted of an offence in relation to the contravention or a civil penalty order has been made against the director in relation to the contravention.[304] In addition, a creditor may, under special procedures,

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[300] ASIC is the corporate regulator in Australia. may itself pursue an insolvent trading claim against directors for the imposition of a civil penalty, up to a certain amount, as well as civil compensation. See Andrew and Michael, p. 32.
[301] Australia Corporations Act s 588R.
[302] Australia Corporations Act s 588S. If the liquidator does not grant the consent within the prescribed period, the creditor may proceed against the director. Alternatively, if the liquidator has a reason why the creditor should not be allowed to proceed, the reason must be produced to the Court in the action in which proceedings have been or are initiated. See s 588T (3).
[303] Paul James, (n 318) p. 2.
[304] Australia Corporations Act, s 588M (1) (d).

recover from the respondent director, as a debt due to the creditor, an amount equal to the amount of the loss or damage.[305]

The Australian law has four alternative defences available to a respondent in a claim for insolvent trading. One, by proving that when the debt was incurred the respondent had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent even if the debt was incurred.[306] Two, that when the debt was incurred the director had reasonable grounds to believe, and he or she did believe, that a subordinate was competent, reliable and responsible for providing adequate information about the company's solvency and the director expected, on the basis of this information, that the company was solvent and would remain solvent even if it incurred that debt.[307]

Three, that when the debt was incurred the director, because of illness or for some other good reason, did not take part in the management of the company at that time;[308] Four, that the director took all reasonable steps to stop the company from incurring the debt.[309] And what is more about the fourth defence is that the legislation has described the term 'all reasonable steps.' In determining whether the director took 'all reasonable steps' courts must be guided by any action taken by the director with a view to appointing an administrator of the company, when that action was taken and the results of that action.[310] In other words, the taking of the reasonable steps is to be assessed in terms of the directors' availing themselves of the Part 5.3A administration regime.[311]

[305] Australia Corporations Act, s 588M (3).
[306] Ibid, s 588H (2).
[307] Ibid, s 588H (3).
[308] Ibid, s 588H (4).
[309] Ibid, s 588H (5).
[310] Ibid, s 588H (6).
[311] Part 5.3A of the Corporations Act s 435A.

To defend successfully the respondent director must prove one of the four defences. Arguably, the Australian approach on defences is generous.

4.4.3 Corporate Rescue in Australia

To a great extent, the Australian position does not empower the company directors to engage in corporate rescue. The Australian law takes a very severe view on illicit trading given that a company is not allowed to incur one debt whilst it is insolvent. A director's duty is to prevent insolvent trading occurring and, taken alone, the law allows little scope for directors to do other than cease trading. As a result, the Australian approach unduly restricts the ability of directors to deal with their company's financial situation in a flexible and entrepreneurial manner.[312] Perhaps, there should be some latitude allowed to a director to continue to trade in a reasonable expectation that, although the company is insolvent, it is most likely to be able to trade out of its difficulties. Therefore, the Australian restrictive position may not ultimately serve the interests of creditors if some other more flexible arrangement would have produced a financially more favorable result.[313]

The Australian regime has a very unique manner of embracing corporate rescue for insolvent companies. While the Australian directors are not allowed to undertake corporate restructuring by themselves, their only alternative is to seek assistance through a voluntary administration processes under the Australian regime.[314] Administration procedure is available for an insolvent company or a company that is likely to become insolvent. Upon entry into administration, the company immediately comes under the control of the administrator who seeks to save the company or

[312] Baxt, "Company - Liability of Directors for the Debts of the Company" (1988) 62 *Australian Law Journal* p. 643.
[313] Andrew and Michael, (n 228) p. 38.
[314] The Corporations Act, Part 5.3A, s 435A. The part provides that an insolvent company should be administered in a way that maximises the chances of the company, or as much as possible of its business, continuing in existence; or if it is not possible for the company or its business to continue in existence results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

otherwise resolve its fate.[315] As a result, the Australian position puts an insolvency administrator in charge of the financial juggling; bringing to bear on the company the benefit of his or her insolvency experience and expertise and in circumstances where creditors are required to stand back while a solution is examined.

4.4.4 Implementation challenges in Australia

The implementation of the remedy for insolvent trading in Australia has been criticized. Much of the criticism has been based on the insolvency factor, as an element of establishing liability. It has been argued that the particular point in time that insolvency occurs, on a cash flow basis, can be difficult to establish, as much in retrospect by a liquidator in a claim for insolvent trading as at the time when the company is experiencing difficulties , and the directors have to assess the company's position.[316] As a result, it will often be a matter of establishing the insolvency of the company through expert evidence, given by the liquidator in the insolvent trading proceedings; and it will often be a matter of directors obtaining expert guidance and advice, if they so choose, at the time that debts are being incurred, respectively.[317]

The Australian concept of assessing liability solely on objective basis, in the exclusion of the subjective test, is not efficient in targeting experienced directors, who are expected to be more responsible that than the inexperienced directors. Unlike the UK defendant whose conduct must be measured against both subjective and objective test, an Australian respondent's conduct is only measured against an objective test. In Australia, the respondent will be found liable if there were, when debts were incurred, reasonable grounds merely to suspect that the company was or would

[315] Part 5.3A of the Corporations Act s 435A.
[316] A Keay, ''The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidations'' (1995) Vol. 21 *Monash University Law Review* p. 305
[317] N. Coburn, *Insolvent Trading: A Practical Guide*, (2nd edn, Law Book Co, 2003) pp. 45–52.

become insolvent.[318] To some extent, this sole objective test is not an effective tool of enforcing liability on experienced directors. For instance, provided that a director meets the objective standard, it matters not that he or she was a very experienced director and did not do what a reasonably diligent person with his or her experience would have done.[319]

4.4.5 Litigation Funding

In addition, Australia has overruled the archaic common law principles of champerty and maintenance, especially on insolvent trading claims. In fact, the liquidator is free to sale or assign a part of the fruits of the claim to a third party, and in return access external funding.[320] The Australian law on liquidator's funding is well designed to prevent its abuse. The liquidator is required to obtain the approval of the court, or of the committee of inspection or a resolution by the creditors.[321] For instance, in *Robinson, in the matter of Reed Constructions Australia Pty Ltd* ,[322] A meeting of creditors passed a resolution authorizing the liquidator to enter into a litigation funding agreement.[323]

4.4.6 Conclusion on the insolvent trading in Australia

The Australian approach to insolvent trading is very simple. It has adopted a very severe view on illicit trading as a company is not allowed to incur one debt whilst it is insolvent. The remedy is an effective tool for ensuring proper managerial conduct. One, the wording of the provisions has

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[318] Paul James, 'Insolvent Trading-An Empirical Study' *Centre for Corporate Law and Securities Regulation* p. 7.
[319] Andrew and Michael, (n 228) p. 36.
[320] Discussion Paper (May 2006) *Litigation funding in Australia* Standing Committee of Attorneys-General p 5. <https://www.justice.nsw.gov.au/justicepolicy/Documents/litigationfundingdiscussionpapermay06.pdf> Accessed on 18th August 2018.
[321] Corporations Act 2001 s 477(2B).
[322] *Robinson, in the matter of Reed Constructions Australia Pty Ltd* (in liq) [2017] FCA 594.
[323] Graham Roberts, 'Australia: Insolvency insights: Recent decisions on liquidator's litigation funding agreements' *Mondaq Advice Centre* (July, 10 2017) <http://www.mondaq.com/australia/x/608900/Insolvency+Bankruptcy/Insolvency+insights+Recent+decisions+on+liquidators+litigation+funding+agreements> Accessed on 18th August 2018.

produced great certainty for Australian directors on their rights, duties and responsibilities. Two, the provisions epitomize legislative clarity, considering its detailed specificity on the exact time when a company debt is deemed to have been incurred. Further, it has certainty on the amount of compensation awardable by the court. Australia has a broader list of potential applicants in a claim for insolvent trading which include the liquidators, creditors, receivers, administrators and the ASIC.

These attributes notwithstanding, the Australian remedy on insolvent trading has been criticized for several attributes. To a great extent, the Australian position does not empower the company directors to engage in corporate rescue. Second, the Australian concept of assessing liability solely on objective basis, in the exclusion of the subjective test, is not efficient in targeting experienced directors, who are expected to be more responsible that than the inexperienced directors. In addition, other criticism has been based on the controversies surrounding the insolvency factor, as an element of establishing liability.

4.5 Champerty and Maintenance in Insolvency Context

Challenges of funding of the liquidator's claim has for the longest time been occasioned by the common law doctrine on maintenance and champerty. Maintenance is the assistance or encouragement of proceedings by someone who has neither interest in the proceedings nor any motive recognized by the law as justifying interference in the proceedings.[324] Champerty is a form of maintenance in that assistance or encouragement of proceedings is provided in exchange for a promise to provide a share of the proceeds of the action.[325] Prohibition of indulging in maintenance and/or champerty has is a well-established common law principle. In 1908, the court in *British*

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[324] Gleghorn, ''Re MT Realisations Ltd; recovering costs from an insolvent company'' (2004) 20 *Insolvency Law & Practice* p. 108.
[325] Andrew and Michael (n 228) pp. 47-48.

Cash and Parcel Conveyors Ltd v. Lamson Store Service Co Ltd[326] held that these rules are made to stop a person from intermeddling in others' disputes where he or she has no interest, is not justified in intermeddling and does so with a view to obtaining a part of the spoils.[327]

The prohibition on engaging in champerty and maintenance is well based on public policy. These rules are designed for two objectives: protect vulnerable litigants; and uphold the purity of justice by preventing the judicial system from becoming a site for speculative business ventures.[328] For the vulnerable litigants, litigation funding has been criticized for promoting frivolous litigation through the funding of weak and unmeritorious cases on terms that are unfavorable to vulnerable litigants.[329] For the purity of justice policy, it has been argued that litigation funding might create "trafficking in litigation" since the funders might be tempted to stir up disputes and encourage recourse to Courts which would otherwise not have been.[330] In addition, the courts are apprehensive that these practices might facilitate abuse of the court process. They have shared their concern that the champertous maintainer might be tempted, for his own personal gain, to inflame damages, to suppress evidence, or even to suborn witnesses.[331]

The first objective on the protection of the protection of vulnerable litigants is of particular interest in the context of insolvency. The objective is based on the fundamental assumption that there is power imbalance between the litigant and the funder. Against this background, courts question the litigant-funder relationship on the basis of fairness of the bargain between the two, emphasizing that there is unequal financial power between the funder and the litigant, creating unequal

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[326] *British Cash and Parcel Conveyors Ltd v. Lamson Store Service Co Ltd* [1908] 1 KB 1006.
[327] Andrew and Michael, (n 228) p. 48.
[328] Law Reform Committee, *Report of The Law Reform Committee On Litigation Funding In Insolvency Cases* (2014) (Singapore Academy of Law) p. 2.
[329] Cento Velijanovski, 'Third Party Litigation Funding in Europe' (2011) *Journal of Law, Economics and Public Policy* p. 35.
[330] Law Reform Committee, (n 328) p. 11.
[331] Re Trepca Mines Ltd (No 2) [1963] Ch 199 at 219-220 per Lord Denning.

bargaining power.[332] Further, it is also feared that there could be possible conflict of interests during the litigation process, which may subordinate the litigant's legitimate interests in favour of the funder's financial demands.[333] For instance, a litigant may turn down a favorable settlement offer, due to a specific term in the funding arrangement which prohibit him from accepting offers below a certain amount.

However, to a great extent, this particular objective has lost its bearing in the insolvency context and it is no longer justifiable. This is so with the recent developments in the insolvency regimes, which have seen the introduction of insolvency professionals (IPs). The involvement of IPs vastly reduces the fears that litigation funding might sully the purity of justice and mitigates the inequality of bargaining power between the funder and the funded.[334] The IPs provide informed advice since they are well-versed in the relevant legal issues and in assessing and negotiating contracts. Further, they have professional reputations to uphold, which is done through the maintenance of a good track record.[335] In addition, the IPs are trustees of the estate and hence they owe a fiduciary duty to the creditors which places an obligation to retain control over the proceedings.

4.6 Kenyan position on Champerty and Maintenance

Kenya has a very strict approach on maintenance and champerty. Kenyan courts have treated champertous agreements as invalid. In *Ahmednasir Abbdikadir & Company Advocates v National Bank* [336] the court held that a champertous agreement violated section 46 and section 36 (2) of the Advocates Act.[337] As a result, the court found the agreement between the parties invalid and it had

[332] Law Reform Commission, (n 328) p. 11.
[333] Ibid.
[334] Law Reform Commission, (n 328) p. 12.
[335] Ibid.
[336] *Ahmednasir Abbdikadir & Company Advocates v National Bank of Kenya Limited* (2007) eKLR
[337] Advocates Act, Cap 16 Laws of Kenya.

no legal effect and its terms could not be enforced against any party. This rule was upheld in *D. Njogu & Co. Advocate v National Bank of Kenya Ltd.*[338] Courts have maintained that when an Advocate makes a champertous agreement with his client, the Advocate is practicing illegality, because the contract's stipulated terms are contrary to the essence and existence of the Advocates Act.[339]

[338] *D. Njogu & Co. Advocate v National Bank of Kenya Ltd* (2009) eKLR
[339] *Njogu & Co. Advocates vs. National Bank of Kenya Limited* [2007] 1EA 297 p. 303

CHAPTER FIVE: CONCLUSION AND RECOMMENDATIONS

5.1 CONCLUSIONS

This study sought to investigate the efficacy of the civil remedies for fraudulent and wrongful trading provided for under the Insolvency Act 2015. Although these remedies have not, so far, experienced any identifiable legal challenge with respect to their implementation, the study argues that the implementation of these remedies is likely to hit a rock in the near future, going by the history of their implementation under the previous regime; the repealed Companies Act Cap 486. Under the repealed regime, these provisions were rarely invoked and it was difficult for a liquidator to establish a director's liability under the remedies.

This study sought to investigate why the law on fraudulent trading, as was under the Companies Act Cap 486 (repealed), was not successfully enforced against fraudulent directors, who had been implicated by parliamentary committees and taskforces, for engaging in illicit trading. The study made two hypotheses; that the repealed provisions were inherently ineffective and that the current sections 505 and 506 of the Insolvency Act 2015 are equally inherently ineffective, been mere replicates of the repealed provisions. The study utilized the doctrinal research method and the comparative research methodology to conduct a thorough desk review on laws and policies, and to investigate lessons from UK and Australia based on their experiences.

The research has verified the two hypotheses of the study. The study has proved that the previous remedy for fraudulent trading, provided under the Companies Act Cap 486 (repealed), was inherently ineffective. The study has also substantiated that the current remedies, provided under sections 505 and 506 of the Insolvency Act 2015 are equally inherently inadequate, since they are mere replicates of the previous law and the previous inefficacies were never addressed.

The inefficacy of the Kenyan remedy for fraudulent trading was majorly occasioned by several legal challenges. There was judicial uncertainty on the interpretation of the key elements of the remedy, especially on the terms 'fraudulent intent' and 'intent to defraud.' Some courts did not understand and appreciate the distinction between the concept of fraudulent trading and the concept of wrongful trading. In addition, courts did not offer a definite standard of burden of proof and there was an intermittent jurisprudence on the application of the statute of limitations on these claims. Lastly, the Courts required the liquidator to pinpoint the exact date on which he discovered the fraudulent trading, which was not an easy requirement to establish.

Kenya has much to learn from the UK on the interpretation of the remedy for fraudulent trading. Kenya can particularly learn from the UK's structured jurisprudence on the interpretation of the phrase 'intent to defraud.' Further, Kenya can learn from the UK's wider class of potential respondents. On other aspects, however, the UK experience does not offer lessons since she is also grappling with contentious issues on the interpretation of this remedy particularly on challenges of establishing 'intent to defraud.'

Kenya can learn much from the UK remedy for wrongful trading. She can emulate the UK's use of both an objective and a subjective test in determining whether there is a 'reasonable prospect.' In addition, Kenya can pick up the UK's flexible approach on the interpretation of the date or time of the deemed knowledge with a view to promote corporate rescue and restructuring. On other aspects, however, the UK does not offer lessons since she is also grappling with same legal challenges especially on the interpretation of the phrase 'every step,' identification of the exact 'date of discovery,' and the challenges of funding the liquidator's claim, caused by common law rules on champerty and maintenance.

Kenya can learn most from the Australian experience. She can borrow the Australia's simplified chart of determining the time when a debt is deemed to have been incurred. Also, Kenya can emulate the Australia's formula on how the courts should arrive at the amount of compensation awardable in a contribution order, and her broader list of potential applicants in a claim for insolvent trading. Further, Kenya can emulate the Australia's severe view on illicit trading and her statutory description of the term 'all reasonable steps.' Lastly, Kenya can learn from the Australia's position which allows a liquidator to assign insolvent trading claims.

5.2 RECOMMENDATIONS

Based on the research findings discussed above, these are the recommendations;

5.2.1 Extending the class of potential Applicants

Chapter four of this study concludes that Kenya can learn from the Australia's broader class of potential applicants for these remedies, which is not limited to the liquidator. To emulate this, it is recommended that both sections 505 and 506 of the Insolvency Act be amended to broaden the list of the potential applicants to include creditors, administrative receivers and administrators. This will empower them to institute the proceedings in case the liquidator has failed or is unwilling to bring the action.

5.2.2 Providing for Definition of key terms

Chapter four of the study demonstrated that Kenya can borrow from the UK and Australia on their specific definitions of the terms 'intent to defraud,' 'wrongful trading,' and 'all reasonable steps.' In order to pick up these best practices, it is recommended that both section 505 and 506 of the Insolvency Act be amended to include comprehensive definitions of these three key phrases. This

will bring certainty and predictability, to any party contemplating to institute an action based on these remedies, on their chances of success.

5.2.3 Assignment of Liquidator's claims

Chapter four showed that Australian liquidators have higher opportunities of instituting claims since they are allowed to assign or sale their claims or fruits of their actions for the purposes of acquiring external funding. In order to provide more chances of institution of these claims, it is recommended that the Insolvency Act 2015 be amended to empower the liquidator to sell or assign his actions under the two provisions. This will increase his chances of instituting the actions, in situations where he would have otherwise been unable, due to insufficiency of funds. This will also ensure that the Kenyan courts will flex their strict adherence to the common law rules of champerty and maintenance, particularly in insolvency proceedings.

5.2.4 Providing the test of determining a 'reasonable prospect'

Chapter four established that UK liquidators have higher chances of establishing a director's liability, based on its use of a combination of both an objective test and a subjective test in determining whether a director should conclude that there is a reasonable prospect that the company will avoid going into insolvent liquidation. To incorporate this good practice in Kenya, it is recommended that section 506 of the Insolvency Act be amended to incorporate both an objective and a subjective test in determining whether there is a 'reasonable prospect.' The combination of these tests will provide a robust way of determining whether the respondent director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, since the approach will assess the reasonability of the director by taking into account his knowledge, skill and experience.

5.2.5 The liquidation problem

Chapter three showed that numerous cases of illicit trading in Kenya were never prosecuted under these remedies because the respective companies never reached the winding up stage. In order to increase the scope of these remedies, it is recommended that both section 505 and 506 of the Insolvency Act 2015 be amended to remove the precondition on invoking the remedy; that the company must be in the process of being liquidated. It should be amended to provide that the remedy can be invoked when the company is under an administration procedure or under any other procedure being overseen by an insolvency practitioner. This will ensure that the applicants do not have to sit and wait until the company is chronically ill and at the deathbed, for them to invoke these remedies.

5.2.6 Provision of a chart to determine the time of incurring corporate debts

Chapter four of the study reveals that the Australia's remedy for insolvent trading has achieved its objective, due to statutory clarity and especially the statutory chart which has a formula of determining the exact time when a corporate debt is deemed to have been incurred. In order for Kenya to achieve similar clarity, it is recommended that the Insolvency Act 2015 be amended to incorporate a table as a schedule at the back of the Act, specifying the exact time when a particular company debt will be deemed to have been incurred. This will ensure the directors are watchful on their conduct when incurring debts and there will be general clarity in ascertaining when liability accrued for the purposes of applying the statute of limitation.

5.2.7 Provision of a method of determining the amount to be awarded in the contribution order

Chapter four demonstrated that an Australian liquidator's decision to invoke the remedy for insolvent trading is influenced by his approximates of the value of the ultimate contribution order. The chapter also revealed that UK directors are deterred from invoking these remedies since they cannot certainly predict the estimated amount which the court might ultimately award. In order to cure these challenges, it is recommended that both sections 505 and 506 of the Insolvency Act 2015 be amended to provide a very clear formula on how the courts should arrive at the amount to be awarded in the contribution order. The formula should be exclusively informed by the actual financial loss suffered by the creditors and hence help the liquidator predict the amount likely to be awarded by the court.

5.2.8 Adoption of a more severe view on illicit trading

Chapter four showed that the Australian regime provides most protection to the creditors, since it prohibits the directors from incurring even one date while the company is insolvent. Australian directors, upon realising that a company is insolvent, are under a duty to invoke administration procedures, through which an insolvency practitioner takes over the business of the company. For Kenya to achieve this level of protection for its creditors, it is recommended that both sections 505 and 506 of the Insolvency Act be amended to impose a very severe view on illicit trading by not allowing the directors to incur a debt while the company is insolvent. The amendment should require the directors to invoke any insolvency procedures like administration, after which the appointed insolvency practitioner can proceed by incurring further debts or otherwise managing the situation. This will ensure that matters of managing insolvent companies are purely left to insolvency practitioners, who have the requisite knowledge and expertise on how to balance the ever competing and conflicting interests of various stakeholders.

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