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SCHOOL OF POSTGRADUATE STUDIES

FACULTY OF LAW

COURSE CODE: CLL802

COURSE TITLE: **CORPORATE LAW, MANAGEMENT AND FINANCE (ADVANCED CORPORATION LAW) II**

NATIONAL OPEN UNIVERSITY OF NIGERIA

Headquarters
Plot 91, Cadastral Zone,
University Village,
Nnamdi Azikiwe Expressway,
JABI - ABUJA
URL: www.nou.edu.ng

Lagos Office
14/16 Ahmadu Bello Way
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COURSE TEAM

Course Developer/Writer: **Dr Francis Okanigbuan Jnr**
Senior Lecturer
School of Law, Liverpool John Moores
University Liverpool, UK

Course Editor: Dr Ernest O. Ugbejeh

Programme Leader: Dr Ernest O Ugbejeh

Programme Coordinator: F.O. ONAMSON, PhD

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CLL802 – CORPORATE LAW, MANAGEMENT AND FINANCE (ADVANCED CORPORATION LAW) II

COURSE GUIDE

INTRODUCTION

The most important benefits of incorporating a company are perhaps the corporate personality status of the company and limited liability of members of the company. These ensure that the company can carry on business and conclude contracts in its own name and the liability of the company does not extend to its members. Members of a company can contribute capital to run the company. Alternatively, the company can raise capital from investors and financial institutions to finance its business.

The ultimate objective of a company is to make profit and to lawfully distribute dividends among its members. As soon as a company is incorporated, it determines how to raise capital to finance its investment. The board and company management determines how this is done in practice, usually with shareholder approval or authorisation. The board supervises the management to ensure that they carry out their duties effectively and in compliance with relevant regulations.

Management boards are expected to ensure that corporate entities can finance their investment opportunities to enhance the economic success of the corporation, for the benefit of members. They must also ensure that relevant corporate regulations are complied with. These regulations cover a broad scope, they include rules that govern the establishment of a company and those that dictates how a company should be run. For example, rules relating to raising capital, internal control and audit functions, taxation among others, are essential aspects of corporate entities that the board must supervise. These supervisory roles are carried out to ensure that the executive management team of the company comply with relevant laws in their bid to promote the economic success of the company for the interest of the company and its shareholders.

WORKING THROUGH THIS COURSE

To complete this course, you are advised to read the study units, recommended books, relevant cases and other materials provided by NOUN. Each unit contains a Self-Assessment Exercise, and at points in the course you are required to submit assignments for assessment purposes. At

the end of the course there is a final examination. The course should take you about 13 weeks to complete. You will find all the components of the course listed below. You need to make out time

COURSE MATERIALS

The major components of the course are.

a) Course guide.
b) Study Units.
c) Textbooks
d) Assignment file/Seminar Paper
e) Presentation schedule.

MODULES AND STUDY UNITS

There are six (6) modules. They are made up of twenty (20) units of study.

Module 1 Corporate finance

Unit 1 The capital market
Unit 2 Equity capital
Unit 3 Debt Capital

Module 2 Protection of Creditors

Unit 1- Contractual Protection and Proprietary Protection
Unit 2 - Charges – Floating and Fixed charges
Unit 3 – Registration of charges

Module 3 – Trading in Securities – Market abuse

Unit 1. False trading and market rigging transactions.
Unit 2. Securities market manipulation.
Unit 3. False or misleading statements and fraudulently inducing persons to deal in securities.
Unit 4. Others –

- Dissemination of illegal information.
- Prohibition of fraudulent means.

- Prohibition of dealing in securities by insiders.
- Abuse of information obtained in official capacity.
- Criminal liability for market abuse

Module 4 - Internal Control and Audit functions

Unit 1 Internal Control

Unit 2 Internal audit

Unit 3 Audit committee of the Board

Unit 4 External audit

Module 5 - Corporate Insolvency

Unit 1 Introduction to Corporate insolvency

Unit 2 Corporate rescue

Unit 3 Liquidation

Unit 4 Liability of directors

Module 6 – Company Taxation

Unit 1 General introduction

Unit 2 Regulation of Corporation Tax

All these Units are demanding. They also deal with basic principles and values, which merit your attention and thought. Tackle them in separate study periods. You may require several hours for each.

We suggest that the Modules be studied one after the other, since they are linked by a common theme. You will gain more from them if you have first carried out work on the law of contract. You will then have a clearer picture into which to paint these topics. Subsequent units are written on the assumption that you have completed previous Units.

Each study unit consists of one week's work and includes specific Learning Outcomes, directions for study, reading materials and Self-Assessment Exercises *(SAE)*. Together, these

exercises will assist you in achieving the stated Learning Outcomes of the individual units and of the course.

References – Further Reading

Certain books have been recommended in the course. You should read them where so directed before attempting the exercise.

Assessment

There are two aspects of the assessment of this course, the Tutor Marked Assignments and a written examination. In doing these assignments you are expected to apply knowledge acquired during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the presentation schedule and the Assignment file. The work that you submit to your tutor for assessment will count for 30% of your total score.

SELF-ASSESSMENT EXERCISES

There is a self-assessment exercise at the end for every unit. You are required to attempt all the assignments. You will be assessed on all of them, but the best three performances will be used for assessment. The assignments carry 10% each. Extensions will not be granted after the due date unless under exceptional circumstances.

Final Examination and Grading

The duration of the final examination for this course is three hours and will carry 70% of the total course grade. The examination will consist of questions, which reflect the kinds of self-assessment exercises and the tutor marked problems you have previously encountered. All aspects of the course will be assessed. You should use the time between completing the last unit and taking the examination to revise the entire course. You may find it useful to review yourself assessment exercises and tutor marked assignments before the examination.

Course Score Distribution

The following table lays out how the actual course marking is broken down.

Assessment	**Marks**
Assignments 1-4 (the best three of all the assignments submitted)	Four assignments. Best three marks of the four counts at 30% of course marks.

Final examination	70% of overall course score
Total	100% of course score.

Course Overview and Presentation Schedule

Module / Unit	Title of Work	Weeks Activity	Assessment (End of Unit)
Course Guide			
MODULE 1	**CORPORATE FINANCE**		
Unit 1	The Capital Market	1	Assignment 1
Unit 2	Equity (Share) Capital	2	Assignment 2
Unit 3	Debt Finance	3	Assignment 3
MODULE 2	**PROTECTION OF CREDITORS**		
Unit 1	Contractual Protection and Proprietary Protection	4	Assignment 4
Unit 2	Charges – Floating and Fixed Charges	4	Assignment 6
Unit 3	Registration of Charges	5	Assignment 7
MODULE 3	**TRADING IN SECURITIES – MARKET ABUSEE**	6	Assignment 8
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Unit 2	Market manipulation and false or misleading statements		
Unit 3	Fraudulently Inducing Persons to Deal in Securities		
Unit 4	Other Types of Market Abuse		
MODULE 4	**INTERNAL CONTROL AND AUDIT FUNCTIONS**		
Unit 1	Internal Control		
Unit 2	Internal Audit	8	Assignment
Unit 3	Audit Committee of the Board		
Unit 4	External Audit Function		
MODULE 5	**CORPORATE INSOLVENCY**		
Unit 1	Introduction to Corporate Insolvency	9	Assignment
Unit 2	Corporate Rescue	10	Assignment
Unit 3	Liquidation (Winding Up)		

Unit 4	Liability of Directors		
MODULE 6	**COMPANY TAXATION**		
Unit 1	General Introduction	9	Assignment
Unit 2	Regulation of Corporation Tax	10	Assignment

How to Get the Most from This Course

In distance learning, the study units replace the lecturer. The advantage is that you can read and work through the study materials at your pace, and at a time and place that suits you best. Think of it as reading the lecture instead of listening to a lecturer. Just as a lecturer might give you in-class exercise, you study units provide exercises for you to do at appropriate times.

Each of the study units follows the same format. The first item is an introduction to the subject matter of the unit and how a particular unit is integrated with other units and the course as a whole. Next is a set of learning objectives. These objectives let you know what you should be able to do by the time you have completed the unit. You should use these objectives to guide your study. When you have finished the unit, you should go back and check whether you have achieved the objectives. If you make a habit of doing this, you will significantly improve your chances of passing the course.

Self-Assessment Exercises are interspersed throughout the units. Working through these tests will help you to achieve the objectives of the unit and prepare you for the assignments and the examination. You should do each Self-Assessment Exercise as you come to it in the study unit. Examples are given in the study units. Work through these when you have come to them.

Tutors and Tutorials

There are 15 hours of tutorials provided in support of this course. You will be notified of the dates, times and location of the tutorials, together with the name and phone number of your tutor, as soon as you are allocated a tutorial group. Your tutor will mark and comment on your assignments. Keep a close watch on your progress and on any difficulties you might encounter. Your tutor may help and provide assistance to you during the course. You must send your Tutor Marked Assignments to your tutor well before the due date. They will be marked by your tutor and returned to you as soon as possible.

Please do not hesitate to contact your tutor by telephone or e-mail if:

- You do not understand any part of the study units or the assigned readings.

- You have difficulty with the self-assessment exercises.
- You have a question or a problem with an assignment, with your tutor's comments on an assignment or with the grading of an assignment.

You should try your best to attend the tutorials. This is the only chance to have face to face contact with your tutor and ask questions which are answered instantly. You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will gain a lot from participating actively.

TABLE OF CONTENT

MODULE 1 CORPRATE FINANCE

Unit 1: The Capital Market

1.1 Introduction

A capital market is a platform that connects providers of capital (surplus economic unit) with those in need of capital (deficit economic unit) in any financial ecosystem. Suppliers of capital usually include banks and other investors, while those who seek capital are business entities, governments, and individuals. Capital markets enable business entities to raise long-term funds, by providing a market for company securities, namely debt and equity. They can also help to hedge against risks. Examples of where to find markets are New York Stock Exchange, London Stock Exchange, Singapore, Hong Kong and Nigerian Exchange Group Plc (Nigerian Stock Exchange).

1.2 Learning Outcome

By the end of the Unit, you should be able to identify the main types of capital markets, explain the functions of capital market and describe capital market instruments.

1.3 Capital Market

1.3.1 Functions of Capital Market

The capital market provides a range of functions. Although it is mainly viewed as a platform for trading securities – equity and debt, it provides a broader function. Some of the functions are briefly outlined below.

1) Corporate capital – it provides a platform or market where companies raise capital to finance their operations. This could be equity or debt capital. Investors acquire equity/shares in a company and become shareholders, while the government, companies and other investors can obtain debt capital from

companies or investors. Equity capital is examined in Unit 2; debt capital is examined in Unit 3.

2) Economic growth - Capital markets can help to promote economic growth in a country. Boom in the capital market signifies economic growth, since capital is made available to those who need it, they can further reinvest the capital, leading to economic growth. People who have surplus capital can provide the capital to the people who need capital; the capital market facilitates this exchange. This can drive growth in both the public and private sectors in a country.

3) Promotes saving habits: corporate entities and investors have the incentive to save and invest in the capital market because of the potential for economic gains from their investment. In the absence of capital markets, individuals and entities with surplus capital would likely engage in unproductive spending, if their funds are not invested. They may also invest in other unproductive ventures if they do not have the opportunity to provide funds to those with investment opportunities that do not have access to capital.

4) Availability of funds**:** As explained above, capital markets provide the platform for investors with surplus capital to locate investors that need capital. Apart from being a platform for trading, it also offers safe and reliable medium where both buyers and sellers of assets can interact and trade their capital and assets.

1.3.2 Main Types of Capital Markets

1) Primary market: When a company issues new securities, they are issued at the primary market. Sometimes termed as new issue market, the primary market offers securities e.g., new shares to investors who will become new shareholders and consequently members of the company. Existing shareholders may also buy additional shares from the newly issued shares at the primary market, to increase the number of their shareholding in the company. When existing shareholder buy shares they may buy on the basis of their right to acquire certain number of shares offered to them by the company. This is known as rights issues. financial institutions, institutional shareholders, investment banks and public accounting firms are the main investors in primary markets.

2) Secondary market: The secondary market is the market where the trading of securities mainly takes place. Investors sell their securities to new investors. It is also referred to as the stock market. The existing investors sell the securities and new investors buy the securities of various entities to spread their risks. The secondary market is more flexible than the primary market because individual investors can buy either large or small number of securities from existing investors at any time.

1.3.3 Capital Market Instruments

Two types of instruments are mainly traded in the capital market -

1) Equity / Shares / Stocks: Stocks are sold and bought at a stock exchange. They represent ownership in the company; the buyers become shareholders of the company. When the names of the shareholders are written in the register of members, they become members of the company. See CAMA 2020, s. 109

2) Bonds: These are debt. When debt securities are traded in the capital market, they are known as bonds. Companies issue bonds to raise capital for the expansion of their business. The bond holders offer capital to the company (or to a government) as debt and the company would pay interest on the capital over a period, until they finally pay off the capital. During the period, the company would use the capital to finance its activities to achieve economic growth.

SELF-ASSESSMENT EXERCISES

a) Is the capital markets key player in the financial ecosystem? Give at least five examples to support your answer.
b) Specifically identify the players of the surplus economic unit as well as the deficit economic unit business entities, governments, and individuals in a financial system.
c) Identify the instruments commonly traded in the capital market.

1.4 Summary

Equity and debt capital are two important types of capital that a company can use to finance its operations. This unit has outlined the meaning of capital markets and the important roles of capital markets, not only to corporate entities but to the economy at large. The types of capital markets and the instruments of capital markets – equity and debt were also briefly highlighted as company securities that are traded in the capital markets. This unit mainly highlights the essential aspects of the capital markets and securities trading. Further reading is required to fully grasp the extensive scope of operation of capital markets.

1.5 References/Further Reading/Web Sources

1) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).
2) Mathias Dewatripont And Jean Tirole, 'A Theory Of Debt And Equity: Diversity Of Securities And Manager-Shareholder Congruence' (1994) *The Quarterly Journal of Economics.*

1.6 Answers to Self-Assessment Exercises

a) As a platform that connects providers of capital with those in need of capital, the capital is relevant in the financial ecosystem. This position is supported by the functions of the capital market, and they include:
   (i) It supports the raising of corporate capital
   (ii) It promotes economic growth
   (iii) It promotes saving habits
   (iv) It encourages availability of funds

b) The players of the surplus economic unit in any financial system are banks, insurance companies, and other investors while those in the deficit economic unit include business entities, governments, and individuals.

c) The instruments traded are equity/shares/stocks and bonds (debt).

MODULE 1 – CORPORATE FINANCE

UNIT 2 Equity (Share) Capital

2.1 Introduction

Equity capital refers to the funds that are contributed into a company by its shareholders, to enable it to finance its operations. The investors that contribute the funds receive shares in exchange for their funds; they become shareholders of the company. Equity capital is the first source of a company's capital, it is also the main source of finance. For contributing the funds, shareholders receive dividends by way of return on investment. The dividends are distributable profits that the company has earned over one or more accounting periods. When shareholders contribute funds as equity capital, the funds are invested into risky ventures. Dividends serve as reward for the risk that shareholders embark on. In the event that the company becomes insolvent, the risk of the shareholders will be limited to the amount that they had contributed to the equity capital of the company; they will not be held personally liable for the debt of the company.

2.2 Learning Outcome

By the end of the Unit, you should be able to distinguish between different types of share capital and also know the meaning of public offer of shares.

2.3 Shares

CAMA 2020, s 18(2); s 22(5); s 27; s 142; s 149;

Every private company limited by shares must have at least one issued share, subscribed to, by the single member who established the company. Public companies must have at

least two or more subscribers. Since private companies cannot issue their shares to the public, the focus of the analysis in this Unit will be public companies limited by shares.

Public companies limited by shares have the option of issuing shares to the public to raise capital to finance its investments. The main factors that the company would have to consider are the type of shares they seek to issue and the source of the company's equity finance. The choice of the company would be dependent on a number of factors, namely, the amount of capital the is needed and the size of the company, among other things. The issued capital of a company at incorporation should not be less than one million naira for a private company and not less than two million naira for a public company.

Small private companies usually operate with limited equity capital, this is complemented with loan capital and retained profits. Alternatively, for large companies, equity capital is quite important because it provides the desirable economic foundation that is needed to strengthen the company's economic base. A company obtains access to the capital market and external funding as it increases further in size.

The important role of the capital market was examined in the previous Unit. Before new shares are issued or allotted by the company in a bid to raise capital, the prior authorisation of shareholders must be obtained, especially in a public company.

Pre-emptive rights require a company that is proposing to allot equity securities/shares to first offer the shares to existing shareholders in proportion to the size of their existing holding (pre-emption rights). If pre-emption rights are to be disapplied, so that directors can issue shares to anyone and not just the existing shareholders, the consent of the shareholders must be obtained.

2.3.1 Types of shares

1) **Ordinary Shares**

   Ordinary shares are the main types of shares in a company, such that where a company refers to its share capital without qualification, it is referring to ordinary shares. Thus, if a company has only one class of share, that class of share is ordinary shares. Ordinary shareholders receive dividends only when a company makes

distributable profits, and the directors declare that dividends will be paid. They have no right to receive any fixed returns from the company, the returns that they receive is dependent on the company's distributable profit. This implies that holders of ordinary shares do not have absolute entitlement to demand that the company should pay dividends. The company's articles of association determine the rules that apply in relation to the payment of dividend. Similarly, when the company is wound up, ordinary shareholders are not entitled to share in the company's assets, except there are surplus left after the liabilities of the company have been settled. They are the residual claimants of the company.

2) Preference Shares

Preference shares are the types of shares in the equity capital of a company that entitles the holder to a fixed amount of dividend to be paid by the company. Usually, dividends that are due to preference shareholders must be paid before the company can pay any dividends to shareholders of ordinary shares. If the company is dissolved, the preference shareholders are entitled to be paid back certain amount before the holders of ordinary shares are paid from the available surplus after the debt of the company has been settled. This implies that preference shareholder rank above ordinary shareholders in certain matters of the company. However, preference shareholders also have limited rights. For example, their shares do not carry voting rights over the affairs of the company. In exceptional circumstances, where the dividends to be paid to preference shareholders is in arrears, they may be entitled to vote. If the agenda of a meeting of shareholders include any matters that would affect the rights of preference shareholders, they may also be entitled to vote at that meeting. The main types of preference shares are cumulative preference shares, non-cumulative preference shares and participating preference shares. A company can create a class of preferred ordinary shares that have rights to vote and to receive priority as to fixed income payments, but no priority as to the return of capital. This implies that preference shareholders may in certain circumstances, be entitled to share in the surplus assets on a winding up of a company. They may also be able to vote in a general meeting. Preference shares may be issued as an alternative to debt. When debt is expensive, preference shares may be issued with an attractive preferential dividend to incentivise investors to subscribe, but with no rights to participate in the surplus and only minimal rights to vote. This is attractive

to companies, since the preference shareholder has no guaranteed right to dividend, unless the shares are cumulative preference shares, unlike creditors, who have a contractual right to receive interest payments.

Types of preference shares

a) Cumulative Preference Shares. If a company does not have the financial resources to pay a dividend to the owners of its preference shares, then it still has the payment liability, and cannot pay dividends to its common shareholders for as long as that liability remains unpaid.

b) Non-Cumulative Preference Shares. If a company does not pay a scheduled dividend, it does not have the obligation to pay the dividend at a later date. This clause is rarely used.

c) Participating Preference Shares. The issuing company must pay an increased dividend to the owners of preference shares if there is a participation clause in the share agreement. This clause usually states that a certain portion of earnings will be distributed further to the holders of participating preference shares in the form of dividends. These shares may have a fixed dividend rate. For example, after the preference shareholders are paid dividends, the preference shareholders with participating rights will receive a further amount in dividends, either with the ordinary shareholders or after the ordinary shareholders have been paid.

2.3.2 Public Offer of Shares

The ability to offer shares to the public is one of the most important benefits of a public limited liability company. It enables a company to raise capital to finance their investments by offering shares to the public. As examined above, there are two main markets among other markets. The primary market is mainly patronised by banks and other financial institution and accounting institutions and in the secondary markets, individuals sell shares to one another – this is the common market for trading securities. However, there are certain challenge. The main challenges include

the requirement to disclose additional information, more than other companies that are not involved in trading. Costs associated with trading is also another challenge. Other challenges and advantages are briefly outlined below.

1) Advantages of public issue of shares

a) Opportunity to raise capital from a range of investors
b) Opportunity for shareholders to exit the company and invest elsewhere.
c) There is flexibility, prestige and value attached to the shares that are publicly traded.
d) It helps to enhance corporate governance. Exit strategy by shareholders may signal to the market that the management board is ineffective, since the shareholders prefer to invest elsewhere

2) Disadvantages of public issue of shares

a) Public issue of shares can be quite expensive. The cost of an IPO extends to underwriting fees, lawyers' and other advisors' fees.
b) Trading companies are required to comply with several disclosure requirements. The disclosure requirements occur not only at the time of the IPO itself, but on a continuous basis. The information relating to dividends and financial statements are required to be published. Other information includes changes to directors. Essentially trading companies are required to publish financial and non-financial information on a regular basis to avoid contravening disclosure requirements.

SELF-ASSESSMENT EXERCISES

a) Briefly differentia between ordinary shares and preference shares.
b) Despite the advantages of preference shares, it has its drawbacks. Give one example.
c) List three types of preference shares.
d) Why is it said that ordinary shareholders do not have an entitlement to demand to be paid dividend?
e) List any three advantages and one disadvantage of public issue of shares

2.4 Summary

In this unit, equity capital was examined as an important component of a company's capital. Ordinary shares and preference shares were examined as the main types of equity capital. Further, the implications of public issue of shares for companies, particularly public companies were highlighted. Further reading is required. See the further reading list. You can also read any textbook and journal articles that provide extensive explanation of the topic.

2.5 References/Further reading/Web Sources

1) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).
2) Mathias Dewatripont And Jean Tirole, 'A Theory Of Debt And Equity: Diversity Of Securities And Manager-Shareholder Congruence' (1994) *The Quarterly Journal of Economics.*

2.6 Answers to Self-Assessment Exercise

a) Ordinary shares are the main types of shares in a company, such that where a company refers to its share capital without qualification, it is referring to ordinary shares. On the other hand, Preference shares are the types of shares in the equity capital of a company that entitles the holder to a fixed amount of dividend to be paid by the company

b) The major drawback of the preference shares is the limited rights that attached to the holders. For example, the shares do not carry voting rights over the affairs of the company.

c) The three types of preference shares are
   (i) Cumulative preference share
   (ii) Non-cumulative preference share
   (iii) Participating preference share

d) This is because ordinary shareholders have no right to receive any fixed returns from the company; the returns they receive is dependent on the company's distributable profit.

e) The advantages and disadvantages of public issue of shares:
   (i) Advantages – includes (i) opportunity to raise capital from a range of investors; (ii) opportunity for shareholders to exit the company and invest elsewhere; and (iii) there is flexibility, prestige and value attached to the shares that are publicly traded.
   (ii) Disadvantage – public issue of shares can be quite expensive.

MODULE 1 – CORPORATE FINANCE

Unit 3: Debt Capital

3.1 Introduction

Just like equity capital, debt capital is an essential aspect of a company's capital. It provides companies with the capacity to finance their investment where equity capital is not adequate. There are several benefits and challenges of debt capital, these will be examined in this Unit. Further, the various types of debt capital will be outlined.

3.2 Learning Outcome

By the end of the Unit, you should be able to distinguish between the different forms of debt capital structures available to a company.

3.3 Debt Finance

In view of the inability of companies to raise sufficient equity capital that is required to finance their investments, they can obtain debt capital to complement their equity capital. In the absence of the required funds to finance investments, the operations of companies would be restricted, and their businesses will not grow. Thus, to ensure that companies expand their businesses and are able to invest in ventures that will result in increase in future income, companies need to borrow capital. Debt financing is a corporate decision taken by the directors of a company unlike equity financing where shareholders have significant control over the powers of the board of directors to allot shares.

Most times, the need to borrow is dependent on the company's cashflow. If a company's cashflow is based on expected future profit, the investment needs of the company have to be met immediately, hence the need to borrow to meet its short-term investment needs and obligations. At other times, a company may need capital for long-term investment. The company would have to consider whether debt or equity financing would be more suitable than the other. There are several varieties in the debt finance available to most companies, compared to available equity finance options because, more variety is available in debt than in equity. The determination of the most appropriate debt financing option will depend on a number of factors, such as the size of the company, the financial position of the company, the nature of the company, the reason for the capital, the nature of its assets, the nature and requirements of the lender, among other things.

3.3.1 Sources of Debt Finance

The main sources of debt finance have significantly increased since the global financial crisis. Loan used to finance corporate investment can be obtained from the 'shadow banking' sector. These are entities that are not banks but they offer credit facilities to corporate entities. The financial institutions that may offer loans generally include banks, institutional investors, hedge funds and private equity houses, and some individuals who have the capacity to offer credit through peer-to-peer lending.

3.3.2 Types of debt capital

There are various types of debt capital, the main types are loans and debt security. The analysis below does not contain an exhaustive list of debt capital (See further reading list).

1) **Loans**

   a) Bank Loans Banks offer loans to companies individually or collectively- a number of banks offering loans to a company. Loans offered to companies can either be committed loans or on-demand lending. A committed loan is a type of loan that is offered over a certain period of time, on the fulfilment of certain conditions. The loan amount can be offered as a term loan, where the amount is offered at once or in successive parts from time to time. The amount is usually repayable for a term once or in parts, with a payment

schedule agreed by the bank and the company. Alternatively, it could be flexible facility in a revolving facility, which is similar to an overdraft, the company can assess some funds, repay and obtain funds again, up to the date the facility ends.

The type of the loan would be dependent on the purpose or need for which the loan is taken. A company is more likely to use a term loan for a one-off purchase, such as land or other asset or in an acquisition. A revolving facility is more often used to raise working capital, since a working capital is required for day-to-day operation, funds can be accessed and replaced intermittently. Other types of loan include a standby credit or 'swingline' used to support an issue of commercial paper. Commercial paper is an unsecured promise to pay a certain amount on a stated maturity date, issued in bearer form. It is a short-term advance which may not be used at all but can be used to tide the company over if it has to repay some commercial paper but does not want to issue another batch immediately because of market conditions.

On-demand lending is an overdraft credit facility. Once there is an agreement between the bank and the customer, the customer can withdraw more money from its current account with the bank than it has paid in, up to the agreed limit. One disadvantage of an overdraft is that it is typically payable on demand, except a contractual agreement varies this condition. The mere fact that the overdraft is available for a period does not mean that a provision that it is repayable on demand is ineffective. This means that, unless the company takes specific steps to ensure appropriate wording in the overdraft documentation, it is in danger of the finance being withdrawn without notice when it is not in breach. Hence overdraft is quite risky, despite its popularity amongst small businesses.

b) Peer-to-Peer Lending. This medium of obtaining debt capital provides a platform where potential lenders are connected with potential borrowers. Types of peer to peer lending include lending by companies, consumer lending, lending for property development

secured on land, among others. P2p lending offers an alternative to bank lending by the Government. For example, where a small business entity is unable to obtain loan from a bank, the bank is required to pass on information about the applicant to financing platforms designated by the government, if the applicant agrees. This would provide an alternative route to successfully obtaining finance required by the small company to finance its investment. Peer-to-peer lending removes the middleman from the lending process, but it also involves more time, efforts, and risks.

3.4 Debt Securities

Debt securities are alternative source of capital to loans. A company may issue debt securities rather than obtaining loans in similar way that equity can be issues instead of loan. There are tradable instruments which a company can issue in the stock market to raise money from a variety of lenders. One way that loan compares with debt security is that a single bank may offer loan to a company, whereas there will be various potential lenders unlike a single bank that may offer loans and be issued debt securities, thereby buying debt securities from the company. The securities from the company are recorded and issued to the investors in exchange for the funds that the investors provide to the company to finance its investment.

Debt securities are usually issued in the primary market examined in Unit 1 above. Once issued, they can be traded in the secondary market, examined in Unit 1 above. Some debt securities are retained by the original owners until their maturity period. However, most debt securities are traded, and they are issued by governments. Known as bonds, they are usually the most highly rated. The reason for this rating is that bonds issued by national governments are often considered low-risk investments since the issuing government backs them. A government issue bonds as a debt security to support its spending and other financial obligations.

Companies and other financial institutions that are in need of short-term finance can also raise debt securities by issuing commercial papers for a specific term, usually one year or less. Unlike bonds or other longer-term debt securities that are traded on the bond market and capital markets, short-term securities are traded in the money markets.

3.5 Comparison between Debt Capital Structures

3.5.1 Securities versus Loan

Several factors are usually considered by a company that is desirous of raising capital either via loan or debt securities. The main factors to consider include the characteristics of loans and securities. Generally, it is cheaper for a company to raise money by issuing debt securities than by taking a loan, since interests must be paid on loan on a regular basis. The interest rate may also be quite high. One of the challenges of issuing debt securities is that it is not as flexible as a loan. The issuing company cannot repay back the debt represented by the securities until the end of the term of the issues. Thus, corporate entities need to carefully consider the merits and demerits of both methods of raising capital in relation to their financial needs, to determine the cheapest and most convenient method to adopt.

3.5.2 Debt Securities versus Equity

There are several factors to consider before a company decides on the type of capital to raise. Both equity and debt capital have their benefits and detriments. The extent to which a company which needs funds issues equity or debt securities would be largely dependent on a number of factors. It is generally cheaper to obtain and maintain debt than equity. However, debt has its own challenges, e.g., too much debt may undermine the financial integrity of a company and threatens its solvency. An advantage of debt securities over equity securities is that the interest paid on debt is tax deductible for the company, unlike dividends paid to equity holders, which cannot be deducted. This is one reason that makes debt cheaper than equity. Also, a type of debt, namely debt securities can be traded, they have tradability value, this makes them similar to equity- shares. Debt securities are traded on the secondary market, and they are usually listed on a stock market, although much of the trading are done over the counter. However, holders of debt securities do not have a stake in the company, they are not members of the company, unlike the owners of equity securities who are members of the company and they determine how the affairs of their company is run. They appoint directors and approve certain important transactions. However, whenever a company raises fund through equity, additional members join the company, and the control of the company is diluted. Debt securities do not dilute the control of the company since holders of debt securities do not

participate in the affairs of the company. The main difference is that the owner of equity securities has a stake in the company and shares its profits and its losses. Another advantage of debt securities, particularly for private companies, is that the existing shareholders do not dilute their control of the company (or the value of their shares). The owner of debt securities does not share in the profits, and, as a creditor, ranks above shareholders if the company is insolvent.

Some securities are characterised of both equity and debt securities. Although they seek to offer investors the benefits of both types of securities, they do not possess the full complement for the benefits of both debt and equity securities.

3.6 Summary

This unit examined debt capital. It examined various types of debt capital and outlined the benefits and challenges of debt capital over equity capital. The sources of debt capital were also highlighted to identify the various options that are available to companies to raise debt capital. Further, some of the benefits and challenges associated with debt and equity capital were highlighted. These are the factors that companies consider, among other things, to decide whether to raise debt or equity capital. There is scope for further reading. See the further reading list below.

3.7 Further reading

1) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).
2) Eilis Ferran and Look Chan Ho, *Principles of corporate finance law* (Oxford University Press, Oxford 2014)
3) Mathias Dewatripont And Jean Tirole, 'A Theory of Debt And Equity: Diversity Of Securities And Manager-Shareholder Congruence' (1994) *The Quarterly Journal of Economics.*

MODULE 2 PROTECTION OF CREDITORS

Unit 1: Contractual Protection and Proprietary Protection

1.1 Introduction

In Module 1, debt capital was examined as one of the types of capital that may be available to a company. The main types of debt capital were examined – loan and debt securities. The benefits and challenges of various types of debt capital and debt securities were also briefly examined. It was also indicated that providers of debt capital do not take part in decisions relating to the affairs of a company, unlike shareholder who provide equity capital. Since shareholders decide how the affairs of a company should be run, for example, they can appoint and remove directors from office, attend and vote at meetings and approve certain transactions, they will likely make decisions that would protect their investment in the company. Creditors and providers of debt capital do not have the opportunity to determine how the affairs of a company should be run. Hence, alternative measures exist to protect the interests of creditors; these are broadly classified as contractual and proprietary protection.

1.2 Learning Outcome

By the end of the unit, you should be able to discuss the two main forms of creditor protection mechanisms, to wit contractual as well as proprietary protection.

1.3 Contractual Protection

Contractual protection refers to those mechanisms that are used to protect the interests of creditors, towards ensuring that the debt capital provided by the creditor can be recovered

by the creditor. These mechanisms are established via contract. The underlying objective of various forms of contractual protection is to protect the right of creditors to be repaid the main capital that is provided in addition to the cost of the loan and interests. Various ways that the interest of creditors can be protected by contract are briefly examined below.

1.3.1 Usual Types of Contractual Protection

1) Restrictions on Borrowing

A creditor can use contractual instrument to control or restrict future borrowing activities of the debtor company. The contractual instrument can include a covenant that requires the borrowing company to maintain a specified gearing ratio. The gearing ratio of a company is the ratio of debt to equity. The higher the debt of a company, the higher the gearing ratio of the company. Hence, to limit the risks and exposure of a company to insolvency, a creditor may require future debt to be limited to certain level. This will ensure that the company retains sufficient capital and be likely able to pay its debt in future.

Alternatively, the creditor can contract with the company to simply restrict its borrowing capacity to only those types of borrowing that do not conflict with that of the lender. This is usually completed by a covenant with the debtor company, so that any further borrowing that the debtor engages in would not rank higher than the rights or privileges of the creditor.

2) **Restrictions on Asset Disposal**

Lenders can restrict the extent to which a debtor company can dispose its assets. A contractual instrument can be drawn up as part of the conditions for the debt capital that empowers the creditor to limit the disposition of substantially all the assets of the company. Except those depositions that are normally within the ordinary course of business, such as those that the company would receive full value as part of trading to make profit or earn income. The consent of the creditor may be required in certain circumstances to enable the company to dispose of some assets.

3) Restrictions on Dividend Payments

Payment of dividend is the distribution of part of the company's profit to its members. Although dividends are usually paid when a company is financially buoyant and deemed able to meet its debt obligations, nevertheless, restrictions can be placed on the payment of dividends. Payment of dividend can be restricted to certain percentage of the company's net profit. Dividend payment by public companies is regulated to ensure that companies are able to meet their obligations before they make distributions to shareholders. Private companies comply with less regulatory requirements, including regulations relating to payment of dividends, hence contractual clauses that restricts payment of dividend are not common with public companies. Creditors tend to benefit from statutory protection in relation to public companies since dividends can only be paid from distributable profits. For example in the UK the *Companies Act 2016,* s 831 ..provides as follows - *A public company may only make a distribution— (a) if the amount of its net assets is not less than the aggregate of its called-up share capital and undistributable reserves, and (b)if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate.* In Nigeria, restriction may apply to private and public companies see *CAMA 2020,* ss 426-433.

4) Change of Control Covenants

Contractual covenants that restrict control of business, such as a change in the type of business and mergers and acquisitions may be established by contract. This is aimed at ensuring that the status and control over the corporate entity remain unchanged during the pendency of the debt or any changes would be subject to conditions that would ensure that the interest of the debt provider is protected. For example, a change in the type of business carried out by the company can greatly affect the credit risk faced by the lender. Apart from the likelihood of the new business being riskier, which may undermine the creditors interests, the value of the loan may also be affected. Bondholders may struggle to transfer their bonds, since prospective investors may be weary of the perceived unstable nature of the

business, especially if it is not guaranteed that the new business will not be accompanied by a downgrading in credit rating.

1.3.2 Other contractual protection includes restriction on debt buybacks and negative pledge clause. Debt buy-back refers to prepayment or repurchase of an existing loan. Borrowers may make prepayment subject to certain agreed restrictions, such as timing and the giving of notice. An optional clause may prohibit the borrower from repurchasing the whole or part of the loan, based on certain conditions. A negative pledge is a term in a contract that prohibits the debtor company from creating security interests over specified property assets. The aim is to protect the creditor by ensuring that the debtor does not use assets that are encumbered as collateral for subsequent loans. It often helps to protect the interests of unsecured lenders that can be negatively impacted by a company's further borrowing.

Apart from the contractual rights that can be enforced against the debtor company, other contractual rights may also apply against third parties that deal with the debtor company. For example, those third parties that protect the debtor company without payment, such as a parent company or a director, and those who do so for a fee, such as a bank or other financial institution whose business is providing credit protection to the company may be affected by the contractual rights.

Contractual rights against third parties are aimed at ensuring that the challenges of contractual rights against the borrower do not undermine the interest of the creditor. For example, if the borrower becomes insolvent, the lender will only be able to prove in the insolvency for a fraction of the amount due. A contractual right against relevant third parties who are more likely to remain solvent would help to protect the lender.

1.4 Proprietary Protection

Apart from contractual protective mechanisms, creditors can protect their interests via proprietary means. Contractual rights give the creditor limited protection especially where the debtor becomes insolvent. One of the main limitations of contractual protection is that contractual rights merely entitle creditors to prove in the liquidation of the insolvent debtor, which generally results in recovery of little or none of the outstanding

debt. However, a creditor with proprietary rights can enforce them either outside the liquidation or, they would be placed in a position of priority to the claims of most of the general body of creditors. Only adjusting creditors are able to protect themselves via proprietary means. Adjusting creditors are those creditors that can adjust the terms of their claims to anticipate or take into account the effects of new developments that can undermine their interests. Non-adjusting creditors are usually not in the position to alter contract terms. Irrespective of whether the debtor is insolvent, a proprietary right can be enforced. However, if a creditor merely has a contractual right to payment of their capital, and the debtor in unable to pay, the creditor has to sue for the debt.

There are other significant advantages that proprietary rights have over contractual rights. For example, outside insolvency, proprietary rights will usually enable the creditor to monitor what the company does with the assets over which it has such rights, including the right to control what the company can do with the assets. The right of control over the assets however depends on the nature of the proprietary rights. For example, assets subject to a floating charge can be disposed of without the charge holder's consent, while a fixed charge holder for example, has to give consent each time a charged asset is to be disposed of by the company.

1.4.1 Absolute Interests

The main difference between absolute and security interests is that an absolute interest refers to a legal right or complete right to, or the ownership of an asset. This implies that, such person usually a creditor retains the sole right to legally possess, sell or derive benefits from such asset. It represents the highest interest that can be held over an asset. No encumbrances that could affect the creditor's right or ownership of the asset. This implies that someone with absolute interest in an asset enjoys the full protection of the law in exercising their rights over the asset, to the exclusion of all others. Absolute interests are mainly obtained by creditors, either by grant or by reservation, usually for the same purpose for which a creditor would obtain a security interest.

1.4.2 Security interests

A security interest is a proprietary interest that A obtains in relation to property owned by B to secure an obligation owed to A by B or, in some instances, by C.

Usually, this obligation is mostly an obligation to pay money owed to the creditor. Examples of security interests include pledge and contractual lien as possessory security interests and mortgage and charge as non-possessory security interests.

There are various features of security interest these are known as the indicia, or incidents of security that indicate that an interest is a security interest and not an absolute interest. The first is that if the asset is sold in order to meet the secured debt, and the amount realised is more than the debt, the debtor has a right to the surplus amount. Second, if the amount realised is less than the value of the secured debt, the debtor remains liable to the lender for the balance. Third, the debtor has the right to redeem; they can get rid of the asset of the creditor's proprietary interest by paying the debt by means other than by the realisation of the asset. Lastly, a security interest can only be created by grant and not by reservation. Grant differs from reservation in the following way. If a debtor grants an interest to a creditor, the grant can either be an absolute interest or a security interest, depending on whether the incidents of security are present. However, if a debtor reserves an interest in an asset, this can only be an absolute interest, even if the creditor is granted many of the rights that are synonymous with ownership, such as the rights to possess, to use and to dispose of the asset.

SELF-ASSESSMENT EXERCISES

a) Give one example each of possessory and non-possessory security interest
b) Contractual rights can hedge the exposure of a creditor to the borrower, but it has a major drawback. Identify it.
c) Give an insight into s 831 of UK Companies Act 2006 with reference to distributable profits of a public company.
d) What is the overall objective of restriction on borrowing by creditors?
e) Enumerate the indicia of security interest.

1.5 Summary

This Unit examined the two broad ways that the interests of creditors can be protected namely, contractual protection and proprietary protection. The main difference between absolute propriety interest and security proprietary interests were highlighted. Further examples of possessory security interest and non-possessory security intertest were outlined. It is beyond the scope of this course to highlight and explain every aspect of

creditor protection, thus, further reading is essential. However, an essential aspect of creditor protection, namely charges as non-possessory security interests will be examined in the next Unit of the module.

1.6 References/Further reading/Web Sources

1) F O Onamson, *Law and Creditor Protection in Nigeria* Malthouse Press Ltd 2017
2) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).
3) Eilis Ferran and Look Chan Ho, *Principles of corporate finance law* (Oxford University Press, Oxford 2014)
4) Mathias Dewatripont And Jean Tirole, 'A Theory Of Debt And Equity: Diversity Of Securities And Manager-Shareholder Congruence' (1994) *The Quarterly Journal of Economics*

1.7 Answers to Self-Assessment Exercise

a) An example of possessory security interest is the pledge, while an example of non-possessory security is the mortgage.

b) A major limitation or drawback is that contractual rights merely entitle creditors to prove in the liquidation of the insolvent debtor, which generally results in recovery of little or none of the outstanding debt.

c) Section 831 UK Companies Act 2006 provides *a public company may only make a distribution— (a) if the amount of its net assets is not less than the aggregate of its called-up share capital and undistributable reserves, and (b)if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate.*

d) The overall objective of the creditor to protect its priority.

e) The indicia of security interest are four. The first is that if the asset is sold in order to meet the secured debt, and the amount realised is more than the debt, the debtor has a right to the surplus amount. Second, if the amount realised is less than the value of the secured debt, the debtor remains liable to the lender for the balance. Third, the debtor has the right to redeem; they can get rid of the asset of the creditor's proprietary interest by paying the debt by means other than by the realisation of the asset. Lastly, a security interest can only be created by grant and not by reservation.

MODULE 2 PROTECTION OF CREDITORS

Unit 2: Charges – Floating and Fixed Charges

2.1 Introduction

This Unit will continue with an analysis of the ways that lenders to corporate entities can be protected from the risks that are associated with lending. In Unit 1, the broad ways that creditors can be protected were examined, namely contractual protection and proprietary protection. In this Unit, we will briefly explore an aspect of proprietary protection - security interests, which can be further classified into possessory and non-possessory security interests. Particularly, the Unit will examine an aspect of non-possessory security interests, namely charges. A charge can either be floating charge or fixed charge. These will be examined, to identify the implications of the types of charges in relation to the interest of creditors. Further reading is recommended in view of the limited scope of the lecture materials. Further reading list will be provided. You are encouraged to read beyond the scope of the reading list – books and journal articles will enhance the scope of your knowledge.

2.2 Learning Outcome

By the end of the Unit, you should be able to understand the meaning of charges and also differentiate between the types of charges and their relative merits and demerits.

2.3 Charge

CAMA 2020, s 203-204

A charge is used to protect the interests of creditors when they offer loan to a company to finance its investment. Since a company may become insolvent and an insolvent company may not be able to meet its obligations to creditors, creditors can secure their

loan by a charge. Usually, creditors do not want a security that will leave them in a queue behind several other creditors on insolvency. Hence creditors require not just a security, but a security that will give them priority over the assets of the debtor company if the company becomes insolvent. A charge is a security interest created by the debtor in favour of the creditor to secure the repayment of a loan. When a company borrows money, the creditor can request that the company should use a part of its properties or assets to secure the loan. A charge is created, so that if it fails to repay the loan or interests on it, the creditor will recover the money from the properties that are used to secure the loan. Thus, a charge is a form of proprietary protection, it is a security given by a company for money borrowed by it. A charge may be in a legal or equitable form.

When a charge is created in writing, by a deed, such as a document under seal, it is a legal charge. An equitable charge is created where a document creating a charge is not under seal, or where in the absence of a formal written document, the title documents of the company's property are held by the creditor as proof of borrowing. The title to the charged property may also be equitable. When a charge is created, the company whose asset has been charged is the 'chargor' and the credited that secures their loan with the asset is the 'chargee'. A charge over a company's assets must be registered with the registrar of the Corporate Affairs Commission CAC. Registration of charges will be examined in Unit 3.

2.4 Types of Charges

There are two types of charges, fixed charge and the floating charge.

2.4.1 Fixed Charge

CAMA, 2020, s 204

A fixed charge is a charge on specific assets of a company that are identified at the time of creating the charge. These include specific land, buildings, plants and machinery or any other identifiable assets of the company. As soon as a fixed charge is created, the company has no right to deal with or dispose of the property without the consent of the creditor. If the debtor company 'the chargor' defaults in paying the loan, the creditor, 'the chargee' can take possession of the charged asset and sell it. If the asset is sold by the company without the approval of the creditor, the charge will follow the property to the buyer. As long as the charge has been registered with the CAC, buyer takes the property subject to the charge.

Hence it is important to ensure that an asset or property is free from encumbrances before acquiring the asset.

Advantages of fixed charge

The Creditor

a) The charged assets cannot be sold or disposed of without the consent of the creditor.
b) if a property is secured by both fixed and floating charge, a fixed charge takes priority over a floating charge.
c) If the charged asset is sold by the debtor company without the approval of the creditor, interest of the creditor remains protected, the buyer takes the property subject to the charge as long as the charge was registered. If the charge was not registered, the buyer would not be bound by the charge, except the buyer has notice of the charge at the time the asset was purchased.
d) As soon as it has been registered, it confers an immediate security for the loan.
e) A fixed charge entitles the creditor to sell or take possession of the asset if the debtor company defaults in paying the loan.

The Debtor Company

a) It is easier to secure a loan by a fixed charge because of the greater assurance to creditors of the security.
b) The debtor company may also be able to negotiate a better interest rate with their creditors.

Disadvantages of Fixed Charge

Creditors can only realise their loans from the asset used to secure the loan. If the value of this asset depreciates, so does the amount that may be recovered from it. If the asset is destroyed, this means that the security has disappeared, hence the need for insurance.

There are certain challenges of fixed charges to debtor companies. Fixed charges encumber the charged asset. Even though the company is financially buoyant and has a very high prospect of being able to repay the loan, the company cannot use a charged asset as security for additional loan.

The company cannot deal with or dispose of the asset without the approval of the creditor. the company cannot create another charge on the property without such permission. If the loan is less than the value of the charged asset, the company cannot use the asset to secure additional loan from another lender without the approval of the creditor charge, the chargee will not likely approve such arrangement. The chargee wants to have abundant assurance about the security of their loan.

A fixed charge is not invalid on the ground that it was granted by a company immediately before liquidation, although the validity of a fixed charged may be challenged on the grounds of invalidity, fraud or as a fraudulent preference. See CAMA 2020, ss, 222, 510.

2.4.2 The Floating Charge

CAMA 2020, s 203

A floating charge is an equitable charge on the assets of the debtor company. The floating charge is valid for the time being that a company carries on business as a going concern. The charge attaches to the charged assets or properties of the company in the various conditions that they happen to be from time to time. Usually, a floating charge is created over a class of present and future assets. These assets and properties or items of the debtor company could be non-permanent, changeable or transient, such as plants, machinery, stock in trade, receivables. and any other items that may change in quantity and value over time. In *Agnew v IRC (Re Brumark*) 20012 BCLC 188 at 192 Lord Millet observed thus,

> *'The floating charge is capable of affording the creditor, by a single instrument, an effective and comprehensive security upon the entire undertaking of the debtor company and its assets from time to time, while at the same time leaving the company free to deal with its assets and pay its trade creditors in the ordinary course of business without reference to the holder of the charge'.*

Where a creditor has a floating charge on all the business of a company, the floating charge covers all the assets of the company that are not subject to a fixed charge.

When a floating charge is created, it remains dormant until the company becomes insolvent or the happening of a thing or event constituting a default. This process is called *crystallization of the floating charge*. The creditor can then appoint a receiver to manage the assets and realise their fund. Before crystallization of the floating charge, the company can use the property in its business as if there was no charge on it. The charge floats or hovers around the charged assets that are not specific, until an event happens, or the company becomes insolvent, then it crystallises, and it becomes fixed on the available assets that are not covered by a fixed charge.

Crystallization occurs when the company fails to meet its obligations under the charge agreement and the creditor decides to call in the assets. Other factors that may led to crystallisation includes, if the company becomes insolvent, if a PLC re-registers as private company, Ii the company ceases to do business prior to winding up, if the company uses the assets other than in the normal course of its business. When crystallization occurs, the charge becomes a fixed equitable charge attaching to the class of assets concerned.

The value of the floating charge that is created is largely dependent on the ability of the creditor to realise the assets charged as security for the debt, without reference to the insolvency rules that govern the distribution of the common fund of unsecured assets. A major challenge of floating charge is that it is usually subject to insolvency rules on distribution to creditors. Priority in the distribution of funds is given to other claims such as fixed charge holders and other preferential debts. Unless the terms on which the floating charge was granted prohibits the company from granting any later charge having priority over the floating charge and the person in whose favour such later charge was granted had notice of that prohibition at the time when the charge was granted to the creditor

Since the debtor company can use the charged assets in its business, the precise assets and their real value cannot be accurately ascertained until crystallization. This implies that it is possible for the assets to appreciate, depreciate, or rise and fall in number and value with time and usage. When a company creates more than

one floating charge over the same class of assets, the charges rank in priority according to the date of their creation. If a previous charge is not registered, a subsequent registered charge would take priority over the earlier charge.

> *Where a company is being wound up, a floating charge on the undertaking or property of the company created within three months of the commencement of the winding-up shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except to the amount of any cash paid to the company at the time of or subsequently to the creation of, and in consideration for, the charge, together with interest on that amount at the current bank rate*. CAMA 2020 s 662

In certain circumstances, the company can use the charged assets as security for further loans, however, there may be a clause in the floating charge agreement that prevents the company from creating further charges, which rank above or equally with the floating charge. This is called a 'negative pledge clause'. It is used to strengthen the position of the creditor - chargee.

Advantages of a Floating Charge

The company

A floating charge allows the company to continue to use the charged asset in the normal course of its business. Unlike a fixed charge, a floating charge does not tie down the charged assets, it does not prevent the company from dealing with the assets, at least until insolvency or the happening of the events that chrysalises the floating charge. However, a negative pledge clause could restrict the ability of the company to raise more money with the assets. If the charged assets lose value or depreciate, the company cannot be made to pay the difference; the lender takes the property in their current state at crystallization.

The advantages that a floating charge offers to a creditor include the following.

a) Creditors can charge a higher rate of interest on loan secured by a floating charge, since the assets are not identified and upon crystallisation, they may lose value.
b) It gives right to all the stock-in-trade or undertaking of a company.
c) The assets may be easier to convert into cash than fixed charge assets.

d) The creditor can appoint an administrator or receiver, or petition for the compulsory winding up of the company.

Disadvantages of a Floating Charge

The creditor

a) A floating charge is less secure and more risky than fixed charge, since the company can use the charged property in the normal course of its business.
b) The charged property may depreciate or lose value by the time it crystallizes. Thus, the creditor might not know the size and/or value of the assets before crystallization. They may be even have ceased to exist.
c) A floating charge is lower in priority than a fixed charge and a company's preferential debts.

The company

a) Higher interests indicate that it may be more expensive to borrow money via a floating charge.
b) Upon happening of agreed event, the creditor may intervene in the business by appointing a receiver / administrator.

SELF-ASSESSMENT EXERCISES

a) What is a charge? State the main types of charges.
b) Define the concept of 'crystallisation.'
c) Differentiate between legal charge and equitable charge.
d) State the unwanted effects of a floating charge to the debtor company

2.5 Summary

This Unit examined charges – floating charge and fixed charge. It identified the effects of charges on the rights of creditors and the debtor company. These were examined in relation to fixed charges and floating charges. The benefits and challenges of both types of charges were examined and outlined in relation to creditors and debtor companies. The analysis in this unit is by no means exhaustive and conclusive of the scope of floating and fixed charges. Efforts have been made to outline the essential aspects of both types of charges, however, further reading is required. Further reading list is provided below.

2.6 Further Reading/References/Web Sources

1) Emuobo Emudainohwo, 'A Critical Analysis of the Nature and Effectiveness of a Floating Charge as a Security in Nigerian Law' *Beijing Law Review*, 2021, 12, 191-204
2) F O Onamson, *Law and Creditor Protection in Nigeria* Malthouse Press Ltd 2017
3) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).
4) Eilis Ferran and Look Chan Ho, *Principles of corporate finance law* (Oxford University Press, Oxford 2014)
5) Mathias Dewatripont And Jean Tirole, 'A Theory Of Debt And Equity: Diversity Of Securities And Manager-Shareholder Congruence' (1994) *The Quarterly Journal of Economics*

2.7 Answers to Self-Assessment Exercise

a) A charge is a security interest created by the debtor in favour of the creditor to secure the repayment of a loan. The main types of a charge are fixed charge and floating charge.

b) The concept of crystallisation refers to the process by which a floating charge becomes fixed on the assets subject to the charge upon or due to the happening of event of default. That is the charge usually floats or hovers around the charged assets until an event of default happens that causes the charge becomes fixed on the assets subject to the charge.

c) When a charge is created in writing, by a deed, such as a document under seal, it is a legal charge. An equitable charge is created where a document creating a charge is not under seal, or where in the absence of a formal written document, the title documents of the company's property are held by the creditor as proof of borrowing.

d) The disadvantages of a floating charge to debtor are:
   (i) Higher interests indicate that it may be more expensive to borrow money via a floating charge.
   (ii) Upon happening of agreed event, the creditor may intervene in the business by appointing a receiver / administrator.

MODULE 2 PROTECTION OF CREDITORS

Unit 3: Registration of Charges

4.3.1 Introduction

This Unit examines the effects and process of registration of charges. You will see that the need to create a charge is as important as the registration of the charge. Failure to register a charge can have devastating consequences on the creditor. In fact, failure to register a charge timeously can have negative consequences on the creditor, thus, time is of the utmost essence in relation to the validity of a charge.

4.3.2 Learning Outcome

4.3.3 Registration of Charges

CAMA ss 215-217, s 222

Non-possessory security interests created by companies, such as charges are required to be registered in the register of company charges. There are several reasons for this requirement. One of the main reasons for the requirement is that it publicises security interests that have been created over assets or properties, so that third parties would have notice of such interests. Otherwise, it would not be obvious to third parties and multiple security interests on a particular asset will create chaos. This is the reason that non-possessory security interests are required to be registered since they cannot be possessed and secured by the creditor during the pendency of the loan agreement.

Every charge created by a company, shall, so far as any security on the company's property or undertaking is conferred, be void against the liquidator and any creditor of the company, unless the charge together with the instrument, by which the charge is

created or evidenced, have been or are delivered to or received by the CAC for registration within 90 days after the date of its creation.

Under CAMA 2020, s 223, for a charge to be registered with the Corporate Affairs Commission CAC, the following particulars should be provided. The required particulars include –

1) if the charge is a charge created by the company, the date of its creation, and if the charge was a charge existing on property acquired by the company, the date of its creation and the date of the acquisition of the property.
2) the amount secured by the charge
3) short particulars of the property
4) the persons entitled to the charge, and
5) or a floating charge, a notice indicating the existence of any provisions in the charge that prohibit or restrict the company from granting any further charge ranking in priority to or *pari passu* with the floating charge.

Where a charge is registered under this Part, the Commission shall issue a registration certificate setting out the parties to the charge, the amount thereby secured, with such other particulars as the Commission may consider necessary. The certificate is *prima facie* evidence of due compliance with the requirements as to registration under this Part. (3) The register kept in pursuance of this section shall be open to inspection by any person on payment of such fees as may be prescribed by the Commission. The chargee may undertake to carry out the registration since it is in their interest to do so, since if the charge is not registered, it becomes void as far as other creditors, administrators, or liquidators are concerned. The creditor chargee will be entitled to recover from the company the amount of any fees paid by them to the Commission on the registration.

The registration certificate is conclusive evidence that the requirements of registration have been complied with, i.e., that the particulars were delivered to the CAC before the end of the 90-day period allowed for registration. A company must keep in its registered office copies of instruments creating charges, and a register of charges. These documents are open to inspection by members of the public.

3.3.1 Effects of Registration

It is imperative that charges on a company's assets are registered with the CAC for the following reasons First, failure to register a charge would make the charge void against the liquidator and any creditor of the company. Second, registration gives warning to third parties, such as future creditors of a company that the assets of the company have been used to secure a debt. Without registration, prospective creditors would not be aware that a charge exists over an asset, and the company may continue to borrow money with the same assets over and above the value of the asset. This implies that the charge holder will not receive anything from the assets of the company in the event of administration or liquidation and other creditors will be entitled to the charged asset. Further, priority of charges depends on whether and when they were registered. If a charge is created today but not registered or is registered at a later date, then another charge created later but registered first will take precedence over the first charge. Time is of the essence in relation to the registration of charges.

Once insolvency proceedings commence, the unregistered charge is void against the company in liquidation or in administration, so that the particular asset will be part of the pool of assets of the company that will be subject to insolvency proceedings. The objective of the charge will be defeated since a charge seeks to remove the asset from the list of assets of the company to be claimed by the chargee creditor. The charge will be void against the unsecured creditors, so that the unregistered chargee becomes an unsecured creditor. It is not clear what the position is regarding a purchaser of assets which are subject to an unregistered charge. Usually, such a person will take free of the charge as they are obtaining the legal interest for value without notice of the charge. However, this depends on when the purchaser acquired the asset. If the asset is acquired just before insolvency, the sale may be challenged by the administrator or receiver.

The need for registration is to enable other parties who may be affected by a security interest to find out about the registered charge easily, quickly, and cheaply without having to rely on the honesty of the company that has granted the interest. The implication that registration is notice to all the world, would appear to lead to unreasonable and undesirable results. This still leaves open, however, the question

of who would reasonably be expected to search the register. However, in view of the need to register a charge, any prospective purchaser of an asset should be cautious to search the register of charges to satisfy themselves that the asset is free from encumbrances. This is not too much of a burden to bear, compared with the challenges that comes with purchasing a charged asset.

3.3.2 Priorities

CAMA 2020, ss 204, 207, 657

Registration of charges protects the creditor in various ways. Apart from ensuring that the charge created by the company is valid, it has other immense benefits. First, if a company uses the same asset to secure more than one loan, i.e., if an asset is the subject of more than one fixed or floating charge, priority over the asset will be determined by the time of registration.

Also, someone may acquire a property either with or without knowledge of the existing charge. Such person will not be deemed to have obtained value without notice, if the charge was registered before the sale was completed. Further, fixed charges have priority over other preferential debt or floating charge in a company, provided that they are registered. Non-registration within the stipulated time would imply that the charge is void and to no effect against an administrator or other creditors.

SELF-ASSESSMENT EXERCISES

a) Outline the particulars to be provided before a charge (other than debenture holders) can be registered in Nigeria.
b) State one of the ways that registration of a charge protects a creditor.
c) What is the effect of a registrable but unregistered charge?

4.3.4 Summary This Unit provides an analysis of the effects of the registration of charges. The effects of registration on the rights of the creditor and the debtor company were briefly outlined. It was shown that lack of registration makes the charge void against the

administrator and other creditors, thus releasing the charged asset into the pool of assets that will be determined by insolvency rules of distribution. The Unit does not contain an analysis of the entire scope of registration of charges; further reading is required.

4.3.5 Further Reading List

1) Emuobo Emudainohwo, 'A Critical Analysis of the Nature and Effectiveness of a Floating Charge as a Security in Nigerian Law' *Beijing Law Review,* 2021, 12, 191-204
2) F O Onamson, *Law and Creditor Protection in Nigeria* Malthouse Press Ltd 2017
3) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).
4) Eilis Ferran and Look Chan Ho, *Principles of corporate finance law* (Oxford University Press, Oxford 2014)
5) Mathias Dewatripont And Jean Tirole, 'A Theory Of Debt And Equity: Diversity Of Securities And Manager

4.3.6 Answers to Self-Assessment Exercise

a) The particulars are:
   (i) if the charge is a charge created by the company, the date of its creation, and if the charge was a charge existing on property acquired by the company, the date of its creation and the date of the acquisition of the property.
   (ii) the amount secured by the charge
   (iii) short particulars of the property
   (iv) the persons entitled to the charge, and
   (v) or a floating charge, a notice indicating the existence of any provisions in the charge that prohibit or restrict the company from granting any further charge ranking in priority to or *pari passu* with the floating charge.

b) It validates the charge and helps in the determination of priority.

c) The effect of a registrable but unregistered charge is that it is void against the company in liquidation or in administration, so that the particular asset will be part of the pool of assets of the company that will be subject to insolvency proceedings.

MODULE 3 TRADING IN SECURITIES – MARKET ABUSE

Unit 1: False Trading and Market Rigging Transactions

1.1 Introduction

The concept of market abuse is quite extensive; it occurs in many forms. It occurs when a person with access to non-public information about a company, uses the information to obtain an economic advantage by obtaining profit for themselves or for their proxy in the financial market. Other ways that market abuse can occur in the financial market include the following- distorting the price of securities, disseminate false or misleading information about a company's financial position, among other ways. These can influence the price of shares in the financial markets and create false or misleading markets. Market abuse can undermine the entire financial system, by creating uncertainty and undermining investors' confidence. Thus, it is imperative that the financial market is regulated to prevent false markets in the trading of securities. As indicated above, there are several ways that false markets can be created in the trading of securities. This Unit will briefly explain false trading and market rigging transactions and the regulatory control over this type of market abuse.

1.2 Learning Outcome

By the end of the unit, you should be able to explain the scope of false trading and market rigging transactions within the context of Investments and Securities Act 2007

1.3 False trading and market rigging transactions.

False trading and market rigging as the names suggest, refer to any act done by any person or persons acting in concert that seeks to mislead security traders and create misleading impressions about the price of securities. There are several ways that false markets and market rigging can occur. They range from fictitious transactions that falsely inflate or depress the price of securities or purportedly buying or selling securities without a change in the beneficial ownership of the traded securities.

The *Investments and Securities Act* 2007, (ISA 2007) s 105 provides thus,

1) *A person shall not create, or cause to be created, or do anything which may create a false or misleading appearance — (a) of active trading in any securities on a securities exchange or capital trade point; or (b) with respect to the market for the price of any such securities.*
2) *A person shall not- (a) by means of purchase or sale of any securities that do not involve a change in the beneficial ownership of those securities; or (b) by any fictitious transactions or devices, maintain, inflate, depress, or cause fluctuations in the market price of any securities.*
3) *Without prejudice to the generality of subsection (1) of this section, a person who- (a) effects, participates in, is concerned with or carries out, either directly or indirectly, any transaction, sale or purchase of any securities, being a transaction, sale or purchase which does not involve any change in the beneficial ownership of the securities; or (b) makes or causes to be made an offer to sell any securities at a specified price where he has made or caused to be made or proposed to make or cause to be made, or knows that a person associated with him has made or caused to be made, an offer to purchase the same number, or substantially the same number of securities at a price which is substantially the same as the first mentioned price; or (c) makes or causes to be made an offer to purchase any securities at a specified price where he has made or caused to be made or proposes to make or cause to be made, or knows that a person associated with him has made or caused to be made or proposes to make or cause to be made, an offer to sell the same number of securities at a price which is substantially the same as the first-mentioned price, shall be deemed to have created a false or misleading appearance of active trading in securities on a securities exchange or capital trade point.*
4) *For an act referred to in subsection (3) of this section, it is a defence if a person establishes that the purpose or purposes for which he did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in securities on a securities exchange or capital trade point.*

The above outlined acts that describe false trading and market rigging transactions are not conclusive. Note the wording of the first line of subsection (1) of s 105 above '*A person shall not create, or cause to be created,* ***or do anything*** *which may create a false or misleading appearance.* Emphasis on 'do anything' draws our attention to the fact that, first, it is impossible to outline every act that could currently possibly be considered as false trading and market rigging. Thus, any act that is not listed above that has the resemblance or characteristics of false market will fall under this section. Also, any future behaviours or acts that are exhibited after the enactment of this Act, that exhibit similar characteristics with those acts listed above and particularly seek to achieve the objectives of false trading and market rigging transactions would fall under this section. Thus, the scope of the Act is far reaching and futuristic.

1.4 Summary

False trading and market rigging are prominent ways that market abuse can be exhibited. As indicated above, it is impossible to outline every possible act or conduct that is considered to be market abuse or that would occur in future as market abuse. The focus is not the act *per se*, but the objective that the act seeks to achieve. Thus, any act that is aimed at promoting false trading and market rigging will be considered to be classified under this section.

1.5 References/Further Readings/Web Sources

1) Okubor Cecil Nwachukwu (2021) Top core elements of the insider trading and market manipulation offences in Nigeria and South Africa (2021) Commonwealth Law Bulletin, 47:4, 719-740
2) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).

MODULE 3 TRADING IN SECURITIES – MARKET ABUSE

Unit 2: Market manipulation and false or misleading statements

2.1 Introduction

In Unit 1, market abuse was briefly explained. Further, false trading and market rigging were explained as an aspect of market abuse. This Unit will continue with further analysis of other types of market abuse, namely, market manipulation and false or misleading statements. Market manipulation and false or misleading statements are another set of prominent ways that market abuse can be exhibited. The regulatory control of these set of market abuse will also be outlined.

2.2 Learning Outcome

2.3 Securities market manipulation and false or misleading statements

As the names imply, securities market manipulation and false or misleading statements are not based on a single set of conducts or acts; they apply similarly as false trading and market rigging, because, they can be detected not merely by act(s) or conduct, but by the objective that the acts seek to achieve. Market manipulation involves any action that seeks to cause an artificial movement in the price of securities, with the objective of obtaining an economic advantage, such as making a profit or avoiding a loss. An example of market manipulation is where a person purports to trade in securities- artificial trade, but the objective of the trade is to move up the price of securities, in order to profit from the price of the security. This type of transactions gives false impression as to the market supply or demand or price of a security to secure/set the price of an investment at an artificial level.

The ISA, 2007, s 106 provides,

> *106 (1) A person shall not effect, take part in, be concerned with or carry out, either directly or indirectly, two or more transactions in securities of a body corporate being transactions which have, or are likely to have the effect of raising or lowering the price of securities of the body corporate on a securities exchange or capital trade point with intent to induce other persons to purchase, sell or subscribe for securities of the body corporate or of a related body corporate.*
>
> *(2) A person shall not effect, take part in, be concerned with or carry out, either directly or indirectly, two or more transactions in securities of a body corporate, being transactions which have or are likely to have the effect of maintaining or stabilizing the price of securities of the body corporate on a securities exchange or capital trade point with intent to induce other persons to sell, purchase or subscribe for securities of the body corporate or of a related body corporate.*
>
> *(3) A reference in this section to a transaction in relation to securities of a body corporate include: (a) a reference to the making of an offer to subscribe, sell or purchase such securities of the body corporate; and (b) a reference to the making of an invitation however made which expressly or impliedly invites a person to offer to subscribe, sell or purchase such securities of the body corporate.*
>
> *(4) No securities of a public company listed on any recognized securities exchange shall be bought or sold outside the facilities of a recognized exchange on which the securities are listed. (5) Any person who contravenes the provisions of subsection (4) above shall be liable to a penalty of N500,000 in addition to a nullification of the said transaction.*

False or misleading statements are closely linked with market manipulation; they are aspects of market abuse. This simply refers to false information published or released by any person with the aim of misleading investors to deal in securities – sell or purchase or generally influence the price of securities.

The ISA 2007, s 107 provides,

> *No person shall knowingly, recklessly or negligently make a statement, or disseminate information, which is false or misleading in any material particular and likely to induce the sale or purchase of the securities by other persons or likely to have the effect of raising, lowering, maintaining or establishing the market price of securities.*

Section 107 outlines the scope of false information that would be considered to be market abuse. The provision has some underlying implications. First, the applicable statements are not limited to false or misleading information made knowingly by the maker. The scope extends to false and misleading information made 'recklessly or negligently' by a person that are liable to induce trading. Irrespective of the actual knowledge of the person that makes the statement, if the statement is discovered to be false and misleading and it induces trading, the maker will be in breach of this section. It is not clear whether innocent statement will exculpate the maker from liability. Thus, it is imperative that caution should be greatly exercised before releasing or publishing statements relating to company securities that are price sensitive. Second, it is not clear whether personal economic benefits will be considered in the determination of the liability of the maker of such statements. From the wording of the provision, it appears that personal economic benefits in the rise and fall of securities is the intention of the legislation. However, the scope of the provision can arguably be extended to include instances where the misleading statements were merely made, without the need to consider whether the maker of the statement or connected persons obtained any economic benefits, since the economic benefits may be difficult to prove.

SELF-ASSESSMENT EXERCISE

a) Is there any relationship between misleading statements and market manipulation?
b) Bring out two underlying implications of section 107 Investments and Securities Act 2007 with reference to false statements.
c) What is the principal motive of market manipulation?

2.4 Summary

In this Unit, market manipulation and false or misleading statements were briefly explained as part of the analysis of market abuse. Although a brief explanation of market manipulation and false or misleading statements were presented, the essential and underlying meaning of these types of market abuse were highlighted. The relevant provisions of the *Investments and Securities Act*, 2007 were also outlined. There is scope for further reading of relevant book chapters and journal articles on the subject, to enhance the scope of your knowledge.

2.5 Further Reading List

1) Okubor Cecil Nwachukwu (2021) Top core elements of the insider trading and market manipulation offences in Nigeria and South Africa (2021) Commonwealth Law Bulletin, 47:4, 719-740
2) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).
3) John Armour et al, *Principles of Financial Regulation* OUP Oxford 2016

2.6 Answers to Self-Assessment Exercise

a) False or misleading statements refers to false information published or released by any person with the aim of misleading investors to deal in securities – sell or purchase or generally influence the price of securities. There is an inexorable relationship between misleading statements and market manipulation to the extent that both of them constitute aspects of market abuse.

b) Two implications of section 107 ISA 2007 are:
   (i) The applicable statements are not limited to false or misleading information made knowingly by the maker.
   (ii) It is not clear whether personal economic benefits will be considered in the determination of the liability of the maker of such statements

c) Market manipulation involves any action that seeks to cause an artificial movement in the price of securities, with the objective of obtaining an economic advantage, such as making a profit or avoiding a loss

MODULE 3 TRADING IN SECURITIES – MARKET ABUSE

Unit 3: Fraudulently inducing persons to deal in securities

3.1 Introduction

The regulation of securities trading in Nigeria is quite extensive. The regulation does not merely apply to conducts that are generally considered to be market abuse; it applies to specific types of market abuse. In Units 1 and 2 above, we examined some of the prominent types of market abuse. This Unit will continue with the analysis of a specific type of market abuse that could undermine the integrity of the Nigerian financial market, namely - fraudulently inducing persons to deal in securities.

3.2 Learning Outcome

By the end of the unit, you should be able to explain the various ways one can be a victim of fraudulent inducement to deal in securities.

3.3 Fraudulently inducing persons to deal in securities

As the name implies, fraudulently inducing persons to deal in security is a fraudulent conduct that is not usually carried out innocently, but deliberately. To fraudulently induce means that the persons that is carrying out the fraudulent act not only intend to defraud, but it also suggests that they intend to obtain certain economic benefit or advantage from the persons to whom the fraudulent acts are directed. The fraudulent acts include but are not limited to the publication of false or misleading information in such a manner that is calculated to induce people to deal in securities. Such statements are published in a way that they would be relied on by a person to deal in securities. The act could also be deliberately withholding information that is relevant. Such information would have helped the relevant person to make informed decision whether they should purchase company securities or not. Deliberately withholding the information from the prospective

investor would undermine the capacity of the investor to make a well-considered investment decision.

See ISA 2007, s 108

> *108 (1) No person shall- (a) make or publish any statement, promise or forecast which he knows to be misleading, false or deceptive; or (b) dishonestly conceals material facts; (c) recklessly make or publish, dishonestly or otherwise of any statement, promise or forecast which is misleading, false or deceptive; or (d) record or store in, or by means of any mechanical, electronic or other device, create information which he knows to be false or misleading in a material particular with intent to induce or attempt to induce another person to deal in securities; (e) make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading.*
>
> *(2) It is a defence to any liability under subsection (1) of this section if it is established that, at the time when the person so recorded or stored the information, he had no reasonable grounds for expecting that the information would be available to any other person.*

From the relevant provision above, apart from publishing false information and dishonestly concealing material information, it can be observed that the act of providing fraudulent misinformation extends to recording or storing misleading information by mechanical or electronic means in a platform that would likely be accessed by persons who are likely to rely on the misleading information to trade. As observed earlier, the fraudulent act of misinformation does not require the need to further prove or show that the person doing the act benefited financially before they can be held liable. The mere act of acting fraudulently would suffice to indict such person.

SELF-ASSESSMENT EXERCISE

a) Explain the ramifications of 'fraudulently inducing persons to deal in securities' in relation to section 108 ISA 2007

3.4 Summary

This Unit highlighted the components of fraudulently inducing persons to deal in securities as an aspect of market abuse. Providing false or misleading information is a prominent aspect of market abuse, since the person that published the misleading information seeks to influence the role of the financial market in the determination of the price of securities and the volume of trade. The various ways that a person can fraudulently induce others to deal in securities are outlined in section 108 of the Act. This makes it abundantly clear, and it removes any doubt as to the scope of the incriminating conduct.

3.5 Further Reading List

1) Okubor Cecil Nwachukwu (2021) Top core elements of the insider trading and market manipulation offences in Nigeria and South Africa (2021) Commonwealth Law Bulletin, 47:4, 719-740
2) Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policies* 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020)
3) John Armour et al, *Principles of Financial Regulation* OUP Oxford 2016

3.6 Answers to Self-Assessment Exercise

Apart from publishing false information and dishonestly concealing material information, the ramifications of the phrase extend to mean the act of providing fraudulent misinformation extends to recording or storing misleading information by mechanical or electronic means in a platform that would likely be accessed by persons who are likely to rely on the misleading information to trade.

MODULE 3 TRADING IN SECURITIES – MARKET ABUSE

Unit 4: Other Types of Market Abuse

4.1 Introduction

In Units 1-3 above, we examined various types of market abuse – ways that the integrity of the capital market can be undermined. These include false trading and market rigging transactions, securities market manipulation, false or misleading statements and fraudulently inducing persons to deal in securities. The specific ways that these offences may be committed were outlined, with the aid of the relevant provisions of the *Investments and Securities Act*, 2007. In this Unit, other types of market abuse will be examined. These are equally serious types of market abuse that attract criminal liability just like those examined in Units 1-3 above. They include - dissemination of illegal information, prohibition of fraudulent means, prohibition of dealing in securities by insiders and abuse of information obtained in official capacity. Finally, the scope of criminal liability for market abuse will also be briefly outlined. This Unit will conclude the analysis of the module on market abuse in the trading of company securities.

4.2 Learning Outcome

By the end of the unit, you should be able to identify and explain the relevant provisions of Investments and Securities Act 2007 in respect of various types of market abuse.

4.3 Other Types of Market Abuse

4.3.1 Dissemination of illegal information

The market thrives on the basis of accurate and timely information. A market where prices fully reflect all available information is an efficient market. The efficient capital market hypothesis EMH suggests that the prices of shares are determined by reference to the information about a company as they become available. This implies that the prices of shares are not generally determined by individual awareness or level of skills in the capital market. When uninformed investors buy diversified portfolio, based on the prices given by the market, they are expected to obtain a rate of return as generous as those purchased by experts. Prices of stocks fully reflect all current available information about a company. As long as a transaction is based on information that is widely available to the public, it is an efficient capital market transaction.

Thus, the following principles apply in relation to efficient markets. First, the market price of shares represents the market's consensus as to the valuation of that security. Second, public information about the economy, financial markets, and the results and prospects of the individual company are widely available to investors. Third, no individual can dominate the market or influence the price of shares. These imply that, while relevant information is a pre-requisite for efficiency, the test for efficiency in an efficient market is the acquisition of share and trading generally at prices that are not only justifiable, but also lead to efficient outcomes irrespective of the purpose for which the shares are acquired. In furtherance of the assumption of the EMH, corporate entities are required to disclose information on a regular basis and transactions relating to the purchase of company shares are regulated to ensure that published information about a company dictate the operation of the market, in such a way that prices of shares are not determined by individual investors. Thus, since the market and investors rely on information to make decisions, it is imperative that information is not only published regularly, but information must also be accurate; they must represent the true and fair view of the relevant companies that publish the information. This means that publishing misleading, inaccurate or illegal information can mislead investors and distort the

market. This is a type of market abuse that undermines the efficiency of the capital market.

The ISA, 2007 s 109 provides thus –

> *A person shall not circulate or disseminate, or authorise or be concerned in the circulation or dissemination of any statement or illegal information to the effect that the price of any securities of a body corporate will or is likely to rise or fall or be maintained by reason of any transaction entered into or other act or thing done in relation to securities of that body corporate, or of a body corporate which is related to that body corporate if —*
>
> *(a) the person or a person associated with that person has entered into any such transaction or done any such act or thing; or*
>
> *(b) the person has received or expects to receive directly or indirectly any consideration or benefit for circulating or disseminating or authorising or being concerned in the circulation or dissemination of the statement or information.*

The section does not state whether an innocent dissemination of illegal information will be without consequences. Usually the person(s) that published the statement would intend the statement to affect the price of securities when acted upon by investors, with the intention of receiving a benefit from someone else that entered a transaction or had done something in relation to the securities of the relevant company. Essentially, the aim of such publication is to influence the price of shares, directly or indirectly. The publisher of such statement and persons acting in concert with them will be held liable for engaging in market abuse.

4.3.2 Prohibition of Fraudulent Means

Another way that market abuse can occur is by engaging in transactions in ways that are fraudulent. Any transaction for the sale or purchase of securities that is deceitful and manipulative in such a way that the innocent party may not have engaged in the transaction, but for the fraudulent act of another, would be deemed to be in breach of this provision.

The ISA, s 110 provides –

No person shall directly or indirectly in connection with the purchase or sale of any securities to

(a) employ any device, scheme or artifice to defraud; or

(b) engage in any act, practice or course of business which operate or would operate as a fraud or deceit upon any person.

This provision is quite straightforward. It seeks to prevent the sale or acquisition of company securities by any means that deceives the innocent purchaser or seller of the securities. The person or persons acting alone or in concert directly or indirectly in connection with such deceitful purchase would be engaging in market abuse and would be liable under this section of the ISA.

4.3.3 Insider Trading and Abuse of Information Obtained in Official Capacity

1) Insider Trading.

Insider trading is the purchasing or selling of publicly traded company's securities while in possession of material information that is not yet made public. It occurs when a person trades in securities on the basis of information that the person obtains from the company before the information becomes available to the public. Such information is usually referred to as material information because it may result in a substantial impact on the decision of an investor regarding whether to buy or sell securities.

Usually, companies are required to regularly publish financial and non-financial information, so that the market will be informed, and investors will have access to the same information and they can make decisions on the basis of equal access to the same information. This ensures that every investor has access to the same information at every given time. Where information about a company has not been published, if a person or persons acting in concert have access to the information, they can trade – buy or sell securities on the strength of the information, this is trading on the basis of insider information. It puts these persons in an advantageous position over other investors that do not have access to the information. It undermines market integrity since it does not promote equality in terms of access to information. For example, if an

executive director becomes aware that the company is undergoing financial challenges, if s/he trades or informs someone so that that person can trade in the securities of the company to make a gain or to avoid a loss, this will be regarded as insider dealing. Thus, buying or selling of securities either by corporate or private insiders, with the aid of information that is non-public information to their own selfish advantage, either to amass huge returns or to prevent large losses is insider dealing/trading.

Usually, insider trading occurs owing to the compromising of company executives as well as company employees, together with the bankers of the company and its auditors, shareholders, financial advisers, brokers and a host of other related parties. The parties usually have access to information of their companies before the information is published. Hence these parties are capable of engaging in insider dealing by virtue of their position or proximity with the company. Their spouses, children, relatives, and close friends can also be classified as persons that may likely be involved in insider dealing.

The Nigerian Stock Exchange Rulebook, r 17(3) defines "inside information" as information related to an issuer of a security or the issuer's securities, either directly or indirectly, which has not been published and whose disclosure may have a significant effect on the price of securities and stocks so listed and traded or derivative instruments which are linked to those securities.

The ISA s. 111

> *(1) Subject to section 104 of this Act, a person who is an insider of a company shall not buy or sell, or otherwise deal in the securities of the company which are offered to the public for sale or subscription if he has information which he knows is unpublished price sensitive information in relation to those securities*
>
> *(2) The provisions of subsection (1) of this section applies where — (a) a person has information which he knowingly obtains (directly or indirectly) from another person who- (i) is connected with a particular company, or was at any time within the six months preceding the obtaining of the*

information, so connected, (ii) the former person knows about, or has reasonable cause to know that the latter individual holds, the information by virtue of being so connected; and (b) the former person knows or has reasonable cause to believe that, because of the latter's connection and position, it would be reasonable to expect him not to disclose the information except for the proper performance of the functions attached to that position.

(3) The former person mentioned in subsection (2) of this section- (a) shall not himself deal in securities of that company if he knows that the information is unpublished price sensitive information in relation to those securities; and (b) shall not himself deal in securities of any other company if he knows that the information is unpublished price sensitive information in relation to those securities and it relates to any transaction (actual or contemplated) involving the first company and the other company, or involving one of them and securities of the other, or to the fact that any such transaction is no longer contemplated.

(4) Where a person is contemplating or has contemplated making (with or without another person) a take-over offer for a company in a particular capacity, that person shall not deal in securities of that company in another capacity if he knows that the offer is contemplated or is no longer contemplated and the offer is unpublished price sensitive information in relation to those securities.

(5) Where a person has knowingly obtained (directly or indirectly) from an individual to whom subsection (4) of this section applies, information that the offer referred to in that subsection is being contemplated or is no longer contemplated, the former person shall not himself deal in securities of that company if he knows that the information is unpublished price sensitive information in relation to those securities

(6) A person who is for the time being prohibited by the provisions of this section from dealing on an approved securities exchange or capital trade

point in any securities shall not counsel or procure any other person to deal in those securities, knowing or having reasonable cause to believe that that person would deal in those securities.

The provision of s 111 of the Act clearly indicates that insider trading is a serious offence, because it distorts the free functioning of the capital market. Several countries prohibit insider dealing to ensure that local and foreign investors have confidence in the integrity of the stock market.

2) Abuse of Information Obtained in Official Capacity

Abuse of information in official capacity refers to the use privileged information for the wrong reasons. Any act that amounts to misuse of information by any person in their official capacity, or information obtained in their former role as an official of a company, would be classified as abuse of information obtained in official capacity. The person may be in official capacity, or they may have resigned. As long as the information was obtained by virtue of their position, it is privileged information. Such information must not be used in a manner that contravenes this provision. There are various ways that such privileged information can be abused. This includes trading in securities with the information, passing the information to others to trade, or acting in any other way that enhances their advantage in dealing with securities.

The ISA s 112

(1) This section applies to any information which- (a) is held by a public officer or former public officer by virtue of his position or former position as a public officer, or is knowingly obtained by a person (directly or indirectly) from a public officer or former public officer who he knows or has reasonable cause to believe held the information by virtue of any such position; (b) it is reasonable to expect a person in the position of a public officer or former position of a public officer not to disclose except for the proper performance of the functions attaching to that position; and (c) the person holding it knows it is unpublished price sensitive information in

relation to securities of a particular company (hereinafter referred to as "relevant securities").

(2) This section applies to a public officer holding information to which this section applies and to a person who knowingly obtained any such information (directly or indirectly) from a public officer or former public officer who that person knows or has reasonable cause to believe held the information by virtue of his position or former position as a public officer.

(3) Subject to section 113 of this Act a person to whom this section applies shall not- (a) deal in any relevant securities; (b) counsel or procure any other person to deal in any such securities, knowingly or having reasonable cause to believe that other person, would deal in those securities; or (c) communicate to any other person the information held or (as the case may be) obtained as mentioned in subsection (2) of this section if he knows or has reasonable cause to believe that he or some other person shall make use of the information for the purpose of dealing or of counselling or procuring any other person to deal on a securities exchange or capital trade point in any such securities.

(4) If it appears to the Commission that the members, officers or employees of or persons otherwise connected with any body by appearing to it to exercise public functions may have access to unpublished price sensitive information relating to securities, the Commission may declare that those persons are public officers for the purposes of this section.

This type of market abuse is similar to insider trading. It applies to extend the scope of misuse of privileged information, so that a person would be held liable, even if they do not trade on the basis of the information but acted in any way that abuses the privileged information that they had obtained.

4.3.4 Criminal Liability for Market Abuse

The criminalisation of market abuse clearly indicates the extent to which it is considered serious. Several countries have outlawed market abuse to promote the

integrity of their stock markets, and to ensure that investors' confidence in the integrity of stock markets are not only maintained but promoted. For example, in the UK, the *Criminal Justice Act 1993* prohibits acts of market abuse, especially insider trading. In the United States of America, SEC Rule 10b-5 prohibits corporate officers and directors or other relevant employees with potential insider information from using confidential corporate information to obtain a profit or avoid a loss, by trading in the company's stock.

Similarly in Nigeria, market abuse is generally prohibited as a criminal offence. A person found guilty of contravening the relevant provision(s) relating to market abuse may be fined or imprisoned. A fine of about 500,000 – 1 million naira may be imposed, depending on whether the offender is an individual or a corporate entity.

See *ISA 2 115 and 116*

> *115 Any person who contravenes any of the provisions of this part of this Act commits an offence and is liable on conviction — (a) in the case of a person not being a body corporate, to- (i) a fine of not less than x500,000 or an amount equivalent to double the amount of profit derived by him or loss averted by the use of the information obtained in contravention of any of the provisions of this part; or (ii) to imprisonment for a term not exceeding seven years; or (b) in the case of a person being a body corporate, to a fine not less than x1,000,000 or an amount equivalent to twice the amount of profit derived by it or loss averted by the use of the information obtained in contravention of any of the provisions of this part. Criminal liability under this Part.*
>
> *116 (1) A person who is liable under this part of this Act shall pay compensation at the order of the Commission or the Tribunal, as the case may be, to any aggrieved person who, in a transaction for the purchase or sale of securities entered into with the first-mentioned person or with a person acting for or on his behalf, suffers a loss by reason of the difference between the price at which the securities would have likely been dealt in such a transaction at the time when the first-mentioned transaction took place if the contravention had not occurred.*

4.4 Summary

This Unit examined other types of market abuse, namely, dissemination of illegal information, prohibition of fraudulent means, prohibition of dealing in securities by insiders and abuse of information obtained in official capacity. The scope of criminal liability for market abuse was also outlined. In addition to the analysis in Units 1-3, this Unit further indicates that market abuse has an extensive scope. It would be impossible to provide detailed notes on all acts that constitutes market abuse, thus, the main aspects of the acts that constitutes market abuse were outlined, with the aid of relevant statutory provisions. This Unit concludes the analyses of the module on market abuse.

4.5 References/Further Reading/Web Sources

1) Okubor Cecil Nwachukwu (2021) Top core elements of the insider trading and market manipulation offences in Nigeria and South Africa (2021) Commonwealth Law Bulletin, 47:4, 719-740
2) Veronica Ekundayo, Amurawaiye Adeoye and Olalekan Moyosore Lalude, 'Insider Trading under the Nigerian Legal Framework' (2020) 31(6) ICCLR, Available at SSRN: https://ssrn.com/abstract=3942075
3) Louise Gullifer and Jennifer Payne, Corporate Finance Law: Principles and Policies 3rd Edition (Hart Publishing Bloomsbury Publishing Plc Oxford, 2020).
4) John Armour et al, *Principles of Financial Regulation* OUP Oxford 2016

MODULE 4 INTERNAL CONTROL AND AUDIT FUNCTIONS

Unit 1: Internal Control

1.1 Introduction

Companies are exposed to risks as a result of their relationships with third parties and the impact of other economic factors on their operations and activities. The risks that companies are exposed to can undermine the stability of an entity and threaten its continuous existence. Companies that are set up to do business cannot avoid risk, rather companies develop effective measures to withstand and absorb risks. The boards and managements are expected to design a risk management system to ensure that effective internal control system is in place to prevent risks from causing a total failure of the company. This Unit will examine internal control measures that can be established to address various risks that companies can potentially be exposed to. Some internal control risks will also be examined as part of the analysis of internal control measures.

1.2 Learning Outcome

By the end of the unit, you should be able to explain the various risks attending to an entity and the various measures which can be deployed to address them.

1.3 Internal Control Systems and Risks

An internal control system is a system that has been established by an organisation or institution to identify internal control risks that can cause losses or undermine the effectiveness of the organisation. The control measures are designed to withstand risks that may arise in an organisation. For example, these measures help to secure the assets of a company, namely money, plant, equipment, and other assets. They can also help to

provide safeguards against fraud, promote compliance with regulations, e.g., safety regulations, promote the accuracy and competency of accounting records and financial information, among other things.

There are different categories of risks that may occur in an organisation. To ensure that these risks do not undermine the operations and integrity of an organisation or threaten the continuous existence of an organisation, certain internal control measures must be established. Internal control risks include the following.

1.3.1 Financial Risks

Financial risks are risks that may occur because of errors or fraud in the accounting system of an organisation. This may also include incorrect financial statements and failure to properly record assets of the organisation. Lack of effective internal control system can increase the likelihood of financial risks. A greater exposure to financial risks may lead to the demise of a company. Examples of financial risks include failure to record/collect moneys that are owed by a customer, failure to record transactions in the company's books and deliberate or careless misstatement of the company's financial statements, including the income statement.

Financial control measures to deal with financial risks – to address the challenges caused by financial risks, financial control measures are designed. These include accounting controls that are specifically designed to provide reasonable assurances that transactions are recorded accurately, and transactions are only made in accordance with management's authorisations. Others are, systems that ensure that financial statements are prepared in accordance with acceptable accounting standards and principles, actual assets of the organisation are regularly compared with accounting records to ensure that they are accurately recorded and quick. Lastly, other measure includes, ensuring that an appropriate system is in place to take action if discrepancies are discovered, among other things. These are some of the financial control measures that can be established to deal with problems of financial risks.

1.3.2 Compliance Risks

The risk of non-compliance with a regulation can be devastating for an organisation. Failure to comply with certain regulations can lead to an imposition of fines by the regulatory agency. In extreme cases, it can lead to the withdrawal of operational license. When this occurs, the organisation will not be able to continue its operations until the revoked license is re-issued. This could cause serious financial loss to the company. It could also cause reputational damage, since it will indicate to customers or potential investors that the organisation is irresponsible as a corporate citizen or stakeholder in the country where they operate.

Compliance Control - Measures that are designed to ensure that an organisation complies with all relevant regulatory measures are compliance control systems. These will be created in accordance with the particular nature of an organisation and the industry where it operates. For example, mining companies and banks/financial institutions, have different regulatory measures, apart from the general regulations that apply when a company is incorporated. These measures ensure that an organisation avoids the risks associated with non-compliance with regulations.

1.3.3 Operational Risks

Operational risk is the risk of losses resulting from inadequate or failed internal processes, people and systems or external events. The risk of breakdown in the system of a company because of software failure or problems, machine failures, building hazards such as health and safety problems, e.g., malfunction of the lifts in a 10-storey building, among other things. These problems will affect the day-to-day operations of a company and ultimately undermine productivity and income. Measures that are established to prevent these types of risks are specifically targeted at any kind of potential challenge that may affect people or systems in an organisation.

Operational Controls – These are measures that help to reduce the operational risks examined above. They can also quickly identify operation failures as soon as they occur, so that the problems can be addressed immediately without impacting the operation of the organisation. For example, lifts can be tested daily to ensure that

they remain operational for staff and visitors. Fire alarms can also be tested regularly. In relation to other aspects of operational risks that may ground the operation of an organisation, the following can be made a prominent feature of operation control system – regular training of staff, regular equipment maintenance and automation of standard procedure, among others.

SELF-ASSESSMENT EXERCISE

a) Explain the meaning of internal control.
b) List the types of internal control risks that an organisation may be exposed to.
c) How does insider trading occur as to constitute it an offence?
d) What is the legal consequence of engaging in market abuse?

1.4 Summary

This Unit introduced internal control measures that can be designed to address the challenges caused by exposure to various types of risks that an organisation may be exposed to. Financial risks, operational risks and compliance risks were examined. Also, the various internal control measures that may be designed to respond to, prevent or limit the extent to which these risks may affect an organisation were also briefly examined. The analysis in this Unit does not represent an exhaustive examination of internal control systems and risks. You are required to engage in further reading. It is beyond the scope of this module to examine every type of internal control risk in detail. The module will only examine financial risk; the essential aspect of financial control will be examined in the remaining Units 2, 3 and 4 of the module.

1.5 References/Further Reading/Web Sources

1) Bob Tricker, *Corporate Governance: Principles, Policies and Practices* OUP 2019
2) Brian Cole, *Corporate Governance ICSA Study Text*, ICSA Publishing Ltd Saffron House London 2015

1.6 Answers to Self-Assessment Exercise

a) An internal control system is a system that has been established by an organisation or institution to identify internal control risks that can cause losses or undermine the effectiveness of the organisation.

b) The risks an organisation may be faced include:

   (i) Financial risk

   (ii) Operational risk

   (iii)Compliance risk

c) Insider trading occurs when a person trades in securities on the basis of information that the person obtains from the company before the information becomes available to the public.

d) The legal consequence of engaging in market abuse is that a person found guilty of contravening the relevant provision(s) relating to market abuse may be fined or imprisoned. A fine of about 500,000 – 1 million naira may be imposed, depending on whether the offender is an individual or a corporate entity.

MODULE 4 INTERNAL CONTROL AND AUDIT FUNCTIONS

Unit 2: Internal Audit

2.1 Introduction

In Unit 1 above, internal control system was examined. As part of the analysis, the types of internal control risks that an organisation may be exposed to were outlined. These include operational risks, compliance risks and financial risks. This Unit will take the analysis further, to examine ways that potential risks may be addressed in anticipation. It is beyond the scope of this module to examine every type of internal control risks in detail. The module will only examine financial control system that may be established to address the problems caused by financial risks. These are internal audit, external audit, and the role of the audit commit of the board. This Unit will examine internal audit functions.

2.2 Learning Outcome

By the end of the unit, you should be able to appreciate and explain the roles of an interna audit department in an organisation.

2.3 Internal Audit Function

The Chartered Institute of Management Accountants CIMA defines internal audit as an independent appraisal activity established within an organisation as a service to it. It is a control, which functions by examining and evaluating the adequacy and effectiveness of other controls. The aim of internal audit function is to assist members of the organisation in the effective discharge of their responsibilities. Internal audit provides an organisation with relevant information such as analyses, appraisals, recommendations, counsel, and information concerning the activities that were reviewed by the internal audit function. This will then aid the organisation in making appropriate decisions.

'The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed.' (Institute of Internal Auditors)

An internal audit function in an organisation should act independently of the executive management. The characteristic of independence is essential to the effectiveness of internal audit function. Lack of independence or control by the executive will likely undermine the integrity of the role of internal audit function. Internal auditors report to the management team of the company and they may recommend that certain actions should be taken. They may also report to the board or the audit committee of the board. Internal audit function is an important requirement of the *Nigerian Code of Corporate Governance 2018*. Principle 18 of the code provides that, *an effective internal audit function provides assurance to the Board on the effectiveness of the governance, risk management and internal control systems.* The recommended practices of the Code in relation to internal audit function indicate the importance of internal audit as an aspect of internal control.

Unlike external auditors, internal audit looks beyond financial risks and statements to consider matters such as an organisation's growth, reputation, impact on the environment and matters that affect employees.

1) **Recommended Practices**

18.1 The purpose, authority and responsibility of the internal audit function should be clearly and formally defined in an internal audit charter approved by the Board.

18.2 Where the Board decides not to establish such a function, internally or outsourced, sufficient reasons should be disclosed in the Company's annual report with an explanation as to how the Board has obtained adequate assurance on the effectiveness of the internal processes and systems such as risk management and internal control.

18.3 The internal audit function should be headed by a member of senior management who is a professional with relevant qualifications, competence, objectivity and experience; and is registered with a recognised professional body

18.4The Board should ensure that the internal audit function is sufficiently skilled and resourced to address the complexity and volume of risk faced by the organisation.

In the UK, the Financial Reporting Council guidance on Audit Committees suggests that the audit committee should ensure that the internal auditor has direct access to the chair of the board, chairman and the audit committee. The management of an organisation can ask the internal auditors to carry out audits of the systems or procedures for which they are responsible. However, the senior internal auditor should have some control over deciding what aspects of the company's systems should be investigated or audited, and also has a responsibility for reporting to the audit committee and the chair of the board. Essentially, even though the executive management team can ask the auditors to carry out certain tasks, they do not have control over the scope of work or direction of work of internal auditors, since internal auditors are expected to demonstrate independence in the discharge of their duties. As recommended by the Nigerian Code of Corporate Governance, the internal audit function should be headed by a member of senior management who is a professional with relevant qualifications, competence, objectivity and experience.

2) The role of internal audit include:

a) Arguably, the most important function of internal auditors is to investigate the accuracy of financial position and records of an organisation. They also report on the timeliness of financial reporting and the accuracy of the information in reports.

b) Reviewing the internal control system. This is an essential role of internal auditors. They carry out independent checks on the financial controls in an organisation, to ascertain whether there are suitable financial control systems that can withstand financial risks. They also assess the effectiveness of existing control system.

c) Internal auditors may also be required by management or the board, to conduct special investigations into various aspects of the organisation's operations to assess the effectiveness of operational or other control systems that generally affect the organisation.

d) Internal auditors may also carry out value for money VFM audits, where the need arises. VFM is an investigation into an operation of an organisation to

ascertain the extent to which operations are economical, efficient, and effective. The organisation will then act on their recommendations in relation to the relevant area(s) of its operation.

e) Other roles of internal audit include reviewing compliance by the organisation with regulations and conducting risk assessment, to ascertain the adequacy of the mechanisms for identifying, assessing, and controlling significant risks to the organisation, from both internal and external sources. They also conduct a review of an organisations value and code of conduct.

Generally, internal audit function assesses the soundness of internal financial controls to ascertain whether new control systems should be established, whether existing control systems should be reviewed or lastly, whether existing control systems are effective.

SELF-ASSESSMENT EXERICSES

a) Define Internal audit.
b) What makes the internal audit function unique in comparison to external audit?
c) What factor could militate against effective internal audit function in an organisation?
d) Explain the aim of internal audit function within an organisatoion.

2.4 Summary

This Unit examined internal audit function as an aspect of internal control in an organisation. It examined internal audit particularly as a financial control measure, to address potential financial risks. It identifies the meaning of internal auditing and the role and scope of internal audit functions. This includes, to investigate the accuracy of the financial position and records of an organisation, reviewing the internal control system, conducting special investigations into various aspects of the organisation's operations, among other functions. The role of internal audit is essential to the success of a corporate entity, since it identifies potential and existing financial risks and other challenges and seeks to address existing and potential challenges caused by existing ones. The Unit does not contain an exhaustive analysis of internal audit. Further reading is required.

2.5 **References/Further Reading/Web Sources**

1) Brian Cole, *Corporate Governance ICSA Study Text*, ICSA Publishing Ltd Saffron House London 2015
2) Bob Tricker, *Corporate Governance: Principles, Policies and Practices* OUP 2019

2.6 **Answers to Self-Assessment Exercise**

a) Internal audit is an independent appraisal activity established within an organisation as a service to it. It is a control, which functions by examining and evaluating the adequacy and effectiveness of other controls.

b) Unlike external auditors, internal audit looks beyond financial risks and statements to consider matters such as an organisation's growth, reputation, impact on the environment and matters that affect employees.

c) Lack of independence or control by the executive will likely militate against or undermine the integrity of the role of internal audit function.

d) The aim of internal audit function is to assist members of the organisation in the effective discharge of their responsibilities. Internal audit provides an organisation with relevant information such as analyses, appraisals, recommendations, counsel, and information concerning the activities that were reviewed by the internal audit function.

MODULE 4 INTERNAL CONTROL AND AUDIT FUNCTIONS

Unit 3: Internal Audit Committee of the Board

3.1 Introduction

As part of the analysis of internal control in corporate entities, this Unit will examine the role of audit committees of boards of directors. Audit committees of boards, perform both regulatory functions and corporate governance functions, as indicated in CAMA 2020 and the Nigerian corporate governance code 2018 respectively. Unit 2 above, examined the role of internal audit as an aspect of internal control. This Unit will explain the extent to which internal audit functions are complemented by the audit committee of the board. The regulatory and corporate governance requirement of audit committee in Nigeria will be highlighted to aid in defining the role of members of the audit committee.

3.2 Learning Outcome

By the end of the unit, you should be able to understand the significance of the audit committee of the committee from the point of function.

3.3 Audit Committee of the board

The audit committee is a committee of the board of directors that the board delegates its responsibilities for oversight functions over the company's financial reporting, audit functions and internal control. The audit committee provides oversight over the internal control function of companies by serving as a check and balance on a company's financial reporting system.

Members of the audit committee should be familiar with the processes and controls that exist in a company. They must also be familiar with the operations of the control measures so that they will be capable of ascertaining the effectiveness of the controls and to determine whether to recommend a new system or a review of the existing control

systems. In view of the central and essential role of the committee, members of the committee are expected to liaise with company management, the internal auditors, and the independent auditor to gain the knowledge needed to provide appropriate oversight functions.

In order to effectively discharge their oversight duties of internal control, members of the audit committee should be knowledgeable in financial matters. Particularly, they should demonstrate awareness of financial statement fraud, which includes intentional misstatements and careless and negligent omissions from financial statements. They should also be able identify asset misappropriation -forgery, theft of money, inventory theft, payroll fraud, or theft of services. Generally, they should be able to identify corruption, and potential areas of corruption in the organisation. These may include schemes such as kickbacks, shell companies and bribes to influence decision makers generally or in offering or manipulation of contracts.

The main duties of an audit committee

The duties of a typical audit committee of the board include, but are not limited to the following.

a) Oversight of the company's independent auditors and to ensure the qualifications and independence of the independent auditor and internal audit function.
b) Oversight of the financial reporting and disclosure process, to promote the integrity of the company's financial statements.
c) Review of a company's financial information, such as its financial statements, financial conditions and any financial information or earnings report.
d) Oversight of the company's risk assessment and management policies.
e) Monitoring of whistle-blower procedures to submit anonymously complaints about the company's accounting policies and practices and internal control over financial reporting.
f) Oversight of compliance programs to ensure compliance with legal and regulatory requirements.
g) Monitoring the company's code of conduct.

These functions are not exhaustive. Companies can determine the particular function of its audit committee; however, the mandatory role of audit committee are often provided by statutes, often referred to as statutory audit committee, in view of the importance of

internal control functions. Thus, the role of audit committee in Nigeria is prescribed by CAMA, 2020, s 404:

(1) The auditors of a company shall make a report to its members on the accounts examined by them, and on every balance sheet and profit and loss account, and on all group financial statements, copies of which are to be laid before the company in a general meeting during the auditors' tenure of office.

(2) The auditors' report shall state the matters set out in the Fifth Schedule in addition to the report made under subsection (1), and the auditor shall in them case of a public company, make a report to an audit committee which shall be established by the public company.

(3) The audit committee referred to in subsection (2) shall consist of five members comprising of three members and two non-executive directors, the members of the audit committee are not entitled to remuneration, and are subject to election annually

(4) The audit committee shall examine the auditors' report and make recommendations thereon to the annual general meeting as it may deem fit.

(5) All members of the audit committee shall be financially literate, and at least one member shall be a member of a professional accounting body in Nigeria established by an Act of the National Assembly.

(6) Any member may nominate another member of the company to the audit committee by giving written notice of such nomination to the secretary of the company at least 21 days before the annual general meeting and any nomination not received prior to the meeting as stipulated is invalid.

(7) Subject to such other additional functions and powers that the company's articles may stipulate, the objectives and functions of the audit committee are to—
(a) ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
(b) review the scope and planning of audit requirements;

(c) review the findings on management matters in conjunction with the external auditor and departmental responses thereon;

(d) keep under review the effectiveness of the company's system of accounting and internal control;

(e) make recommendations to the board with regard to the appointment, removal and remuneration of the external auditors of the company; and

(f) authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

These provisions are complemented by the Nigerian Code of Corporate Governance, 2018. See 11.4 of the Code

11.4.1 Without prejudice to the provision of extant laws on the Statutory Audit Committee, it is desirable for every Company to have a Board committee responsible for audit.

11.4.2 All members of the committee should be financially literate and should be able to read and understand financial statements. At least one member of the committee should be

a financial expert, have current knowledge in accounting and financial management and be able to interpret financial statements.

11.4.3 For private companies, members of the committee responsible for audit should be NEDs, and a majority of them should be INEDs where possible.

11.4.4 In the case of the statutory audit committee, a chairman should be elected from amongst its members, and should have financial literacy.

11.4.5 The committee should meet at least once every quarter.

11.4.6 Subject to the provisions of extant laws, every public

company should establish a statutory audit committee which shall perform the following functions:

11.4.6.1 Ascertain whether the accounting and reporting policies of the Company are in accordance with legal requirements and agreed ethical practices.

11.4.6.2 Review the scope and planning of audit requirements.

11.4.6.3 Review the findings in management letter in conjunction with the external auditor and

management responses thereon.

11.4.6.4 Keep under review the effectiveness of the Company's system of accounting and internal control.

11.4.6.5 Make recommendations to the Board regarding the appointment, removal and remuneration of the external auditors of the Company.

11.4.6.6 Authorise the internal auditor to carry out investigations into any activities of the Company which may be of interest or concern to the committee.

As indicated above, the important role of the audit committee of the board is re-echoed by the corporate governance code, even though it is a statutory requirement for public companies. See 11.4 of the Code in detail, for the extensive roles of the audit committee.

SELF-ASSESSMENT EXERCISES

a) The role of audit committee in a Nigerian company is a matter of statutory mandate. Do you agree? Justify your response.
b) Mention any two roles of the audit committee of a board.
c) While members of audit committee are expected to be knowledgeable in financial matters, there are broad specific and general characteristics they are expected to possess to be able to meaningfully contribute to the work of the committee. Briefly discuss the particular and general traits an audit member must possess.
d) What is audit committee?

3.4 Summary

This Unit outlined the scope of the role of audit committee of the board of directors of a company. It outlines the roles of the committee in furtherance of the analysis of the module of the internal control system in a company. The analysis of the role of audit committee in this Unit is not an exhaustive examination of the role of audit committees. Further reading is required. However, the main duties of an audit committee have been highlighted in the Unit. Particularly, the statutory role of audit committee in Nigeria were outlined. This is complemented with an outline of the provisions of the Nigerian Code of Corporate Governance 2018 on the role of audit committees in corporate entities registered in Nigeria.

3.5 References/Further Reading/Web Sources

1) Brian Cole, *Corporate Governance ICSA Study Text*, ICSA Publishing Ltd Saffron House London 2015
2) Bob Tricker, *Corporate Governance: Principles, Policies and Practices* OUP 2019
3) Deloitte, The Role of the Audit Committee, Centre For Board Effectiveness 2018 access via the link - https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/us-audit-committee-resource-guide-section-2.pdf

3.6 Answers to Self-Assessment Exercises

a) Yes, I agree. By virtue of section 404 CAMA 2020 and Nigerian Code of Corporate Governance 2018 all public companies must have an audit committee. For private companies, this depends on whether it is a public interest entity within the meaning of Financial Reporting Council of Nigeria Act 2011 and specifically, section *11.4.3 of the Nigeria which provides that for (relevant) private companies, members of the committee responsible for audit should be NEDs, and most of them should be INEDs where possible.*

b) The roles of the audit committee of the board include:
   (i) review of a company's financial information, such as its financial statements, financial conditions and any financial information or earnings report.
   (ii) Oversight of compliance programs to ensure compliance with legal and regulatory requirements.
   (iii) Monitoring company's code of conduct

c) Particularly, they should demonstrate awareness of financial statement fraud, which includes intentional misstatements and careless and negligent omissions from financial statements. They should also be able identify asset misappropriation - forgery, theft of money, inventory theft, payroll fraud, or theft of services. Generally, they should be able to identify corruption, and potential areas of corruption in the organisation. These may include schemes such as kickbacks, shell companies and bribes to influence decision makers generally or in offering or manipulation of contracts.

d) It is a committee of the board of directors that the board delegates its responsibilities for oversight functions over the company's financial reporting, audit functions and internal control. The audit committee provides oversight over the internal control function of companies by serving as a check and balance on a company's financial reporting system

MODULE 4 INTERNAL CONTROL AND AUDIT FUNCTIONS

Unit 4: External Audit Function

4.1 Introduction

This Unit concludes the analysis of internal control functions in corporate entities. The scope of the role of external auditors and the significance of external auditors as an important aspect of internal control will be examined. The analysis will show how external audit function complements internal auditing and the audit committee of the board. It will also indicate the role of external auditing in promoting internal control and risk management functions of corporate entities.

4.2 Learning Outcome

By the end of the unit, you should be able to understand the statutory position of the external auditor and the situations which can impinge on the discharge of the function.

4.3 The role and scope of external audit function

Company investors, creditors and other stakeholders rely on the information contained in the annual report and accounts of a company. The accounts and reports are audited annually by independent external auditors. The purpose of an independent audit is to confirm whether the reports and accounts that are prepared by the company represent a true and fair view of the position of the company. They confirm whether the financial statements are objective and can be relied on. After the review and audit, the auditor's reports are then presented to shareholders of the company.

The audit report has two main purposes, this includes, (i) to report to the shareholders of the company whether the financial statements give a true and fair view of the financial

position of the company as at the end of the financial year covered by the report, and of its financial performance during the year; and (ii) to confirm whether the financial statements comply with the relevant laws.

The audit report is contained in the company's annual report and accounts, and it is addressed to the shareholders of the company. The report containing the opinion of the auditors is required to be independent and based on a thorough investigation of the company's control systems, accounting systems and financial transactions in the period under review.

Since audit reports are addressed to shareholders, it is generally assumed that if auditors provide a favourable audit report, the financial statements should be deemed to be free from fraud or error. This view is based on the belief that since professional and reputable accountants have checked the figures, they must be correct, unless the accountants have been negligent and careless in the discharge of their responsibilities. Auditors are not particularly responsible for detecting fraud or error in a company's financial statements. The board of directors of a company is responsible for preventing and detecting fraud in their company. The board is expected to establish an effective system of internal control that should detect and prevent fraud and financial misstatements. A company's system of internal control should be designed to limit the risk of fraud and error, and the board is also responsible for monitoring and reviewing the effectiveness of the internal control system.

The external audit can act as a deterrent to fraud, since they will be expected to audit the accounts and statements of the company. The auditors will carry out checks of control procedures, documents and transactions of the company in the period under review. If they discover fraud or deliberate or negligent misstatement during their audit work, they should report the matter to the directors, except they have reasons to believe that the fraud was carried out by the directors.

The auditors will assess the risk or possibility that the fraud or error might have caused the financial statements to be materially misleading. The auditors should therefore design audit procedures that will provide reasonable reassurance that material fraud or error has not occurred, and that the financial statements give a true and fair view of the company's financial position and performance. However, it must be noted that no matter how

detailed and well-planned an audit system is, it is impossible to completely guarantee that risk of fraud or error would be detected. There is scope for errors or fraud to be undetected in certain instances. The reasons for this include the following –

a) there is limited time available to auditors to review the financial position and statements of a company. In view of the complex nature of auditing, for which there is only a limited amount of time and resources, and since auditing is done by sampling and testing, it would be impossible to ensure that all errors or frauds would certainly be detected.

b) accounting systems and internal control procedures are quite vulnerable to fraud and error, arising from criminal collusion between or among employees.

c) the decisions by management to override the system of controls.

However, auditors ought to be able to identify fraud or a significant error during the course of their audit work, even though all fraud and errors may not be detected. This implies that while auditors' work is not conclusive proof that fraud will be detected, a failure by the auditors to discover a major fraud or material error might be argued to be the result of professional negligence. Hence, auditors must be vigilant and thorough in the discharge of their auditing duties. If auditors are negligent, they should be held liable to the company and its shareholders. In some instances, they can be held criminally liable. In the performance of their duties, auditors are expected to exercise the duties of care, diligence and skill. See *London & General Bank No2* (1895) Ch 673, at 683. Where is was held that…'*...it is the duty of an auditor to bear on the work he had to perform that skill, care and caution which a reasonable competent, careful and cautious auditor would use…*' . Auditors are watchdogs, whose professional judgment about a company's performance can attract investors to the company. In *Ajayi v Securities and Exchange Commission*, (2009)13 NWLR (pt 1157)1, the National Council on Privatisation had offered for sale, Federal Government's 86.4 million ordinary shares of African Petroleum AP Plc. A company, Sadiq Petroleum bought 30% of the shares and became the core investor, but later discovered that there was a concealment of AP's debt of about 22.5 billion naira and that the auditors were negligent in auditing AP Plc's accounts. If the auditors were not negligent, Sadiq Petroleum would have negotiated on different terms, since they would be aware of the debt burden of the company.

4.3.1 Liability of Auditors

CAMA 2020, s 415

Auditors can be held liable for recklessly allowing an audit report to include matters that are misleading, false or deceptive.

415.—(1) A company's auditor shall in the performance of his duties exercise all such care, diligence and skill as is reasonably necessary in each particular circumstance.

(2) Where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him by subsection (1), the auditor is liable for negligence and the directors may institute an action for negligence against him in the Court.

(3) If the directors fail to institute an action against the auditor under subsection (2) of this section, any member may do so after the expiration of 30 days' notice to the company of his intention to institute such action.

416.—(1) An officer of a company commits an offence if he knowingly or recklessly makes to a company's auditors a statement (whether written or oral) which—

(a) conveys or purports to convey any information or explanation which the auditors require, or are entitled to require, as auditors of the company ; and (b) is misleading, false or deceptive in a material particular.

(2) A person who commits an offence under this section is liable to a penalty as the Commission shall specify in its regulations.

4.3.2 Auditor Independence and Challenges

In view of the nature of work that auditors perform, they are essentially required to be independent of the company where they carry out their auditing duties. The requirement for independence would ensure that that are not influenced in the discharge of their duties and that the audit opinion will not be influenced by the relationship between the auditor and the company.

Auditors are required to provide an unbiased and honest professional opinion to the shareholders about the financial statements and accounts of the company. An

unmodified audit report is often seen by investors as a 'clean bill of health' for the company.

To ensure that audit reports are unquestionable and reliable, auditors must be seen to be manifestly independent. Safeguards can also be put in place to ensure that auditors are not influenced by anyone in the discharge of their audit functions.

Sometimes doubts can be expressed about the independence of external auditors especially in the absence of effective corporate governance mechanisms that promote auditor independence. In the absence of effective corporate governance measures, a firm of auditors may reach audit opinions and judgements that are influenced by their relationship with the management of a client company. This may undermine the integrity and reliability of the audit reports that are prepared by such audit firm. For example, an official 2010 report on the collapse of Lehman Brothers (in the USA in 2008) criticised the external auditors Ernst & Young for allowing the company to account for certain transactions (repo 105 transactions) in a way that misleadingly improved the look of the end-of-quarter balance sheets during 2007 and 2008 before the bank collapsed. Also, auditors of Enron, Arthur Andersen were held liable for misleading audit reports following the collapse of Enron in the United States in 2001.

There are several threats to auditor independence. These threats are outlined in Brian Cole's, *Corporate Governance ICSA Study Text*, ICSA Publishing Ltd Saffron House London 2015 page 161. They are outlined below.

a) Self-interest threat. This is the threat that an auditor or audit firm is earning such a large amount of fee income from the audit and non-audit work that its judgement will be affected by a desire to protect this income stream. For example, if the audit firm earns a large proportion of its revenue from a client company, it may be unwilling to annoy that client by challenging the figures and assumptions used by management to prepare the company's financial statements.

b) Self-review threat. This can arise when the audit firm does non-audit work for the company, and the annual audit involves checking the work done by

the firm's own employees. The auditors may not be as critical of the work, or prepared to challenge it, because this would raise questions about the professional competence of the audit firm. For this reason, the accountancy profession has an ethical rule that firms must not take on non-audit work that may be the subject of future audit by its staff.

c) Advocacy threat. This can arise if the audit firm is asked to give its formal support to the company by providing public statements on particular issues (such as promoting a new issue of shares by the company) or supporting the company in a legal case. Acting as advocate for a company means taking sides, and this implies a loss of independence. The accountancy profession therefore has an ethical rule that firms should not take on any non-audit work in which they may be required to act as 'advocate' for the client.

d) Familiarity threat. A threat to independence occurs when an auditor is familiar with a company or one of its directors or senior managers, or becomes familiar with them through a working association over time. Familiarity leads to trust and a willingness to believe what the other person says, without carrying out an investigation into its accuracy or honesty. The auditor will also be unwilling to think that the other person is capable of making a serious error or committing fraud. A familiarity threat may also arise through personal association (for example, family connections) and through long association with the company and its management.

e) Intimidation threat. An auditor may feel threatened by the directors or senior management of a company. For example, a company CEO or finance director may act aggressively and in a bullying manner towards audit staff, so that the auditors are browbeaten into accepting what the 'bully' is telling them. Both real and imagined threats can affect the auditor's independence. A company may also threaten to take away the audit or stop giving the firm non-audit work unless the auditor accepts the opinions of management. In practice, the threats to auditor independence are most likely to be self-interest threats, familiarity threats and, possibly, intimidation threats. Threats to auditor independence must be identified, and measures should

be taken to limit the threat to an acceptable level of risk. This is a professional requirement for audit firms, but companies should also be aware of the need to ensure the independence of their auditors and take appropriate measures.

See Brian Cole's, *Corporate Governance ICSA Study Text*, ICSA for further reading.

SELF-ASSESSMENT EXERCISES

a) Enumerate Brian Cole's typology of threats to auditors' independence?
b) From your study, what factor raises as to doubts as to the independence of external auditors?
c) The study exposed the potential dangers of absence of external auditor independence. State them.
d) While the law recognises and punishes an external auditor for negligence audit, the officers of a company is not spared. What acts of a company officer is capable of constituting an offence within the purview of external audit?
e) Do you agree with the view that audit report can be a strategic document in the hands of a potential investor?

4.4 Summary

This Unit examined the role of external auditors as part of the analysis of the module on internal control systems in a corporate entity. The Unit concludes the analysis of the module on internal control. It identifies the role of external auditors as an essential aspect of internal control measures. As part of the analysis of the Unit, the role and scope of auditor's functions were examined. Further, the extent to which auditors may be held liable was outlined. In view of the essential nature of audit functions, the requirement for independence of auditors was highlighted. Finally, the challenges and threats to auditors' independence were outlined from Brian Cole's ICSA study text. The analyses on external auditors are not exhaustive, students are required to engage in further reading to enhance the scope of their knowledge on the topic.

4.5 References/Further Reading/Web Sources

1) Brian Cole, *Corporate Governance ICSA Study Text*, ICSA Publishing Ltd Saffron House London 2015
2) Bob Tricker, *Corporate Governance: Principles, Policies and Practices* OUP 2019

4.6 Answers to Self-Assessment Exercises

a) Brian Cole's threat are:
   (i) Self-interest threat
   (ii) Advocacy threat
   (iii) Familiarity threat
   (iv) Self-review threat
   (v) Intimidation threat

b) The absence of effective corporate governance mechanisms that promote auditor independence.

c) The potential dangers are that a firm of auditors may reach audit opinions and judgements that are influenced by their relationship with the management of a client company. Effectively, this may undermine the integrity and reliability of the audit reports that are prepared by such audit firm.

d) CAMA 2020 provides for this. Thus, a company officer commits an offence if he knowingly or recklessly makes to a company's auditors a statement (whether written or oral) which conveys or purports to convey any information or explanation which the auditors require, or are entitled to require, as auditors of the company; and is misleading, false or deceptive in a material particular. A person who commits an offence under this section is liable to a penalty as the Commission shall specify in its regulations.

e) Yes, I agree. This is why it is said that an unmodified audit report is often seen by investors as a 'clean bill of health' for the company. Therefore, auditors are required to provide an unbiased and honest professional opinion to the shareholders about the financial statements and accounts of the company.

MODULE 5 CORPORATE INSOLVENCY

Unit 1: Introduction to Corporate Insolvency

1.1 Introduction.

This Unit will commence the analyses on the options available to a company that is undergoing financial challenges. Several options are available to a company that is undergoing financial difficulties, these include attempts to rescue the company. Rescue attempts include informal arrangement with creditors and formal arrangements such as schemes of arrangement, company voluntary arrangement and administration. Where a company cannot be rescued, liquidation will be ultimately considered. Units 2 and 3 will examine corporate rescue options and liquidation respectively. Unit 4 will examine the extent to which directors and company officers may be held liable for corporate failure. This Unit will outline the elementary aspects of insolvency. It will explain the factor(s) that make a company financially distressed. It will also highlight the ideal objectives of good modern insolvency law.

1.2 Learning Outcome

By the end of the unit, you should be able to differentiate between the various events of insolvency which constantly face a company.

1.3 Introduction to Corporate Insolvency

1.3.1 What Makes a Company Insolvent?

There are various ways of defining corporate insolvency. The meaning of corporate insolvency is important because it has legal consequences, not just for the company, but for its creditors and other relevant stakeholders. Insolvency indicates financial difficulties; thus, any definition of corporate insolvency reflects the extent to which

a company is financially challenged. Cash flow/commercial insolvency, balance sheet insolvency and ultimate insolvency are briefly explained below as types of insolvency.

1) **Cash flow insolvency**

Cash flow insolvency can also be referred to as commercial insolvency. It occurs when a company is unable to pay its debt as they become due. Even where the assets of a company are not in deficit, if the company is merely unable to meet its debt obligations to creditors, it may be considered to be insolvent. The reason for this type of insolvency is that a company that in unable to meet its debt obligations as they fall due has cash flow problems which prevents it from being able to meet its obligations.

In the UK this is a legally recognized type of insolvency. Under the *Insolvency Act 1986*, s 123 (1)(e), A company is deemed unable to pay its debts **(e)** if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due. In *BNY Corporate Trustee Services Ltd v Eurosail* [2013] USKC 28 The UK Supreme Court explain inability to pay debts as 'presently-due debts' and debts falling due from time to time in the reasonably near future'.

Similarly in Nigeria, the *Companies and Allied Matters Act 2020*, s 571(d) outlines the cash flow test of corporate insolvency as a company that is unable to pay its debts. Further, s 572 outlines the circumstances when the condition in s 571(d) would be deemed to be present.

A company is deemed to be unable to pay its debts if— (a) a creditor, by assignment or otherwise, to whom the company is indebted in a sum exceeding N200,000, then due, has served on the company, by leaving it at its registered office or head office, a demand under his hand requiring the company to pay the sum due, and the company has for three weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor; (b) execution or other process issued on a judgment, act or order of any Court in favour of a creditor of the company is returned unsatisfied in whole or in part ; or (c) the Court, after taking into account any contingent or

prospective liability of the company, is satisfied that the company is unable to pay its debts.

2) Balance Sheet Insolvency

A company may be insolvent if the value of its assets is less than the amount of its total liabilities. It is important to assess the financial position of a company before it is considered to be either solvent or insolvent. For example, a company that is insolvent in balance sheet may not necessarily be commercially insolvent, it may still have a good cash flow, despite its huge potential liability, so that if its assets are realized, they may be able to meet its debt obligations. However, when the value of the assets of the company is less than the amount of its liabilities, it is deemed to be insolvent.

The UK *Insolvency Act 1986*, s 123(2), defines balance sheet insolvency as follows – *company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities*. In *BNY Corporate Trustee Services Ltd v Eurosail* [2013] USKC 28 The UK Supreme Court held that, '*…The express reference to assets and liabilities is in my view a practical recognition that once the court has to move beyond the reasonably near future (the length of which depends, again, on all the circumstances) any attempt to apply a cash-flow test will become completely speculative, and a comparison of present assets with present and future liabilities (discounted for contingencies and deferment) becomes the only sensible test. But it is still very far from an exact test, and the burden of proof must be on the party which asserts balance-sheet insolvency…*' see para 37.

3) Ultimate insolvency

Ultimate insolvency is determined as conclusive proof that a company is insolvent. When a company is undergoing financial challenges either as a result of its inability to meet its debt obligations as they fall due or the value of its assets is less than its liabilities, the assets of the company may be realized (sold) to meet its obligations. If the value of the assets is less than the amount of its liabilities, the company deemed to be insolvent.

1.3.2 Objectives Modern Corporate Insolvency Laws

Below are some of the ideal objectives of modern insolvency law.

1) To identify and deal with an imminent insolvency at an early rather than a late stage.
2) To attempt to rescue the distressed company as best as possible, so that insolvency can be avoided, and the company can continue to trade as a going concern.
3) To provide an equal and fair procedure in handling the affairs of the insolvent compony, ensuring that creditors receive an equal and equitable distribution of assets.
4) To provide a procedure that promotes the realisation of the assets of the insolvent which should properly be taken to satisfy its debts, with the minimum delay and expense.
5) To ensure that the insolvency process is conducted in a fair, honest, independent and competent manner.
6) To provide a mechanism that protects the interests of all parties – creditors, debtors and stakeholders as best as possible.
7) To provide a procedure that diminishes the challenges of insolvency on the public.
8) To provide a mechanism that ascertains the reason(s) for the insolvency, to investigate the conducts of the insolvent, their associates, and officers of corporate insolvents.

These objectives are not the only objectives of a modern insolvency regulatory regime. The objectives seek a regulation that creates a balance between the interests of creditors and debtor companies. Importantly, it suggests in (b) above that a main objective should be to rescue a company, so that the company can go through the insolvency process and remain in business. This is important in view of the effects of liquidation on various stakeholders of the company, namely, shareholders, creditors, employees, the community, the government, the economy and other stakeholders. Where rescue is impossible, the insolvency procedure should be as fair as possible, taking into consideration the various interests that would be affected and a mechanism to address the reasons for the insolvency.

SELF-ASSESSMENT EXERCISES

a) Name three types of insolvency that can face a company.

b) List at least four objectives of corporate insolvency laws.

c) Explain what you understand by 'ultimate insolvency.'

1.4 Summary

This Unit examined the introductory aspect of corporate insolvency. It explained the meaning of insolvency by reference to cash flow insolvency, balance sheet insolvency and ultimate insolvency. The various objectives of a modern insolvency regulatory regime were also outlined. These objectives may be contentious, depending on the quality of the arguments presented. Insolvency is an extensive topic in corporate law. The analyses in this unit merely identify the essential aspects of the introduction to insolvency, further reading is required.

1.5 References/Further Reading/Web Sources

1) Andrew Keay and Peter Walton, *Insolvency Law: Corporate and Personal* 4th Edition Lexis Nexis 2017
2) *Sealy and Worthington's Cases and Materials in Company Law* 10th Edition OUP

1.6 Answers to Self-Assessment Exercises

a) The three types are:
   (i) Cash flow insolvency
   (ii) Balance sheet insolvency
   (iii) Ultimate insolvency

b) The objectives of corporate insolvency laws are:
   (i) To identify and deal with an imminent insolvency at an early rather than a late stage.
   (ii) To attempt to rescue the distressed company as best as possible, so that insolvency can be avoided, and the company can continue to trade as a going concern.
   (iii) To provide an equal and fair procedure in handling the affairs of the insolvent compony, ensuring that creditors receive an equal and equitable distribution of assets.
   (iv) To provide a procedure that promotes the realisation of the assets of the insolvent which should properly be taken to satisfy its debts, with the minimum delay and expense.
   (v) To ensure that the insolvency process is conducted in a fair, honest, independent and competent manner.

c) Ultimate insolvency is determined as conclusive proof that a company is insolvent. When a company is undergoing financial challenges either as a result of its inability to meet its debt obligations as they fall due or the value of its assets is less than its liabilities, the assets of the company may be realized (sold) to meet its obligations. If the value of the assets is less than the amount of its liabilities, the company deemed to be insolvent

2.1 Introduction

When a company is undergoing financial difficulties, there are several options available to the company before the company may be liquidated. These options are attempts to rescue the company, so that it can continue to carry on business and trade its way out of insolvency. Rescue attempts include informal arrangement with creditors and formal arrangements such as schemes of arrangement, company voluntary arrangement and administration. This Unit will examine the main formal and informal arrangements that can be attempted to rescue a company that is undergoing financial challenges.

2.2 Learning Outcome

By the end of the unit, you should be able to

2.3 Corporate Rescue

1.3.3 Informal process

Informal process of attempting to rescue a financially challenged company refers to any means that do not resort to statutory insolvency procedures. The informal process can be commenced by the directors or creditors of the company, with professional advice. The process involves negotiating with creditors to permit the debtor company to make alternative arranged payments that are different from the original terms of the loan of the company. Informal process may include internal process and work out.

Internal process usually involves professional advisors in designing a plan on how the debt may be refinanced or restructured over a period of time. As the name suggests, an internal agreement is made between the creditors and the debtor

company to make certain payments towards the principal amount of the debt. The payment period and arrangements are determined by reference to the circumstances of the debt and the nature of the company's financial position at the time of the agreement, considering any changes to the company's income in the near future.

Workout is also an informal process of negotiating the payment of debts due to creditors of a debtor company. The agreement usually includes the debtor company trading through its difficulties with cooperation and support of creditors, with the expectations that the company will trade its way out of its financial difficulties and ultimately be able to meet its debt obligations to creditors. The arrangement embodying work out may also include a standstill agreement with the creditors. The creditors would agree not to enforce their security or demand payment of their debts from the company for a period of time, to enable the affairs of the company to be investigated. It may ultimately lead to renegotiations of the debts, restructuring or refinancing of the debt. Since workout is an informal procedure, the negotiations will be guided by contract between the parties, rather than by insolvency regulations. The circumstances of the company and the likelihood of future payment of the loans would determine the success of workout process between the company and the creditor(s).

1) **Advantages of informal process**

   There are several benefits of adopting informal process in resolving the challenges faced by a company with financial difficulties.

   a) The process helps to protect the company from public disclosure of its financial challenges, which could undermine its commercial reputation.
   b) It involves private negotiations, and it does not require compliance with insolvency requirement.
   c) Since it is informal, it is flexible, there are no rules. The agreement is determined by the parties.
   d) It is quick, since there are no formal procedures.
   e) Both parties – the debtor and creditor can agree in ways that best suit them
   f) Informal process saves costs.

2) Challenges of informal process

Some of the disadvantages of the informal process include the following.

a) Since it is an informal process, investigation into the cause of financial challenges is is not included in the arrangement.
b) Informal process requires unanimous agreements of the parties, since it is determined by contract, rather than by insolvency regulations.
c) Since unanimous consent is required, it is not binding on creditors that do not agree with the process.
d) Since it is an informal process, with lack of investigation, the directors/officers of the company may continue trading when they ought to stop trading, thus leading to potential wrongful trading liability.
e) Workouts may not be accepted by every creditor, especially smaller creditors, since it may include restructuring / refinancing.

1.3.4 Formal Process

The formal process involves the use of measures that are prescribed by regulations to attempt to address the financial challenges of corporate entities. The negotiations and agreements of the parties should be in compliance with applicable regulations. These mainly include scheme of arrangement, CVA company voluntary arrangement and administration.

1) Scheme of Arrangement

CAMA 2020 ss 711-715; UK Companies Act 2006, ss 895-896, 899

A scheme of arrangement is a formal process of restructuring a company. It is an arrangement between a company and its shareholders or its creditors for restructuring the debts of the company, such as by a debt for equity swap or by a wide variety of other debt-reduction strategies. Usually, a scheme requires approval by at least 75% in value of each class of the members or creditors who vote on the scheme, being also at least a majority in number of each class. If the scheme includes a reduction in the company's share

capital, a separate members meeting will be called and a special resolution must be passed (requiring a 75% majority of those voting).

CAMA 2020, s 715

> *715. (1) Where a compromise or arrangement is proposed between a company and its creditors or any class of them, the Court may, on the application, in a summary way, of the company or any of its creditors or members or, in the case of a company being wound up, of the liquidator, order a meeting of the creditors or class of creditors, or of the members of the company, or class of members, as the case may be, to be summoned in such a manner as the Court directs.*
>
> *(2) If a majority representing at least three quarters in value of the shares of members or class of members, or of the interest of creditors or class of creditors, as the case may be, being present and voting either in person or by proxy at the meeting, agree to any compromise or arrangement, the compromise or arrangement may be referred by the Court to the Securities and Exchange Commission which shall appoint one or more inspectors to investigate the fairness of the compromise or arrangement and to make a written report on it to the Court within a time specified by the Court.*

Since scheme of arrangement is a formal process, the permission of the court is required to convene the meetings of members and creditors to vote on the scheme. The court will review the scheme before it is approved, to consider whether there has been compliance with regulation, e.g., whether the relevant members and creditors have approved the scheme. If the court sanctions the scheme, it becomes binding on all affected creditors of the company, the members of the company and the company.

A scheme of arrangement has the following characteristics -

a) It is initiated by application made to the court
b) Court orders meetings of members / creditors

c) Majority approval 75%
d) Application for court to sanction scheme compliance with statutory provisions; classes were fairly represented; and the statutory majority are acting *bona fide* and are not coercing the minority. See *Re National Bank Ltd* [1966] 1 All ER 1006. *Re Card Protection Plan Ltd* [2014] EWHC 114

The main benefits of scheme of arrangement include its flexibility, since shareholders and creditors can decide the scope of the scheme. Further, there is no recourse to insolvency requirement since it helps to avoid insolvency. Lastly, as soon as it is approved by the court, it becomes binding on the company and its creditors.

The main challenges include the significant involvement of the court, and generally the lack of moratorium. Moratorium is a period of time that creditors will not demand that the payment of debt should be made. This could be regular monthly payments being suspended for a period of time. In Nigeria, moratorium applies for a period of six months. See CAMA 2020, s 717.

2) <u>Company voluntary arrangements CVAs</u>

CAMA 2020, s 434. UK Part 1, Insolvency Act 1986

A CVA is an alternative to insolvency. If a company is undergoing financial challenges, and it becomes aware that it would likely not be able to meet its debt obligations as they become due, it can contract with its creditors to pay part of the debt. Since company voluntary arrangement is a statutory procedure aimed at assisting in the rescue of a company in financial difficulties, it allows a company to agree a composition or an arrangement with its creditors in satisfaction of some, or all, of the debts it owes. CAMA 2020, s 434 outlines the procedure for CVA. The process is similarly outlined in Part I of the UK *Insolvency Act 1986* and the Insolvency (England and Wales) Rules 2016.

Although the management of a company may retain its position during a CVA, a CVA is usually implemented under the supervision of a registered insolvency practitioner. CVA requires the approval of the requisite majorities of the company's creditors and shareholders.

The CVA takes effect if approved by both the creditors and the shareholders. If the decision taken by the creditors' meeting differs from that taken by the company meeting, a member of the company may apply to the Court. The Court may order the decision of the company meeting to have effect instead of the decision of the creditors' meeting; or make such other order as it deems fit. See s 438. Once the CVA is approved, it binds all the company's unsecured creditors who were entitled to vote at the meeting or would have been so entitled if they received notice of the meeting. A CVA cannot bind secured or preferential creditors without their consent. CVA must not unfairly prejudice the interests of any creditor.

The company's directors, or an administrator, where the company is in administration or a liquidator, where the company is in liquidation can make a proposal to the company and its creditors that a CVA should be contracted. Neither creditors nor shareholders can propose a CVA, since they are not fully knowledgeable about the financial prospect of the company.

While the directors remain in control of the management of the company throughout the CVA process, an insolvency practitioner, called a nominee, would be responsible for assisting the directors with the preparation of the Proposal. After the CVA has been approved, the nominee – insolvency practitioner will oversee the implementation of the CVA.

Benefits of a CVA

a) It is a rescue option for the company; hence insolvency procedure is avoided.

b) It is flexible.
c) As soon as it is approved, it becomes binding on everyone entitled to vote.
d) It is mainly controlled by debtors, hence the extent to which their interests would be undermined is limited.

Challenges of a CVA

A CVA must be approved by secured and preferential creditors. Any proposal or modification which affects the rights of a secured creditor of the company to enforce their security, will not be applicable, except it is approval by the creditor concerned.

3) Administration

CAMA 2020, Chapter 18. UK, Insolvency Act 1986, Schedule B1,

When a company is undergoing financial challenges, attempts may be made to save it from being liquidated, by appointing other people to manage its affairs. A mechanism known as administration may be used to rescue a financially distressed company. An administrator is a person appointed to manage the affairs, business, and property of a financially challenged company.

The powers of an administrator are quite extensive. Once appointed, an administrator takes over the running of the company and the entire business. The directors of the company can only exercise the functions that are assigned to them by the administrator. Administrators can do anything necessary or expedient for the management of the affairs, business and property of the company, including the sale of assets under a floating charge without the consent of creditors and they can dispose of assets secured by fixed charged with the approval of the court.

The appointment of an administrator creates a period of moratorium. Moratorium means the general postponement of enforcement of all debts owed by the company to its creditors. During the period of moratorium, no legal action for the recovery of debt can be brought against the company. Also, execution cannot be levied against the property of the company. Since

insolvency proceedings cannot generally be taken against a company in administration, the effect of moratorium is that rights of third parties are frozen.

An administrator owes a fiduciary duty and a duty of care to the company. Thus, they must perform their assignment with care and in such a manner as an ordinarily qualified and diligent insolvency practitioner would do. In *Peskin v Anderson [2001] BCC 876,* and in *Kyrris v. Oldham [2004] BCC 111),* it was held that an administrator does not owe a fiduciary duty or duty of care to unsecured creditors of a company unless there is a special relationship between them. This implies that creditors are in the same position as the company shareholders with respect to directors 'duties that are now to be performed by administrators.

The following are characteristics of administration.

a) Only qualified insolvency practitioners may be appointed as administrators. An insolvency practitioner is a person licensed by law to engage in insolvency practice.
b) An administrator may be appointed by the courts on the application of the company, its directors, or its creditors. He may also be appointed by a holder of a floating charge on the whole undertaking of a company.
c) An administrator must perform his duties in the interest of the company and creditors.
d) An administrator must deal with the properties of a company for the benefit of all parties, i.e., the company, shareholders, and creditors.

The purposes of administration include the following order of priority

a) To try to rescue the company, so that it can continue trading as a going concern. This objective must first be pursued by an administrator, unless this is not reasonably practicable or
b) To achieve a better result for creditors than would be achieved on winding-up. This is the second priority of an administrator. This option should be undertaken when the first option is not reasonably practicable or would not lead to a better result or

c) To realise the properties of the company for the purpose of paying off secured and preferential creditors. This is a last option. This option would be undertaken if the first two options are not reasonably practicable, and the interests of creditors would not be harmed unnecessarily.

The court must be satisfied that the company is likely to be insolvent, and that administration is reasonably likely to achieve a better purpose than would be achieved if the company becomes liquidated. Gibson J. in *Re Consumer and Industrial Press Ltd*., held that

> *The court must be satisfied on the evidence put before it that at least one of the purposes in s. 8(3) is likely to be achieved if it is to make an administration order. That does not mean it is merely possible that such purpose will be achieved; the evidence must go further than that to enable the court to hold that the purpose in question will more probably than not be achieved.* In *Re Transbuss International Ltd. [2004] 2 All ER 911,* it was held that an administrator is only required to comply with instructions and proposals approved by the creditors or the court; he is not required to actively seek directives from the court or creditors before he could act. He could "do anything necessary or expedient for the management of the affairs, business, and property of the company," without having to seek the approval of the court or the creditors.

SELF-ASSESSMENT EXERCISE

a) State the benefits of a scheme of arrangement.

b) List any three purposes of administration.

c) What can you identify as the challenge of company voluntary arrangements?

d) What are the two types of informal process of business rescue?

2.4 Summary

This Unit examined the various mechanisms by which or through which steps can be taken to reverse, positively, the fortunes of a financially necessitous company that is fast receding into insolvent liquidation.

1.7 References/Further Reading/Web Sources

1) Andrew Keay and Peter Walton, *Insolvency Law: Corporate and Personal* 4th Edition Lexis Nexis 2017

1.8 Answers to Self-Assessment Exercises

a) The benefits of a scheme of arrangement are:
   (i) It is initiated by application made to the court
   (ii) Court orders meetings of members / creditors
   (iii) Majority approval 75% Application for court to sanction scheme compliance with statutory provisions; classes were fairly represented; and the statutory majority are acting *bona fide* and are not coercing the minority.

b) The purposes of administration are:
   (i) To try to rescue the company, so that it can continue trading as a going concern. This objective must first be pursued by an administrator, unless this is not reasonably practicable, or
   (ii) To achieve a better result for creditors than would be achieved on winding-up. This is the second priority of an administrator. This option should be undertaken when the first option is not reasonably practicable or would not lead to a better result, or
   (iii) To realise the properties of the company for the purpose of paying off secured and preferential creditors. This is a last option. This option would be undertaken if the first two options are not reasonably practicable, and the interests of creditors would not be harmed unnecessarily.

c) A company voluntary arragemente must be approved by secured and preferential creditors. Any proposal or modification which affects the rights of a secured creditor of the company to enforce their security, will not be applicable, except it is approval by the creditor concerned.

d) The informal process involves internal process and a work out.

MODULE 5 CORPORATE INSOLVENCY

Unit 3: Liquidation – Winding Up

3.1 Introduction

There are several options available to a company that is undergoing financial challenges. First the company may try to be rescued by trading its way back to financial security. The main ways that this can be done were examined in Unit 2 above. These include the informal and formal processes. This Unit will take the analysis further. When a company experiences financial challenges, and the rescue options examined in Unit 2 are unsuccessful, the company will be liquidated. This Unit examines the meaning and regulatory control over the liquidation of companies as a result of insolvency.

3.2 Learning Outcome

By the end of the Unit, you should be able to understand the various modes of winding up of a company, how and when to activate them.

3.3 Liquidation

Where the rescue options examined in Unit 2 are unsuccessful, the life of the company will be wound up. This is referred to as liquidation or winding up the affairs of a company. This would either be compulsory liquidation or voluntary liquidation.

3.3.1 Compulsory liquidation

A compulsory winding up occurs when a court makes an order that a company should be wound up. It is also referred to as winding up by the court. The court may wound up a company for various reasons, including the inability of a company to

pay its debt, i.e., an amount exceeding N200,000 two hundred thousand naira is not paid after three weeks, when demanded by the creditor(s). In such instance, the court winds up the company because the company is insolvent. The Federal High Court has the jurisdiction to wind up companies in Nigeria.

See CAMA, 2020, ss 570, 571 (d) and 572

571. A company may be wound up by the court if

(a) the company has by special resolution resolved that the company be wound up by the Court

(b) default is made in delivering the statutory report to the Commission or in holding the statutory meeting ;

(c) the number of members is reduced below two in the case of companies with more than one shareholder ;

(d) the company is unable to pay its debts ;

(e) the condition precedent to the operation of the company has ceased to exist ; or

(f) the Court is of opinion that it is just and equitable that the company should be wound up.

It can be observed from the provisions of s 571 above that there are several instances where the court may wind up a company. However, the most important circumstance for the compulsory winding up of a company is as due to the inability of the company to meet its debts obligations and on the ground that it is just and equitable to wind up the company. Since the focus of the analysis in this Unit is liquidation as a result of insolvency, the inability to pay debt in s 571(d) is the focus of our analysis. S 572 defines the circumstance(s) where a company will be deemed to be unable to meet its debt obligations.

572. A company is deemed to be unable to pay its debts if—

(a) a creditor, by assignment or otherwise, to whom the company is indebted in a sum exceeding N200,000, then due, has served on the company, by leaving it at its registered office or head office, a demand under his hand requiring the company to pay the sum due, and the company has for three weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor;

(b) execution or other process issued on a judgment, act or order of any Court in favour of a creditor of the company is returned unsatisfied in whole or in part; or
(c) the Court, after taking into account any contingent or prospective liability of the company, is satisfied that the company is unable to pay its debts.

Since winding up in an insolvency process, the court will appoint a liquidator to conduct the proceedings in winding-up a company and to perform the duties conferred on them by the court. Where there is a vacancy, the official receiver shall by virtue of his office, act as liquidator until such a time when the vacancy is filled. On the appointment of the liquidator, the powers and duties of directors will cease, these duties will now be performed by the liquidator, except as determined by the court.

The powers of the liquidator are quite extensive. They can exercise all the powers of the directors and other powers that are reasonably incidental to the role of a liquidator, such as –

a) bring or defend any action or other legal proceeding in the name and on behalf of the company;

(b) carry on the business of the company so far as may be necessary for its beneficial winding-up;

(c) appoint a legal practitioner or any other relevant professional to assist him in the performance of his duties;

(d) pay any classes of creditors in full

See s 588 for the extensive powers of a liquidator.

3.3.2 Voluntary winding up

CAMA, 2020 s 564 and 573

Voluntary winding up may be instituted by a petition from the company, its director, creditors, or any of the parties outlined in s 573 (1).

573. (1) An application to the court for the winding-up of a company shall be by petition presented subject to the provisions of this section, by —

(a) the company or a director;

(b) a creditor, including a contingent or prospective creditor of the company;

(c) the official receiver ;

(d) a contributory;

(e) a trustee in bankruptcy to, or a personal representative of, a creditor or contributory;

(f) the Commission under section 366 of this Act ;

(g) a receiver, if authorised by the instrument under which he was appointed; or

(h) by all or any of those parties, together or separately.

Upon receipt of the petition to wind up a company, the court shall consider the merit of the petition. The Court shall not make a winding-up order on any petition unless the court is satisfied that the voluntary winding-up or winding-up subject to supervision, cannot be continued with due regard to the interests of the creditors or contributories.

3.3.3 Priority in distribution to creditors

The priority in the distribution of assets of a liquidated company is outlined in s 657.

657.—(1) In a winding-up, there shall be paid in priority to all other debts—

(a) all local rates and charges due from the company at the relevant date, and having become due and payable within 12 months immediately before that date, and all pay-as-you-earn tax deductions and other assessed taxes, property or income tax assessed on or due from the company up to the annual day of assessment next before the relevant date, and in the case of pay-as-you-earn tax deductions not exceeding deductions made in respect of one year of assessment and, in any other case, not exceeding in one year's assessment ;

(b) deductions made from the remuneration of employees and contributions of the company under the Pension Reform Act ;

(c) contributions and obligations of the company under the Employees' Compensation Act ;

(d) all wages or salaries of any clerk or servant in respect of services rendered to the company

(e) all wages of any workman or labourer, whether payable for time or for piece of work, in respect of services rendered to the company ; and

(f) all accrued holiday remuneration becoming payable to any clerk, servant, workman or labourer (or in the case of his death to any other person in his rights)

on the termination of his employment before or by the effect of the winding-up order or resolution.

Further, under subsection 4 of s 657, the next order of priority in the distribution of the assets of a liquidated company after the liabilities in subsection 1 have been satisfied are –

(4) The debts shall—

(a) rank equally among themselves after the expenses of the winding-up and shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions; and

(b) if the assets of the company available for payment of general creditors are insufficient to meet them, have priority over the claims of holders of debentures under any floating charge created by the company and be paid accordingly out of any property comprised in or subject to that charge.

(5) Subject to the retention of such sums as may be necessary to discharge the costs and expenses of the winding-up, the debts shall be discharged immediately if the assets of the company are sufficient to meet them.

(6) Notwithstanding the foregoing and any other provisions of this Act and any other law applicable in Nigeria where it relates to settlement of claims in the winding-up of a company, claims of—

(a) secured creditors, as defined under this Act, shall rank in priority to all other claims, including any preferential payment under this Act or any other debts inclusive of expenses of winding-up ; and

(b) the equity holders shall rank last.

(7) In this section, "the relevant date" means—

(a) in the case of a company ordered to be wound up compulsorily which had not previously commenced to be wound up voluntarily, the date of the winding-up order; and

(b) in any other case, the date of the commencement of the winding-up

It should be noted that there is a difference between liquidation and receivership. Where a receiver is appointed, the appointment is made by a secured creditor, usually a bank or any other creditor, to manage the company in the interest of the secured creditor. The receiver will manage the company and recover the amount owed to the

creditor. Liquidation is a process where the affairs of a company are wound up and a liquidator is appointed to manage the company and sell the assets of the company in order to recover the amount of money that is owed to creditors. If any assets or money is left after the creditors are paid, the shareholders will share in the remaining assets, then the company will be dissolved.

SELF-ASSESSMENT EXERCISE

a) Identify cases which constitute evidence of a company's inability to pay its debt.
b) What is the difference between receivership and liquidation?
c) What consideration will limit the discretion of the court to make a winding up order?
d) Who can present a petition for voluntary winding up?

3.4 Summary

This Unit explained liquidation as the ultimate option available to a financially distressed company if the rescue options examined in Unit 2 are unsuccessful. Liquidation or winding up can either be voluntary or compulsory. A voluntary winding up may be commenced by the company, directors, creditors or contributory, by a petition to the court. A compulsory liquidation is also referred to as liquidation by the court. The Unit also identified the powers of a liquidator. It was stated that the powers of liquidators are quite extensive. The limit of their powers can only be curtailed by the court. Since liquidation brings the life of a company to an end, and in view of the multiple interests attached to a company, the court often considers the extent to which liquidation is the best option, having regard to the particular circumstances of the company and the interests of the stakeholders. The analysis in this Unit is not an exhaustive discussion of the regulatory framework for liquidation. The Unit merely outlined the main aspects of liquidation. Further reading is required.

3.5 References/Further Reading/Web Sources

1) Andrew Keay and Peter Walton, *Insolvency Law: Corporate and Personal* 4th Edition Lexis Nexis 2017

2) Imo J. Udofa and Richards U. Ekeh, 'The Status and Role of Liquidators in the Winding-Up of Companies in Nigeria: A Critical Evaluation' (2016) 8 *European Journal of Business and Management* 148-158.

3) P. Omar, 'Thoughts on the Purpose of Corporate Rescue' (1997) *Journal of International Banking Law*

4) P. Okoli, 'Rescue culture in the United Kingdom: realities and the need for a delicate balancing act' *(2012) International Company and Commercial Law Review 61*

3.6 Answers to Self-Assessment Exercise

a) The cases in which a company is deemed unable to pay its debt are:
   (i) a creditor, by assignment or otherwise, to whom the company is indebted in a sum exceeding N200,000, then due, has served on the company, by leaving it at its registered office or head office, a demand under his hand requiring the company to pay the sum due, and the company has for three weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor;
   (ii) execution or other process issued on a judgment, act or order of any Court in favour of a creditor of the company is returned unsatisfied in whole or in part; or
   (iii) the Court, after taking into account any contingent or prospective liability of the company, is satisfied that the company is unable to pay its debts

b) Where a receiver is appointed, the appointment is made by a secured creditor, usually a bank or any other creditor, to manage the company in the interest of the secured creditor. The receiver will manage the company and recover the amount owed to the creditor. Liquidation is a process where the affairs of a company are wound up and a liquidator is appointed to manage the company and sell the assets of the company in order to recover the amount of money that is owed to creditors.

c) The Court shall not make a winding-up order on any petition unless the court is satisfied that the voluntary winding-up or winding-up subject to supervision, cannot be continued with due regard to the interests of the creditors or contributories.

d) The following persons can present the petition for voluntary winding up:
   (i) the company or a director
   (ii) a creditor, including a contingent or prospective creditor of the company
   (iii) the official receiver
   (iv) a contributory
   (v) a trustee in bankruptcy to, or a personal representative of, a creditor or contributory
   (vi) the Commission under section 366 of this Act
   (vii) a receiver, if authorised by the instrument under which he was appointed; or
   (viii) by all or any of those parties, together or separately.

MODULE 5 CORPORATE INSOLVENCY

Unit 4: Liability of Directors

4.1 Introduction.

The role of the board of directors in central to the success of a company. They run and manage the business of a company; they determine the investment strategies and ensure that the company policies will promote the economic success of their companies. They are also ultimately responsible to the shareholders of the company. Thus, corporate failure or success are often attributed to the role of directors. In view of the essential role that directors play in running a company, they may be personally liable if it is shown that they acted negligently or fraudulently in the period preceding the insolvency of their company. This Unit will examine the extent to which directors may be held liable when a company becomes insolvent, especially where directors were negligent or where they acted fraudulently. The analysis in the Unit will be limited to wrongful trading and fraudulent trading. Further, the extent to which directors may be disqualified will be included in the analysis.

4.2 Learning Outcome

By the end of the unit, you should be able to explain the meaning of wrongful trading and fraudulent and also identify circumstances in which a director can be disqualified.

4.3 Liability of Directors

4.3.1 Wrongful Trading

CAMA 2020, s 673; UK Insolvency Act 1986, s 214

When a company is undergoing financial challenges, the directors should assess the financial situation of the company. The reason for this assessment is to consider whether the company can continue to trade, without making the financial position of the company worse and further undermine the interests of creditors. If a company is undergoing financial crisis and the directors fail to assess the financial position of the company and continue to trade, they could plunge the company into further crisis. The directors may be held personally liable if the company is wound up. The court may order the directors to personally contribute to the assets of the company upon winding up. A liquidator can apply to the court that the directors should be made to personally contribute to the assets of the company.

The wrongful trading provision applies where the following occurs.

a) a company goes into insolvent liquidation, and
b) the directors of the company knew or ought to have known that in view of the financial challenges that the company was experiencing, there was no prospect of the company avoiding insolvent liquidation, and
c) The directors did not take every step that ought to have been taken to minimise losses to the company's creditors.

In determining whether a director knew or ought to have known that the company cannot avoid insolvent liquidation, and whether s/he took every step to minimise the losses of the creditors, the standard to be used is that of a *reasonably diligent person*. The court will consider the extent to which the directors acted reasonably by reference to

a) the general knowledge, skill, and experience of a person carrying out the functions of a director, and
b) the general knowledge, skill and experience of the particular director.

See s 673

> *673.—(1) Subject to subsection (3), if, in the course of the winding-up of a company, it appears that subsection (2) applies in relation to a person who is or has been a director of the company, the Court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the Court deems proper.*

(2) This subsection applies in relation to a person if—

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding-up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time.

(3) The Court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection

(2) (b) was first satisfied in relation to him, that person took every step with a view to minimising 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.

(4) For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both—

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

(b) the general knowledge, skill and experience that that director has.

For directors to be personally liable under s 673, above, there is no need to prove that the company or the directors acted with the intent to defraud creditors. *What is required is that the directors had not taken every step necessary to safeguard the interest of creditors. They acted carelessness or negligently.* Before a wrongful trading claim can be brought against directors, the company should be undergoing insolvent liquidation process, because, the only person who can bring a wrongful trading claim is the liquidator. On the application by the liquidator, the court may declare that the director is liable to make a contribution to the company's assets in an amount that the court thinks fit.

In *Re DKG Contractors Ltd.* (1990), the company had a contract to do some work and a director carried out the work himself with his own equipment and workers,

while the company provided the materials. The money that was due to the company was paid to the director. In the last 10 months of its life, the company was insolvent but within this period, a further sum of £400, 000 was paid to the director. The liquidator applied to the court to recover this money. It was held that the director was liable for wrongful trading since creditors are entitled to have the company's assets kept intact.

See *Re Continental Assurance Co of London plc* [2007] 2 BCLC 287

The company became insolvent and the liquidators argued among other things that the directors should be held liable for wrongful trading under the UK *Insolvency Act 1986*, s 214. The directors continued to trade after a crisis meeting, which should have made it clear that there was no reasonable prospect of avoiding insolvency. It was held that the liquidators failed to show a case of wrongful trading or misfeasance against the director. That the directors acted appropriately given their available information and advice. They had made careful considerations at the crisis meeting.

Directors are not prevented from trading while the company is undergoing financial difficulties, since it is practicable for a company that is undergoing financial challenges to trade its way out of the financial challenges. What is required is that the directors must assess the situation and diligently consider whether having regard to the financial circumstances of the company, there is a likelihood of the company avoiding insolvent liquidation. If it is unlikely that the company would not avoid liquidation, then directors should stop trading. So, there is directors dilemma whether to stop trading. This dilemma should be resolved by diligently assessing the financial position of the company. Directors should seek competent advice.

The court *in Sec. of State for Trade and Industry v. Taylor (1997) observed thus:*

> *The companies legislation does not impose on directors a statutory duty to ensure that their company does not trade while insolvent; nor does that legislation impose an obligation to ensure that the company does not trade at a loss… Directors may properly take the view that it is in the interest of the company and of its creditors that although insolvent, the company should continue to trade out of its difficulties. They may properly take the view that it is in the interest of the company and its creditors that some loss-making business should be accepted in anticipation of future profitability. They are not to be criticised if they give effect to such views*

properly held. But the legislation imposes on directors the risk that trading while insolvent may lead to personal liability. Section 214 imposes that liability where the director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid insolvent liquidation.

A director may avoid liability if he can show *that he took every step necessary to minimise the losses to the company's creditors* as soon as he realised that the company has no reasonable prospect of avoiding insolvent liquidation.

4.3.2 Fraudulent Trading

CAMA s 672

Fraudulent trading occurs where directors or other officers of a company engage in trading with intent to defraud creditors of their company, any other creditors, or they trade for any fraudulent purpose. It implies that, from the onset, the directors or officers of the company, used the company and a vehicle to commit fraud. They dishonestly engage in the transaction for the purpose of obtaining benefits without intending to pay the creditors. The difference between fraudulent and wrongful trading is that fraudulent trading involves the deliberate intention of directors to commit fraud, by engaging in transactions without the intent of paying the creditors. For example, obtaining goods on credit without intending to pay for the goods, obtaining loans from lenders using false accounting record and receiving large deposits from customers without intending to supply them with the goods are examples of fraudulent trading.

Whereas wrongful trading is not a deliberate attempt at defrauding creditors, but the directors acted carelessly or negligently, by failing to assess whether the company would likely be able to pay for the transactions that they engaged in.

See CAMA 2020, s 672

1) If, in the course of the winding-up of a company, it appears that any business of the company has been carried on in a reckless manner or 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 deems proper to do so,

declare that persons who were knowingly parties to the carrying on of the business in that manner, is 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.

In relation to wrongful or fraudulent trading, creditors of a company include suppliers of goods or services and lenders of money to the company. It does not matter whether the debts are payable immediately or at a future time. In *Morphites v. Bernasconi* [2003] EWCA Civ 289, it was held that the defrauding of a single creditor by a single transaction could properly be described as the carrying on of a business with intent to defraud creditors. *Re Williams Leith Bros* [1932] 2 Ch 71 – incurring debt when there is no reasonable prospect of paying it back was an indication of dishonesty. *R v Grantham [1984]* QB 675 – Purchasing goods on credit when there was no likelihood of payment was fraudulent trading.

Similar to the circumstances relating to wrongful trading, a company may continue to trade when it is undergoing financial challenges, with the hope of avoiding insolvent liquidation. Failure to avoid liquidation, without fraud will not likely lead to the liability of directors. Per Buckley J in *Re White and Osmond (Parkstone)* Ltd (1960) *105 CLR* (unreported) observed that:

There is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them get over the bad time.

Making a bad but honest commercial judgment to continue trading while insolvent is therefore not evidence of fraud.

4.3.3 Disqualification of Directors

CAMA s 280

A company director may be disqualified from holding the position of director for a certain period of time if they were involved in fraud or misfeasance. The *Companies and Allied Matters Act*, 2020 CAMA makes provision for instances where a person may be disqualified as a director.

The first instance is without regards to the winding up of a company. A fraudulent person may be disqualified by the court from becoming directors and a person who is convicted can also be unilaterally disqualified by the court, by virtue of being convicted of an offence in connection with the promotion, formation, or management of a company. The effect of the disqualification is that they shall not be a director or in any way directly or indirectly concerned or take part in the management of a company for a specified period not exceeding 10 years.

The second instance is in relation to a company being wound up. A person may be disqualified from being a director of a company if their conduct contributed to the winding up of the company. If it appears in the course of winding up that a person has been guilty of an offence whether or not he has been convicted, or has been guilty, while an officer of the company, of any fraud in relation to the company or of any breach of his duty to the company, the court shall make an order that that person shall not be a director of or in any way, whether directly or indirectly, be concerned or take part in the management of a company for a specified period not exceeding 10 years.

See s 280 (1)

(a) a person is convicted by a High Court of any offence in connection with the promotion, formation or management of a company, or

(b) in the course of winding-up a company, it appears that a person—

(i) has been guilty of any offence for which he is liable (whether he has been convicted or not) under sections 668-670 of this Act, or

(ii) has been guilty of any offence involving fraud, the court shall make an order that that person shall not be a director of or in any way, whether directly or indirectly, be concerned or take part in the management of a company for a specified period not exceeding 10 years

(2) The period of disqualification referred to in subsection (1) shall commence after the sentence for the offence has been served or on the date the fine for the offence is paid.

The objective of the disqualification order is to ensure that only fit and proper persons are appointed to manage the affairs a company. It is aimed at providing

safeguards to the public by prohibiting people that are unfit to manage the affairs of a company from doing so for a period of time. See the UK *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558, also known as the 'Cork Report'.

SELF-ASSESSMENT EXERCISES

a) What are the indicative events of wrongful trading?
b) What compelling case would mitigate or relief the personal liability of a director for wrongful trading?
c) Under what circumstances would a person be disqualified from being a director in a company?
d) What is the significance of a disqualification order?

4.4 Summary

This Unit identified instances where directors and officers of an insolvent company may be held liable for wrongful trading and fraudulent trading. The difference between fraudulent trading and wrongful trading was outlined. Fraudulent trading occurs if it is shown that directors intended to defraud creditor, while wrongful trading occurs where directors carelessly or negligently continue to trade, leading to losses to creditors. In wrongful trading, what is required is that the directors had not taken every step necessary to safeguard the interest of creditors. It is therefore easier to prove wrongful trading than fraudulent trading. Further, the powers of the court to disqualify directors for misconduct was outlined. This power is exercised by the court to safeguard the public interests and prevent fraudulent and unfit persons from managing the affairs of a company. There is scope for further reading. See the further reading list below.

4.5 References/Further Reading/Web Source

1) Andrew Keay and Peter Walton, *Insolvency Law: Corporate and Personal* 4th Edition Lexis Nexis 2017
2) Prince Diarah, 'Comparative Analysis of the Legal Regime for the Disqualification of Directors: Nigeria and UK Compared' (2020) 4 *Unilag Law Review* 160-185
3) Valentine Tebi Mbeli, 'Disqualification of Company Directors Under Nigerian Law: An Overview' (2017) 1 KIULJ

4) R. Werdnik, ‘Wrongful trading provision – is it efficient?’ 2012 Insolvency Intelligence 81
5) I. Dabor, ‘The directors' disqualification compensation order regime: the panacea for preventing corporate abuse?’ (2018) 39 Comp. Law. 243

4.6 Answers to Self-Assessment Exercise

a) The indicative events of wrongful trading are:
   (i) a company goes into insolvent liquidation, and
   (ii) the directors of the company knew or ought to have known that in view of the financial challenges that the company was experiencing, there was no prospect of the company avoiding insolvent liquidation, and
   (iii) the directors did not take every step that ought to have been taken to minimise losses to the company’s creditors.

b) Where the wrongful trading is not a deliberate attempt at defrauding creditors, but the directors acted carelessly or negligently, by failing to assess whether the company would likely be able to pay for the transactions that they engaged in.

c) The first instance is without regards to the winding up of a company. A fraudulent person may be disqualified by the court from becoming directors and a person who is convicted can also be unilaterally disqualified by the court, by virtue of being convicted of an offence in connection with the promotion, formation, or management of a company. The second instance is in relation to a company being wound up. A person may be disqualified from being a director of a company if their conduct contributed to the winding up of the company.

d) The effect or significance of the disqualification is that they shall not be a director or in any way directly or indirectly concerned or take part in the management of a company for a specified period not exceeding 10 years.

MODULE 6 COMPANY TAXATION

Unit 1: General Introduction

1.1 Introduction

There are several reasons for paying taxes. These reasons can be summarised into two main objectives, these include, to fund government expenditure and to promote the objectives of welfare economics. Governments across the world engage in infrastructural development and other public service functions. To fund these objectives, governments require significant financial resources, hence, taxes are levies to aid governments in fulfilling their mandate

Apart from aiding government financial requirements, taxes can be imposed to promote the objectives of welfare economics. Welfare economics is concerned with the ways that government allocates resources in a country, to meet the needs of people in a society and enhance their wellbeing. Examples of ways that taxes can be used to promote the objectives of welfare economics include, income redistribution, to correct market failures, via negative externalism, e.g., additional taxes levied on industries that cause environmental pollution and via paternalism by imposing additional taxes on cigarettes to discourage smoking. Thus, among other reasons, the main reasons for imposing taxes include funding government expenditure and to promote welfare economics.

There are several types of taxes, these include personal income tax, value added tax, capital gains tax, corporation tax and in some countries, inheritance tax may be levied. This Module is concerned with corporation tax. The main aspects of corporation tax will be examined in the module. The Unit will explain the introductory matters relating to corporate taxation in Nigeria

1.2 Learning Outcome.

By the end of the unit, you should be able to

a) Explain the rationale for taxation
b) Identify taxable persons (entities) in Nigeria and
c) Understand the concept of tax holidays and eligible entities.

1.3 Business Entities and Taxation in Nigeria

Different types of business can be established in Nigeria, such as companies limited by shares, partnership business, (including limited partnership and limited liability partnership) and trusts. Some of these business vehicles may be exempt from paying taxes, these include, approved charitable organisations, cooperative societies, religious bodies, trade unions and companies formed to promote sports. The tax-exempt status is limited to income generated from their explicitly mandated activities and does not apply where they engage in business outside those activities. These organisations may be established either as trusts at common law or under CAMA 2020, as companies limited by guarantee or as incorporated trustees.

The scope of taxation as it affects organisations have been extended to educational institutions; they no longer enjoy tax exempt status and they have now been excluded from the list of tax-exempt vehicles under the *Finance Act, 2021* s 28.

Some business organisations that are created by legislation can also be exempt from paying taxes, depending on the establishing law and the purpose of setting up the organisation. Statutory corporations that are established to promote socio-economic development in Nigeria are exempt from paying taxes. However, those statutory corporations that have profit making objectives may be required to pay taxes, such as the Nigerian National Petroleum Corporation NNPC, in view of their profit-making underlying objective.

Companies are required to pay income tax on their taxable profits. The distributable dividends in companies are also subject to withholding tax, before the dividends are paid out to the shareholders of the company. Meanwhile partnership business pay tax on the income of the partners. Trust entities are taxed on the income paid out to the beneficiaries of the trusts. For example, the trustee of a unit trust is treated as a company and the unit

holders are treated as shareholders for income tax purposes. However, dividends that are distributed to unit holders in a unit trust are exempt from tax.

1.4 Tax Holiday

Finance Act 2021

Capital Income Tax Act 2007

Nigeria Export Processing Zones Authority Act 1992

In Nigeria, some companies that operate in certain industries are either exempt from paying taxes for a period of up to five years or they pay a reduced rate of tax. The exemption and reduction apply to the profit of these companies and the dividends declared by the directors in the company. The companies eligible for these tax incentives are those that operate in the following sectors of the Nigerian economy; agricultural loans, manufacturing, export-orientated businesses, petrochemical projects, and research and development activities. In addition, enterprises in the various free trade zones are exempt from taxes, levies and duties, and foreign exchange restrictions.

Further to the objectives of the tax relief/incentives, these entities are now required to file tax returns with the Federal Inland Revenue Service FIRS. These tax exceptions and incentives are targeted at critical and essential industries in the Nigerian economy; to encourage the growth of these industries and their contribution to the economy. Multiple tax incentives cannot be claimed by the same company and the incentives do not apply to companies that have already claimed an incentive for trade or business under any other law in Nigeria. Tax incentives cannot be claimed more than once, they mainly apply to support budding companies. For example, companies that are engaged in gas utilisation enjoy a three-year tax-free period. This tax-free incentive can be renewed for a further two years after the initial three-year period, and no more. This implies that the tax incentive cannot be claimed by a company more than once and cannot be enjoyed by any company that is created by the restructuring of companies or by companies that have formerly enjoyed the incentive.

SELF-ASSESSMENT EXERCISES

a) What is the rationale for taxation?
b) What is the impact of Finance Act 2021 with reference to educational institutions?
c) Which entities are eligible for tax holiday in Nigeria?
d) What component of a company's income is subject to tax?
e) Is it possible for an entity to claim tax incentive twice?

1.5 Summary

This Unit outlined the objectives of taxation and the extent to which taxation can generally be used as a tool to promote the objectives of governance. It also identified the organisations and business entities that are subject to taxation. Some business entities that enjoy tax holiday were identified as entities that operate in industries that critically affect the economy, such as the manufacturing sector and others. The tax holiday does not extend beyond five years, and they are mainly applicable to new companies in a single five-year period only.

1.6 References/Further Reading/Web Sources

1) John Kay, 'The Rationale of taxation (1986) 2 *Oxford Review of Economic Policy* 1-6
2) Maryam Ishaku Gwangdi and Abubakar Garba, 'Administration of Companies Income Tax in Nigeria: Issues of Compliance and Enforcement' (2015) 7 *European Journal of Business and Management* 18-25
3) Onyejekwe, C. 'Corporate tax as a utility for economic growth: challenges of compliance and enforcement in Nigeria' (2018) 29 *International Company and Commercial Law Review* 449-463
4) Abel Ebeh Ezeoha and Ebele Ogamba, 'Corporate tax shield or fraud? Insight from Nigeria' (2010) 52 *International Journal of Law and Management* 5-20
5) Olatunde Julius Otusanya, 'The role of multinational companies in tax evasion and tax avoidance: The case of Nigeria, (2011) 22 *Critical Perspectives on Accounting* 316–332

1.7 Answers to Self-Assessment Exercise

a) The rationale for payment of taxes include, to fund government expenditure and to promote the objectives of welfare economics. Governments across the world engage in infrastructural development and other public service functions. To fund these objectives, governments require significant financial resources, hence, taxes are levies to aid governments in fulfilling their mandate.

b) The impact is that the scope of taxation as it affects organisations have been extended to educational institutions; they no longer enjoy tax exempt status and they have now been excluded from the list of tax-exempt vehicles. Section 28 Finance Act 2021.

c) The entities are agricultural loans, manufacturing, export-orientated businesses, petrochemical projects, and research and development activities. In addition, enterprises in the various free trade zones are exempt from taxes, levies and duties, and foreign exchange restrictions.

d) Companies are required to pay income tax on their taxable profits. The distributable dividends in companies are also subject to withholding tax, before the dividends are paid out to the shareholders of the company.

e) Tax incentives cannot be claimed more than once, they mainly apply to support budding companies.

MODULE 6 COMPANY TAXATION

Unit 2: Regulation of Corporation Tax

2.1 Introduction

This Unit will examine the regulation of company taxation in Nigeria. It will highlight the regulatory control over corporation tax and the rates of tax required to be paid by various sizes of companies in Nigeria. Relevant sections of the Acts that regulate corporation tax will also be highlighted in relation to their application. Other relevant types of taxes will also be outlined along the requirement for the main corporation income tax. Finally, the administration of taxation in Nigeria and the powers of the administrative body will be outlined.

2.2 Learning Outcome

By the end of the unit, you should be able to

2.3 Corporation Tax Rate

The Company Income Tax Act CITA 2011, is the principal law that regulates the taxation of companies in Nigeria. Provisions of the Finance Act 2021 also apply in relation to corporation tax in Nigeria. Although taxation in Nigeria is administered by the three tiers of government, Federal, State and Local government, depending on the entity or service that is taxed, corporation tax is under the control of the federal government of Nigeria. Companies that are registered to do business in Nigeria are required by law to pay taxes to the federal government, known as companies' income tax. Hence, the laws that regulate corporation tax is enacted by the National Assembly and the agency that administers corporation tax is an agency of the federal government, namely the Federal Inland Revenue Service FIRS.

Companies Income Tax CIT is a tax that is paid on the profits of companies in Nigeria. Any company whether foreign or local, that is registered to do business in Nigeria is required to pay CIT. This includes private and public limited liability companies.

Resident companies are liable to corporate income tax on their worldwide income, while non-residents are subject to CIT on their Nigeria-source income.

In Nigeria, CIT is charged at the rate of 30% of a company's income for companies that have more than N100 Million Naira annual turnover. For companies that record between N25 Million and N100 Million, CIT is charged at the rate of 20% of company income. The tax is assessed on a preceding year basis - tax is charged on profits for the accounting year ending in the year preceding assessment. Companies having less than N25 Million turnover are not liable to pay company income tax in line with the *Finance Act 2021*.

Other rate of corporate tax include –

1) **Real Estate Investment**

   Companies Real Estate Investment Companies that are approved by the Securities and Exchange Commission to operate in Nigeria will be exempt from income tax on rental income. Also the dividends earned in a financial year will be exempt from income tax provided that at least 75% of the dividend is distributed within 12 months.

2) **Petroleum profit tax (PPT)**

   Petroleum profit tax is a tax on the income of companies that carry out petroleum operations in the upstream sector, PPT is paid in lieu of CIT. The PPT rates vary, depending on the operation. - It is 50% for petroleum operations under production sharing contracts PSC with NNPC.

   a) The rate is 65.75% for non-PSC operations, including joint ventures (JVs), in the first five years during which the company has not fully amortised all of its pre-production capitalised expenditure.
   b) The rate is 85% for non-PSC operations after the first five years. Upstream gas profits are taxed at 30%.

   Holders of a Petroleum Prospecting Licence and Petroleum Mining Lease will be required to pay CIT at 30%, and Hydrocarbon Tax (HCT). HCT rates are as follows:

Converted/renewed Onshore and Shallow Offshore (PML)- 30%; or Onshore and Shallow Onshore (Prospecting Petroleum Licence & Marginal Fields) - 15%

Deep offshore are exempt from HCT. This means that the highest headline tax rate for companies in the upstream oil and gas industry will be 60%.
See the *Petroleum Industry Act 2021* for additional details.

3) Tertiary education tax

Tertiary education tax is imposed on every Nigerian company at the rate of 2.5% of the assessable profit for each year of assessment. See the *Finance Act 2021*. The tax is payable within two months of an assessment notice from the FIRS.

In the determination of the profit of a company that should be subject to CIT, under the Companies Income Tax Act, certain deductions are allowable. Section 24 of CITA outlines the scope of these deductions, in determining the taxable profits of the company. Section 24 provides that '*save where the provisions of subsection (2) or (3) of section 14 or 16 of this Act apply, for the purpose of ascertaining the profits or loss of any company of any period from any source chargeable with tax under this Act, there shall be deduction all expenses for that period by that company wholly, exclusive, necessarily and reasonable incurred in the production of those profits.*

Section 24 further includes the following categories of deductions:

(a)any sum payable by way of interest on any money borrowed and employed as capital in acquiring the profits;

(b) rent for that period, and premiums the liability for which was incurred during that period, in respect of land or building occupied for the purposes of acquiring accommodation occupied by employees of the company.

(c) in the case of any property-holding company expenses attributable to the maintenance of the property, directors' remuneration, which shall not exceed N10,000 per annum in respect of each director, and the number of directors to be so remunerated shall in no case exceed three;

(d) any outlay or expenses incurred during the year in respect of salary, wages, or other remuneration paid to the senior staff and executives cost to the company of any benefit or allowance provided for the senior staff and executives which shall not exceed the limit of the amount prescribed by the collective agreement between the company and the employees.

(e) Any expenses incurred for repair of premises, plant, machinery or fixtures employed in acquiring the profits.

(f) Bad debts incurred in the curse of a trade or business proved to have become bad during the period for which the profits are being ascertained.

(g) Any contribution to a pension, provident or other retirement benefits fund, society or scheme approved by the Joint Tax Board under the powers conferred upon it by paragraph (g) of section 85 of the Personal Income Tax Act.

(h) in the case of profits from a trade or business, any expense or part thereof

(i) the liability for which was incurred during that period wholly, exclusively, necessarily and reasonably for the purposes of such trade or business and which is not specifically referable to any other period or periods, or

(ii) the liability for which was incurred during any previous period wholly, exclusively, necessarily and reasonably for the purpose of such trade or business and which is specifically referable to the period of which the profits are being ascertained;

Section 25 and 25A of CITA also provide for deductions of donations made to fund, body or institutions in Nigeria for the purpose of ascertaining the profits. Section 26 of the Act permits a deduction for the purpose of research and development, provided such a deduction does not exceed 10% of the profit ascertained before any deductions.

Certain deductions are not permitted by the Act, these are outlined under s 27.
Deductions not allowed

Notwithstanding any other provision of this Act, no deduction shall be allowed for the purpose of ascertaining the profits of any company in respect of-

(a) capital repaid or withdrawn and any expenditure of a capital nature;

(b) any sum recoverable under an insurance or contract of indemnity;

(c) taxes on income or profits levied in Nigeria or elsewhere, other than tax levied outside Nigeria on profits which are also chargeable to tax in Nigeria where relief for the double taxation of those profits may not be given under any other provision of this Act;

(d) any payment to a savings, widows and orphans, pension, provident or other retirement benefit fund, society or scheme except as permitted by paragraph (g) of section 24 of this Act;

(e) the depreciation of any asset;

(f) any sum reserved out of profits, except as permitted by paragraph (f) of section 24 or 25 of this Act or as may be estimated to the satisfaction of the Board, pending the determination of the amount, to represent the amount of any expense deductible under the provisions of that section, the liability for which was irrevocably incurred during the period for which the income is being ascertained;

(g) any expense of any description incurred within or outside Nigeria for the purpose of earning management fee unless prior approval of an agreement giving rise to such management fee has been obtained from the Minister;

(h) any expense whatsoever incurred within or outside Nigeria as management fee under any agreement entered into after the commencement of this section except to the extent as the Minister may allow;

(i) any expense of any description incurred outside Nigeria for and on behalf of any company except of a nature and to the extent as the Board may consider allowable.

The Federal Inland Revenue Service (FIRS) is the body that administers or oversees company taxation. It is an agency of the federal government with enormous powers to administer tax regulation in Nigeria. The extensive powers of the FIRS are outlined in the *Federal Inland Revenue Service (Establishment) Act, 2007*.

SELF-ASSESSMENT EXERCISES

a) Outline the various types of corporate tax in Nigeria.

b) List at least three prohibited deductions.

2.4 Summary

This Unit concludes the Module on corporate taxation. It also concludes the course. It briefly identifies the rate of corporate taxation in Nigeria. The rate of corporation tax varies, depending on the size of companies and the industries where they operate. The main rates were outlined in the Unit. Further, the scope of deductions that are allowable from the income of a company before the income is taxed was outlined, as provided under s 24 of the CITA 2011. Deductions that are not allowed are outlined under s 27 of the Act. This Unit highlights the main corporate tax rates in Nigeria, it does not contain an exhaustive examination of the scope of corporate taxation in Nigeria. Further reading is required to enhance the scope of your knowledge on the topic.

2.5 References/Further Reading/Web Sources

1) Maryam Ishaku Gwangdi and Abubakar Garba, 'Administration of Companies Income Tax in Nigeria: Issues of Compliance and Enforcement' (2015) 7 *European Journal of Business and Management* 18-25

2) Onyejekwe, C. 'Corporate tax as a utility for economic growth: challenges of compliance and enforcement in Nigeria' (2018) 29 *International Company and Commercial Law Review* 449-463

3) Abel Ebeh Ezeoha and Ebele Ogamba, 'Corporate tax shield or fraud? Insight from Nigeria' (2010) 52 *International Journal of Law and Management* 5-20

4) Olatunde Julius Otusanya, 'The role of multinational companies in tax evasion and tax avoidance: The case of Nigeria, (2011) 22 *Critical Perspectives on Accounting* 316–332

2.6 Answers to self-Assessment Exercise

a) They include Companies' Income Tax, Petroleum Profits Tax, and Tertiary Education Tax.

b) The prohibited deductions are:

(i) *capital repaid or withdrawn and any expenditure of a capital nature;*

(ii) *any sum recoverable under an insurance or contract of indemnity;*

(iii) *taxes on income or profits levied in Nigeria or elsewhere, other than tax levied outside Nigeria on profits which are also chargeable to tax in Nigeria where relief for the double taxation of those profits may not be given under any other provision of this Act;*

(iv) *any payment to a savings, widows and orphans, pension, provident or other retirement benefit fund, society or scheme except as permitted by paragraph (g) of section 24 of this Act;*