The Equality of Creditors: A Theoretical Idea or a Functional Reality?

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This article by **Ryan Caruana** was previously submitted as an assignment for CVL4025 and is being published with the author's permission. The article purports to analyse the ranking of creditors in insolvency proceedings under Maltese Law with particular reference to the tension that exists between the principle of creditor equality and lawful causes of preferences. The author delves into the aforementioned principle and lawful causes. Afterwards, he examines the limitations of creditor equality in Maltese insolvency law, ultimately concluding that the equality of creditors, as established by the Civil Code, has effectively become the exception than the rule.

TAGS: Civil Law, Law of Guarantees, Creditors, Creditor Equality, Insolvency, Lawful Causes of Preferences

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1. Introduction

Article 1994 of the Civil Code states that a debtor 'who has bound himself personally is obliged to fulfil his obligations with all present and future property'.[1] Article 1995 further provides that the property of the debtor constitutes the common guarantee of creditors, all of whom rank equally unless there exists a lawful cause of preference.[2] Ranking of creditors gains relevance in insolvency proceedings whereby the debtor's assets are insufficient to satisfy all of his creditors' claims and such creditors are, thus, required to compete over the debtor's limited assets.[3] This article purports to analyse the ranking of creditors in insolvency proceedings under Maltese Law with particular reference to the tension that exists between the principle of creditor equality and lawful causes of preferences.

2. The Principle of Creditor Equality

The Civil Code establishes the principle of universal patrimonial liability whereby any debtor who has bound himself personally to fulfil an obligation must do so with all of his property, present and future.[4] Consequently, the debtor's entire patrimony constitutes the pool of assets against which creditors may act to satisfy their claims. This demonstrates patrimony's indivisible nature as there is no legal distinction between the debtor's assets and liabilities such that every single asset is subject to respond to any of the debtor's liability.

Article 1994 must be read in conjunction with Article 1995 which states that the debtor's property is the common guarantee of creditors, all of whom possess an equal right over such property unless there exists a lawful cause of preference.[5] This reflects the principle of *par condicio creditorum* whereby by default creditors rank equally in the distribution of the debtor's assets and they get paid *pro rata* according to the value of their claim.[6] This is significant in insolvency proceedings where the law seeks to ensure that the debtor's limited assets are distributed equitably such that each creditor gets a proportionate share of their debt due.

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[1] Chapter 16 of the Laws of Malta
[2] ibid.
[3] Tonia Huntingford, 'The Ranking of Creditors under Maltese Law' (LLD thesis, University of Malta 1977), 1
[4] Civil Code (n 1), Article 1994
[5] ibid.
[6] Nicole Cassar, 'The Law of Ranking – Are all creditors on an equal footing?' (LLD thesis, University of Malta 2017), 13

This principle is not limited to civil law but finds application within Maltese company law. Article 287 of the Companies Act outlines that, subject to any preferential debts or payments, upon the winding up of the company, its property is 'to be applied in satisfaction of its liabilities *pari passu*.'[7] Therefore, reflecting Article 1995, creditors of a liquidated company share proportionately its assets unless there exists a lawful cause of preference.

3. Lawful Causes of Preferences

Creditor equality is not absolute, as recognised by Article 1995 itself, stating that creditors are to rank *pro rata* 'unless there exist between them lawful causes of preference'.[8] A cause of preference grants the creditor a right to rank above other creditors of the same debtor, irrespective of when the credit was created.[9] Article 1996 of the Civil Code states that there are three lawful causes of preferences: privileges, hypothecs, and the benefit of the separation of estate.[10]

Lawful causes of preference attempt to establish a balance between the theoretical ideal of creditor equality and the realities of socio-economic policy objectives. Preferences promote the circulation of credit by providing creditors with the necessary security to lend funds, therefore making credit more accessible. From an equitable standpoint, preference is often given to creditors who have ameliorated the debtor's patrimony or who have provided him with essential assistance. By establishing a hierarchical cause of preference, the legislator sought to ensure that the distribution of limited assets in insolvency proceedings reflects an intentional ranking of socially and economically significant claims.[11]

The first lawful cause of preference is privilege. Article 1999 defines privilege as 'a right of preference which the nature of a debt confers upon a creditor over the other creditors, including hypothecary creditors.' Therefore, it is only debts of a particular nature, as established by law, which may be privileged. Article 1999 grants privileged creditors a ranking over all other creditors, including hypothecary creditors. Privileges may exist over movables and immovables and they may be either general, such that they extend over all of the debtor's assets, or special, such that they attach to particular assets.[12] General privileges are typically given to debts which are deemed as socially essential, including judicial costs and employee wages.[13] Special privileges over immovables possess a *droit de suite* such that the creditor still maintains their

[7] Chapter 386 of the Laws of Malta
[8] Civil Code (n 1)
[9] Tonia Huntingford (n 3), 5
[10] Civil Code (n 1)
[11] Tonia Huntingford (n 3), 6
[12] Civil Code (n 1), Articles 2000-2001
[13] ibid Article 2003

claim over the immovable to which it attaches even if the debtor is no longer the owner.[14] However, for these to have effect *erga omnes* they must be registered in the Public Registry within two months.[15]

The second lawful cause of preference is hypothec, 'a right created over the property of a debtor or of a third party, for the benefit of the creditor as security for the fulfilment of an obligation.'[16] Hypothecs can be of three types: legal, judicial or conventional.[17] Similar to privileges, hypothecs can be general, covering all of the debtor's property, both present and future, and special hypothecs, attaching to a specific immovable property and having a *droit de suite*.[18] However, distinct from privileges, hypothecs rank chronologically by their date of registration in the Public Registry.[19] The validity of hypothecs depends on their registration as otherwise the right loses all practical value against third parties.[20]

The third lawful cause of preference is benefit of the separation of estates whereby the creditors of a deceased person have the right to demand that the property of the inheritance remains separated from that of the heir's.[21] Its scope is to safeguard the creditors' rights in case of an insolvent heir such that the deceased's assets are used to pay the deceased's creditors with preference over the heir's personal creditors.[22]

These lawful causes of preferences restrict the *pari passu* principle under Article 1995 of the Code, prioritising certain creditors over the others. Privileges enjoy a higher ranking than hypothecs, even if the hypothec is registered at an earlier date. Among privileges, ranking is determined by the nature of the debt. On the other hand, hypothecs rank according to their date of registration in the Public Registry.

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[14] Nicole Cassar (n 6), 20-21
[15] Civil Code (n 1), Article 2029
[16] ibid Article 2011
[17] ibid Articles 2017-2028
[18] ibid Article 2012; Nicole Cassar (n 6), 23
[19] Nicole Cassar (n 6), 26
[20] Nadya Fiott, 'The Nature of Privileges and Hypothecs in the Context of their Registration' (LLD thesis, University of Malta 2009)
[21] Civil Code (n 1), Article 2096
[22] Tonia Huntingford (n 3), 135

4. The Limits of Creditor Equality in Maltese Insolvency Law

In practice, the *pari passu* principle is 'more the exception than the rule' as most often the existence of preferential creditors frustrates its application.[23] Secured creditors typically exhaust all of the debtor's assets, leaving unsecured creditors with limited or no assets from which they can satisfy their claims.[24]

Rules for the ranking of creditors are found throughout different special pieces of Maltese legislation which creates a complex ladder of preferences that must be satisfied before any *pari passu* distribution can begin.[25] In his dissertation, Grech provides a tier of the ranking of creditors.[26] Article 293 of the Companies Act states that the costs which are properly incurred in the process of winding-up a company, including the remuneration of the liquidator, 'shall be payable out of the assets of the company in priority of all other claims'.[27] According to Grech, such privilege should rank first because if the costs of liquidating an insolvent company are not guaranteed then the process of liquidation, upon which subsequent creditors are to be paid, may not be carried out since no person would act as a liquidator unless he is guaranteed payment.[28] Ranking second are the claims of employees for unpaid wages rank which, as per Article 20 of the Employment and Industrial Relations Act, 'shall constitute a privileged claim over the assets of the employer and shall be paid in preference of all other claims, whether privileged or hypothecary.'[29] Ranking equally are the claims of the Director of Social Security in respect of Class One contributions.[30] In the third ranking, as per Article 23(11) of the Income Tax Management Act, there ranks the Commissioner of the Inland Revenue whose claims shall rank immediately after wages of employees and the Director of Social Security's claims.[31] The fourth ranking, as per Grech, should be the general privilege of judicial costs.[32] Ranking fifth there should be the special privilege enjoyed by the

[23] Bjorn Grech, 'Dealing with Insolvencies: The Ranking of Creditors' (Bachelor of Accountancy (Hons) thesis, University of Malta 2010), 50
[24] ibid 31
[25] ibid 50
[26] ibid 47-49
[27] n (7)
[28] Bjorn Grech (n 24), 47
[29] Chapter 452 of the Laws of Malta
[30] Social Security Act, Chapter 318 of the Laws of Malta, Article 116(3)
[31] Chapter 372 of the Laws of Malta
[32] Bjorn Grech (n 24), 48

Commissioner of Value Added Tax (VAT), although Grech notes that insolvency judgments have inconsistently interpreted the ranking of such privileges.[33] Ultimately, there is the ranking found in the Civil Code whereby privileges rank before hypothecs according to the nature of the debt followed by hypothecs which are ranked in accordance to their date of registration.

The ranking ladder presented by Grech shows that there exists a clear departure from the *pari passu* principle. The *pari passu* principle is also derogated from by the Courts whereby they have created a split-level hierarchy between creditors holding a special privilege by treating them differently depending on whether they are a private or public entity. Article 2029 of the Civil Code requires that special privileges over immovables be registered within two months in order for them to be effectual.[34] However, Article 62 of the VAT Act grants the Commissioner of VAT a special privilege that exists 'notwithstanding anything contained in any other law.'[35] This has created doubts as to whether the Commissioner's special privilege ought to be registered or not for it to be effectual. This tension was highlighted in the ***Carmelo Gauci Limited vs X*** judgment where the First Hall concluded that the Commissioner of VAT ought to register their privilege like any other private creditor to have effect but the Court of Appeal reversed such decision.[36] The Court of Appeal drew a distinction between the credit and the privilege and held that the Commissioner's fiscal credit ought to be paid in preference even if the privilege itself was not registered. This judicial interpretation, if applied consistently, would allow state claims to take preference over private secured creditors who have diligently adhered to the registration formalities, thereby undermining the principles of *pari passu* and legal certainty. However, there have been dissenting judgments, including that in the names of ***HSBC Bank Malta plc vs Kummissarju tat-Taxxa fuq il-Valur Mizjud et*** where the Court concluded that the two-month time frame required by the Civil Code applied to all creditors, including the Commissioner of VAT.[37] In light of such judicial inconsistencies, legislative amendments are required to clarify the position of Article 62 of the VAT Act as to whether the Commissioner of VAT ranks before or on an equal footing with private creditors holding a registered special privilege.

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[33] Value Added Tax Act, Chapter 406 of the Laws of Malta, Article 62
[34] Civil Code (n 1)
[35] Value Added Tax Act (n 33)
[36] 523/2006/1, *Konsors tal-Kredituri ta' Carmelo Gauci Limited (C5376) vs X*, Court of Appeal (Civil, Superior) 27 February 2009
[37] 78/2006, *HSBC Bank Malta plc vs Kummissarju tat-Taxxa fuq il-Valur Mizjud et*, Civil Court (First Hall) 8 November 2011

5. Conclusion

The principle of *par condicio creditorum* is applicable only to the residual class of unsecured creditors which rank last. Although these are the only creditors to whom the *pari passu* rule truly applies, ironically they are the most likely to receive nothing at all. Given that the statutory ladder for ranking is rather extensive, encompassing liquidation costs, employee wages, and taxes, the debtor's assets are frequently exhausted before reaching the last tier of the hierarchy. Consequently, the equality of creditors mentioned under Article 1995 of the Civil Code has effectively become more the exception than the rule, serving as a mere theoretical idea as opposed to a functional reality.



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