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**ENHANCING CREDITOR PROTECTION RULES
UNDER NIGERIAN CORPORATE LAWS**

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Abstract

Credit is the heart of business. Businesses thrive on loans and credit provided by creditors. However, where business fails creditors are at the receiving end and at the mercy of debtors. This leads to loss of capital and the need to protect creditors. Under Nigerian corporate laws the principles of separate legal personality and the concept of limited liability are two legal concepts that form the foundation of modern company law and play a role in creditor protection. These principles transfer risks to creditors which if not protected or regulated may lead to not only harm to the investors but shortage of capital to run the economy. If creditors are left exposed to the vagaries of company law concepts of limited liability and separate legal personality doctrines they stand at a disadvantage position because if the company cannot pay the money it borrows from its creditors, the creditors will lose their money as the shareholders of a company can only be liable to the extent of their shareholdings and the capital they contributed to form the company. This article examines this from the perspective of contractual rights and legislative enactments under the Nigerian Companies and Allied Matters Act (CAMA). The article finds out that the legal regimes on creditor protection in Nigeria are very weak especially when viewed from the provision of the Companies & Allied Matters Act of Nigeria (CAMA). The article concludes by pointing out that there exist gaps in our legislations which need to be enhanced so as to remove the clog in the wheel of corporate law and practice in Nigeria dealing with protection of creditors.

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1. Introduction

Credit is at the heart and sustenance business. Companies cannot do without capital to carry out their activities as a going concern. A company needs capital to carry on its business activity, to purchase raw materials, to pay its staff and workers and to pay its other financial obligations and liabilities. In doing this, companies resort to borrowing from lenders and other creditors with a view to take care of their finances. However, because of the doctrines of legal personality and limited liability principle there is the fear that members of the company would only be liable to creditors to the extent of their interest or shares of the company because a company is separate and distinct from the members who formed it. This may leave creditors exposed to the risk of not getting back the money they lend to the company and therefore necessitates the need for protection.

There are rules under the Nigerian corporate laws that are tailored to protect creditors. Some of these rules are derived from law of contract while some are made through legislative enactment specifically meant for companies under company law. It is on this premise that this article seeks to discuss and explore the concept of creditor protection under Nigerian corporate laws.

The article begins by highlighting the meaning and import of creditors and the types of creditors under Nigerian corporate laws. The basis of creditor protection is hinged on the doctrines of separate legal personality and the limited liability principle which rationale was to protect creditors especially because of the economic development of the financial market, the need for capital accumulation and allocation of resources, good corporate governance and the prevention of fraud and other wrongful trading activities and directors' duties to creditors shall also be examine. Similarly, the article highlights the various methods by which creditors are protected through the use of self-help strategies when drawing up credit contracts or under legislative enactments in our corporate laws.

The way and manner in which the legislation under our company laws protect creditors through requirement of minimum capital, share capital reduction, capital maintenance doctrine, directors duties and creditor disclosure obligations will be stated and examine. Finally, the article concludes by comparing the laws and rules on creditor protection in other common law countries with a view to enhancing the laws and rules on creditor protection in Nigeria.

2. Creditor and Creditor Protection under Nigerian Corporate Laws

A creditor of a company is a person or company that is owed money (or some kind of other debt by a company).¹ On the other hand, creditor protection is all about giving protection to lenders both individual and corporate who loan out capital to companies. Creditors of Company are divided into two namely:

- (1) *Secured Creditor: A secured Creditor is a creditor whose debt is secured by one or more of the company's assets and property. Example of this is where a company borrows money from a bank, the bank will ask for security like title deed to a building or property or other collateral to serve as a security and guarantee that the company will pay the loan back on agreed basis.*
- (2) *Unsecured Creditors: These are creditors whose debts are not secured by any assets of the company. Therefore if the company cannot pay all its debt then unsecured creditor will only receive payment if there are funds remaining after the secured creditors have been paid off.*²

a. The Legal Basis for the Creditor Protection Doctrine under Nigerian Corporate Laws

The basis for the protection of creditors is anchored on two principles of company law which are the legal personality principle and the limited liability doctrine.

1) Separate Legal Personality Principle

This is a fundamental feature of company law that says a company is a separate legal entity distinct from its members and shareholders.³ This doctrine dates back to more than hundred years ago when the House of Lords of the United Kingdom decided in *Salomon v. Salomon & Co Ltd*⁴ that a company is a legal entity separate from its shareholders. Those shareholders will not be liable for the company's debt. In Nigeria section 37 of the Companies & Allied Matters Act (CAMA) it was provided that

¹Creditors: Their Duties and Powers. A Quick Guide. p.1. Available at <http://www.odce.ie>. Last visited 15th January, 2014.

²*Ibid.* p.2

³Mohammed R. Corporate Insolvency: The Protection of Creditors Interest. Available at <http://www.ssrn.com>. Last visited 13th January, 2014.

⁴(1897) AC. p. 221.

from the date of incorporation a company becomes a body corporate and capable of exercising legal powers and separate from its members who formed it. This principle was upheld in the case of Union Bank of Nigeria Ltd V Penny Mart.⁵ Consequent upon this, the cause of action of company's creditors are limited only to the company itself and not the shareholders or even its directors.⁶ Therefore, this principle necessitates the having in place a regime for the protection for company's creditors.

2) Limited Liability Doctrine and its Relevance to Creditor Protection

Limited Liability principle connote that the liability of shareholders is limited to the amount of unpaid on their shares. This has the tendency of shifting risk of entrepreneurship from shareholders to creditors.⁷

If the company do well the gains will go to the shareholders but where the company fail or becomes insolvent the creditors will suffer.⁸ This necessitates protection of creditors.

b. The Rationale behind the Doctrine of Creditor Protection

The protection of creditor has a number of rationales which benefit not only the company itself but the economy in general. In the opinion of Atilano and Alejandro⁹ creditor protection is a crucial thing to do in order to develop the performance of the credit market. They argued that the primary function of lending in the credit market is to provide cheap funds which function can only be accomplished when creditors are protected and sanctions are imposed on nonperforming debtors. Other rationales or reasons behind creditor protection are:

- 1) Development of the Financial Market: Protecting creditors and investors lead to the development of the financial market and by extension companies; If creditors are protected they will be willing to lend more capital which in turn will encourage the development of lending. This is

⁵(1992) 5 NWLR Pt. 240 p. 228 at 237.

⁶Supra note 3 at p. 9.

⁷*Ibid.*

⁸Supra note 3 at p. 9.

⁹Atilano J.P & Alejandro R. The Cost and Benefits of the Strict Protection of Creditor Rights: Theory and Practice. Available at <http://www.iadb.org/res.32.htm>. Last visited 12th January, 2014.

because countries that protect creditors have better larger markets as can be seen in the case of Europe.¹⁰

- 2) Capital Accumulation and Allocation of Resources: Lending also has an impact on economic development. With creditors protected they are ready to put forward more funds to finance companies thereby fastening capital accumulation.¹¹
- 3) Stability of market: Creditor protection stabilizes financial markets and the business environment.
- 4) Improvement of Corporate Governance in Companies
When creditor's rights are protected they have the possibility of accessing company information and decisions. This can help in detecting managers and director's fraudulent behavior easier thereby ensuring corporate governance.
- 5) To prevent fraud and financial rascality by company directors because most at times borrowers have the incentive to engage in opportunist behavior at their creditors expense.¹²
- 6) Strict protection also leads to cheaper credit because protection confers lenders or creditors and force entrepreneurs to risk their own wealth and provide them with the right incentive to perform.¹³

c. Creditor Protecting Rules in Nigeria

There are two methods by which creditors are protected which are;

- 1) Through Self help strategies or Contracts
- 2) Through legislative enactment.¹⁴

¹⁰Elis J. Protection of Creditors in Public limited Companies, Second Council Directive and Albanian Company Law Compared: Is there a need for Reform? Available at <http://ssrn.com/abstract=1130311>. p. 9.

¹¹*Ibid.*

¹²Supra note 3 at p. 15.

¹³*Ibid.*

¹⁴Andrew K. Directors Duties to Creditors: Contractual Concerns Relating to Efficiency and Overprotection of Creditors. Available at <http://jstor.org/page/info/stable/3699083>. Last visited 10th January, 2014.

Protection by self help strategies involves the insistence on the inclusion of certain terms in the credit contract between a creditor and a company by requiring the provision of security or guarantee. While on the other hand legislative enactment protect creditors through regulations and laws which are primarily founded on the Companies Act and laws and Insolvency Act.¹⁵

3. Creditor Protection Rules Under the Nigerian Companies and Allied Matters Act (CAMA)

There are several ways in which Creditors are protected in company law. In the opinion of Mathias¹⁶ the following are the methods through which creditors are protected.

a. The Minimum Capital Requirement

Company laws set out minimum share capital for companies. This is done with view to improve minimum share capital and decide whether the consideration for share should be in cash or for consideration other than cash. An obvious strategy to fight the first pattern of abuse seems to be a rule which requires a company to raise a minimum amount of capital. The legal capital doctrine as such precludes the loss of share capital by trading only requires a public company to convene an extraordinary share-holder meeting if the assets fall below one half of its legal capital but does not require any particular action to be taken.

b. Reduction in Share Capital

This is a very important way of protecting creditors in company law. A company cannot reduce its issued share capital unless as authorized by the provision of Companies and Allied Matters Act (CAMA). Section 105 of CAMA provides that:

“Except as authorized by this Act, a company having a share capital shall not reduce its share capital.”

The procedure for the reduction of share capital follows very rigorous processes which are:

¹⁵*Ibid.*

¹⁶Mathias M.S., et al “The Protection of Creditor of a European Private Company”, Available at <http://ssrn.com/abstract=1885230>. Last visited 9th January, 2014.

- 1) The calling of Meeting of Directors to resolve that the share capital be reduced.
- 2) Preparation of scheme of reduction.
- 3) Convening a general meeting of the company. The notice of meeting should be accompanied by explanatory circular and the scheme of reduction.
- 4) At the meeting a special resolution would be passed reducing the capital and approving the scheme.
- 5) A copy of the special resolution would be delivered to the commission.
- 6) Applying to the court to confirm the reduction and approve the scheme or reduction.
- 7) Obtain from the commission a certificate of registration of the order and minutes on production to it of order confirming reduction and delivery of a copy of the order and of the minutes.
- 8) Annex the approved minutes and order of reduction to the memorandum.

Section 107 of CAMA provides that:

1. *Where a company has passed a resolution for reducing share capital., it may apply to the court for an order confirming the reduction*
2. *If the proposed reduction of share capital involves either*
 - (a) *diminution of liability in respect of unpaid capital*
3. *Every creditor of the company who at the date fixed by the court is entitled to any debt or claim which, if that date were the commencement of the winding up of the company, would be admissible in proof against the company, shall be entitled to object to the reduction of capital.*¹⁷

See also section 108 of CAMA on the procedure to be adopted by the court before confirming the reduction. The application for the reduction and the procedure for doing so at the Federal High Court are stated under section 4 and 650 (1) of CAMA.

The essence of the above provisions is to protect creditors. *In the case of Exparte West burn Sugar Refinery Ltd*¹⁸ the court held that:

¹⁷The Companies and Allied Matters Act (CAMA), Cap C14 LFN 2004.

¹⁸(1951) AC p. 625.

How much of the paid up share capital can be dispensed with is a domestic matter for the shareholders of a company to decide amongst themselves. If the amount which they had decided on worked no injustice to creditors or shareholders the court should not be concerned to know the precise figure which the company's capital is surplus to its requirement.

Similarly, in the case of *Re Lawson Store Service Co: In Re National Reversionary Investment Co.*,¹⁹ the court held that: No court has power to dispense with the settling of the consent of creditors in the reduction of capital.²⁰

c. Director's Duty to Protect Creditors

There is a duty on directors to protect creditor of their company. This arises out of the fallout of fiduciary duty relationship between them that require them not to undervalue transaction or engage in loss making venture.²¹ Under English law, directors owe the company fiduciary duties and duties of skill, care and diligence. Although the company is a commercial entity distinct from its members, the interests of the company as a *going concern* are traditionally equated with the long-term interests of the shareholders as a whole. Since they stand last in line to receive the economic benefits of the company's activities, creditors are considered as the company's 'residual claimants'.

In the corporate group context, it follows from the separate legal entity principle that the directors of each company within the group are required to act in the interest of the company to which they are appointed rather than in the interest of the group as a whole legal entity doctrine. In recent English case of *Re Pantone 485 Ltd.*²² the court held that as part of the director's duties to their companies, directors must in their decision making take account the interest of the creditors of their companies.

¹⁹(1898) 2 Ch p. 726.

²⁰See also Section 108 of CAMA which requires the consent of creditors.

²¹Davies P. Directors Creditor Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency. EBOR p. 301.

²²(2002) 1 BCLC 206.

d. Capital Maintenance Doctrine and the Distributions of Assets to Shareholders

The capital maintenance doctrine is another good example of protecting the interest of creditors in a company. The doctrine is aimed at protecting the share capital of a company from being returned to its shareholder. The rules were intended to protect creditor against the extra risks associated with limited shareholder liability. It is aimed principally for the protection of creditor's interest.²³ Rules on capital maintenance act as a constraint against the distribution of assets to shareholders. Its main idea is to ensure that a company maintains its share capital as equity in favor of creditor. This rule restricts the powers of companies to dispose of their assets in order to reduce their risk of default on debt obligation. The doctrine places restriction on dividends or other distribution, share repurchases, financial assistance or capital reduction.²⁴ The law set out the maximum amount that can be distributed by way of dividend.

Jessel M.R observed in *Re-Exchange Banking Company, Flit Croft's Case*²⁵ that:

The creditor therefore, I may say...gives credit to the company on the faith of the representation of the capital shall be applied only to for the purpose of the business, and therefore has a right to say that the corporation shall keep its capital and not return it to shareholders.

Similarly, in the case of *Trevor V. Whitworth*²⁶ Lord Watson observed that: Paid up capital may be diminished or lost in the course of the company's trading: that is a result which n legislation can prevent, but persons who deal with, and give credit to a limited company entitled to assume that part of the capital which has been paid up into the coffers of the company has been subsequently paid out, except In the legitimate course of business.

The non-distribution of share capital of a company as a profit is a capital maintenance doctrine which is concern with the restoration and sufficiency of the company's capital. Distribution of company's capital can be made in two ways: either by paying of dividends to the shareholders or by acquiring own shares.

²³The Capital Maintenance Regime. Available at www.cr.gov.hk/en. Last visited 10th January, 2014.

²⁴*Ibid.* p. 7

²⁵(1879) 21 Ch D p. 518 at 533-534.

²⁶(1887) 12 Ch 409 pp. 423-424.

The prohibition of company from purchasing its shares is another way of protecting creditor. Under these rules a company cannot purchase its own shares and dividend can only be paid out of distributable profits.²⁷ This was the reason why common law prohibits a company from acquiring its shares. Section 55 of the old Nigerian Companies Act of 1968 has a provision relating to the prohibition of a company acquiring its shares. But there is no equivalent provision under the CAMA.²⁸ Other rules under the capital maintenance doctrine aimed at creditor protection are: First, shares must not be issued at a discount to their normal par value (no-discount rule). Second, a company cannot, in principle, purchase its own shares since this would result in a reduction of capital. Thirdly, the company, or any of its subsidiaries, is not allowed to give financial assistance to any person wanting to buy its shares. Fourth, the company is not allowed to make a loan to a director of the company or its holding company. Again, the prohibition is more restrictive on public companies than on private ones.

e. Disclosure Obligations Imposed on Companies

Disclosure helps creditors to determine the credit worthiness of a company before they engage in any transaction with it. This is done through mandatory disclosure rules. The most important public information is the company's annual report and accounts, which contains the financial statements and the auditors' and directors' report. This is required in order to give creditors the opportunity to look at the accounts of the company through analysis of its financial statement before embarking on any loan transaction. The law imposes on the directors the duty to prepare a balance sheet and a profit and loss account for each financial year.

f. Piercing the Corporate Veil of a Company

Lifting and piercing the veil of incorporation is another method by which creditors are protected. The phrase lifting the veil means the erosion of the legal personality principle by going behind corporate personality to know who are behind

²⁷Supra note 24.

²⁸Nwamara T.A., *The Encyclopedia of Laws of the Federal Republic of Nigeria* (1st Edi) (Lagos: Law & Educational Publishers Ltd,1992). p. 100.

the actions of a company in terms of its officers and members and shareholdings.²⁹ The law will thus go behind the corporate personality to the individual members or ignore the separate personality of the company in favor of economic entity constituted by a group of associated concerns.³⁰

Lifting the veil is classified into those provided by statute, those under judicial interpretation and cases of fraud.³¹ Protection of Creditors falls under statutory piercing. Accordingly, section 631(4) of CAMA provides that anyone who misdirects a company may be personally liable in respect of any liability arising under the transaction in which the company has been misdescribed. The clear import of this provision is to protect any innocent creditor who may have entered into any transaction with such a person or company. Similarly, under section 336 of CAMA notwithstanding the concept of corporate personality companies belonging to a group or have group structure are required to have a single financial statement of account with a view to let the investing public have an accurate idea of the financial position of the group. Section 506 of CAMA also renders personally liable, for the purpose of company's debt and liabilities, any person who were knowingly to the carrying on the business of the company in a reckless manner.

Therefore one obvious strategy to enhance *legal* protection of creditors is to render a company liable for its debts. The first way to this is by piercing the corporate veil; the second is embodied in the fraudulent and especially wrongful trading provisions of company law.

4. **Creditor Protection Rules in other Common Law Countries**

a. **England**

In England section 263 of the old Companies Act of 1985 prohibits any form of distribution of corporate assets to shareholders except where the value of the distributions is less than that of the profits available for distribution. This section is saying that only profits may be distributed by a company to its shareholders while

²⁹Paul L.D., Gower's Principles of Modern Company Law (London: Sweet & Maxwell, Sixth Edition, 1997). p. 148.

³⁰Ola C.S., Company Law in Nigeria (Ibadan: Heinemann Educational Books (Nigeria) Plc, 2002). p. 35.

³¹*Ibid.* p. 35.

it is solvent.³² Similarly, section 135 of the same Act provides that no company may reduce the amount of its capital stated within its account without the express consent of the court. This is also aimed at protecting the creditor interest in the capital.³³ Section 423 of the Insolvency Act of England provides that creditors are entitled to apply to court to have certain transaction at a undervalue entered into by a company with the aim putting its assets out of the search of the creditor avoided.

Moreover, section 212 of the same Act is of the same effect. This provision was interpreted in the case of *Kinsela V Russell Kinsela Pty Ltd (In Liquidation)*³⁴ that:

“Where a director or a person having management of an insolvent company acts in breach of his duty to the company by causing assets of the company to be transferred in disregard to the interest of its its creditors or creditor, under English Law he is answerable through the scheme of the parliament (section 212 of the Insolvency Act of 1986).”

Other measures provided by the law in England with a view of protecting Creditors are mandatory disclosure rule under section 363 and 364 of the Companies Act which h requires the company to publish its financial statement and must contain auditors and directors reports .Section 226 of the t also imposes a duty on directors of a company to prepare a balance sheet and a profit and loss account.

b. Australia

In Australia there are three ways by which Creditors are protected. They are:

- 1) Through restriction on credit activities
- 2) Through Creditor contract rights
- 3) Through Creditors Right in Insolvency³⁵

In the first instance, restriction deter debtor companies from entering into any transaction that might harm creditor’s interest whole the company is a going concern. The process is done through the minimum capital requirement, dividend

³²Armora J. Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law. Michigan Law Review. p. 355.

³³Supra note 8 at p. 15.

³⁴(1986) 10 ACLC. p. 395

³⁵Helen A. The Evolution of Shareholder Protection in Australia: An International Comparison. Available at <http://www.ssrn.com/abstract=1782412>. Last visited 12th January, 2014

restrictions, equitable subordination, piercing the corporate veil and public enforcement.³⁶ Other measures are the directors duties to creditors as can be seen in the case of *Walker V. Winborne*,³⁷ where the Australian High Court recognized that as part of directors duties to act in the interest of the company they have an obligation to consider the interest of creditors when the company is nearing insolvency. Creditor's contract rights involve measure used by creditors under contract rules. These rules are the right of set off, enforcement of contract and retention of title³⁸ while creditors right to insolvency are rights protected by the insolvency laws.³⁹

c. Canada

In Canada, apart from the rules of company law dealing with creditor protection there is the Canadian Companies Creditors Arrangement Act of 1933 which contain provision on better return for creditors of companies.

d. Malaysia

The Malaysian the Companies Act of 1965 regulates the law and practice of Company Law. The law has provisions for creditor protection which protect creditors in several ways among which are:

- 1) Directors and Officers statutory duties to creditors and the company as enshrined in section 304(1) of the Act that says where a company has been carried on with the intent to defraud creditors then any person who was knowingly a party to the act of that business in that manner shall be personally liable for the debt or other liabilities of the company.
- 2) Wrongful trading; any wrongly trading by a company's directors or officers is criminalized. Therefore any trading doe with intent to defraud creditor is an offence.

³⁶*Ibid.* p. 21.

³⁷(1976) 137 CLR p. 1.

³⁸*Supra* note 29 at p. 23.

³⁹*Ibid.*

- 3) Other measure are provided under section 305 and 176 which deals with misfeasance scheme of arrangement or mergers, section 130 which deals with special administrator under *the Pengurusan Danaharta Nasional Berhad Act of 1998* called (*the Danaharta Act*)⁴⁰ which is aimed at forming an asset management company responsible for acquiring, managing, financing and disposing assets and liabilities of companies which is similar to the Nigerian Asset Management Company (AMCON).

e. The United States of America (the USA)

In the USA I was able to lay my hands on the laws on creditor protection with respect to trading of shares and securities. However, most of the basic principles of creditor protection in company law apply *mutatis mutandis*. The first legislation I consulted that has to do with creditor protection is Securities Act of 1933 which deals with transaction involving companies at the stock exchange. The law requires full disclosure when new securities of companies are introduced to the market. Similarly the Securities and Exchange Act of 1934 has the same provision. The Trust Indenture Act of 1939 has rules concerning the placement of bonds while the Company Act of 1940 and the Investment Advise Act of 1940 are all aimed at protecting creditor's interests.⁴¹

5. Conclusion and Recommendation

This article examined the laws and rules dealing with creditor protection in Nigeria, The article highlighted the meaning of creditors under Nigerian corporate laws and a creditor is understood to include persons who give out loans and credits to legal entities that carry out business for profit. A creditor is central to business activity because of the role he plays in giving capital to companies for business. A creditor includes both secured and unsecured creditors who are indebted by company.

⁴⁰See: fuller discussion in Mohammed R. Comparative Insolvency and the Protection of Creditors. Available at <http://www.ssrn.com/abstract=1462902>. Last visited 13th January, 2014.

⁴¹See: Klaus J.H. Comparative Company Law. Available at <http://www.ssrn.com/abstract=980959> p. 21. Last visited 10th January, 2014.

The basis of the creditor protection rules in Nigerian corporate law has been stated especially its relevance in understanding the twin concepts of the separate legal personality principle and the limited liability doctrine. The wisdom behind the principle of creditor protection borders on the need to develop companies and the financial market, and to ensure stability, fraud prevention and prevention of financial recklessness in the economy.

The method of protecting creditors in Nigeria takes the form of contract rules and legislative enactments under the Companies and Allied Matters Act (CAMA) of 1990. Under CAMA creditor protection rules include provisions on share capital reduction, capital maintenance doctrine, director's duties to creditors as well as lifting the corporate veil to ascertain whether fraud has been committed and minimum share capital requirement.

Finally this article recommends the need to amend CAMA provisions in order to insert strong provisions that will adequately protect creditors in view of the gaps in the laws and the need to draw lessons from other common law jurisdictions that have strong laws on creditor protection, This will go a long way in encouraging foreign investors to come an invest in Nigeria.
