

**“THE LIQUIDATION AND RECEICERSHIP PROCESS IN
ZAMBIA- *WITH SPECIAL REFERENCE TO THE BANKING
INSTITUTIONS.*”**

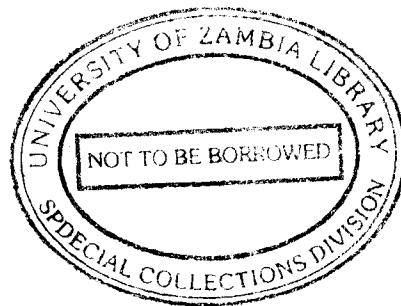
BY

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THE UNIVERSITY OF ZAMBIA
SCHOOL OF LAW

I recommend that this obligatory essay prepared under my supervision

By

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Entitled:

**“THE LIQUIDATION AND RECEIVERSHIP PROCESS IN
ZAMBIA-WITH SPECIAL REFERENCE TO THE BANKING
INSTITUTIONS”**

*Be accepted for examination. I have checked it carefully and I am
satisfied that it fulfils the requirements relating to formality as laid down
in the regulations governing obligatory essays.*

Date. 28/12/05

Signed.
Mr. Geoffrey C. Mulenga
SUPERVISOR

DEDICATIONS

This piece of work is dedicated to my husband Mr. Mulutula Chilufya for being my guiding angel during research and for that ‘pearl of strength’ in my times of need.

It is also dedicated to my four wonderful children, Mwewa, Chola, Kalaba and Mumba for being an understanding bunch during those long periods of my absence from family participation. This work is for you guys and thanks once more for being such good children.

To Dad-I am eternally indebted to you for instilling in me a sense of purpose and courage during my formative years. It was always your wish to have at least one of your children take after you. Sadly, you have not lived to see your wish come true. MYSRIP. To Mum thanks for teaching me to reach for the stars.

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INTRODUCTION

This essay is divided into five chapters, each covering different topics of the liquidation process of financial institutions with a bias for banking. This page deals with introductory issues and an overview of the whole essay.

As will be seen later, this paper has restricted itself to financial institutions and as the Banking and Financial Services Act is the one that regulates banks and other non-banking financial Institutions, I have picked on banks as the main theme of discussion.

In the first chapter, no discussion of the liquidation process applicable to banks is attempted, as this is reserved for subsequent chapters. Notwithstanding that, I have also avoided starting with discussing the process that is followed when the bank is being wound-up in my first chapter. This approach is deliberate as the essay begins by pointing out the contradictions that have been created by the formation procedure of banks and the effect this has on the winding-up process. However, chapter II discusses that in greater detail.

Chapter I delves into the incidents of the two Acts i.e. The Banking and Financial Services Act and the Companies Act, that regulate the financial Institutions and how banks are formed under two different statutory provisions and the effect this has on the liquidation process. It has also touched on the duties and powers of the liquidator as they are found under both Acts. An attempt is made to answer the question, what is the practice and procedure of the court in this process?

Chapter II looks at some of the causes of bank failures and how Bank of Zambia has tried to respond to some of these problems considering the nature of banks. Hence it has looked at the role played by the liquidator who is the main actor in the whole process.

Chapter III is concerned with whether or not the parties to the liquidation process are getting a fair deal under the existing legislation and case law. This looks at the problems

raised in chapter II and is all the more poignant as it will delve into problems that the interested parties face. In this chapter, an attempt is made to address the question of how the law has failed the parties if at all it has.

Chapter IV is the conclusion of the whole essay and restricts itself to providing a critical analysis of the main issues raised in the essay. The conclusions are based on my perception of the liquidation process and what may possibly be done to improve its administration.

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CHAPTER ONE

1. BANK AND COMPANY FORMATION

1.0 BANKS AS COMPANIES FIRST AND FINANCIAL INSTITUTIONS SECOND

A company comes into existence by a legal process and when, for any reason, it is desired to end its existence, it must again go through the legal process of winding up its affairs. This is because it is an incorporated association, which is an artificial person, created by law, having separate entity, with a perpetual succession and a common seal¹. In the words of **Professor Gower**: “*Winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members.*”² It was thus held in **Reuss(Princess) V. Bos** that a registered company can only be extinguished by winding up or in certain cases by being struck off the register without winding-up proceedings being taken.³ Winding up or liquidation is the process by which the management of a company’s affairs is taken out of its director’s hands, its assets are realized by a liquidator, and its debts are paid out of the proceeds of realization. If any balance remains in the hands of the Liquidator, it is divided among the members of the company in accordance with their rights under the Articles⁴. The winding up of a company is a statutory process by which the existence of a company is brought to an end. This essay is concerned with how the company/bank is managed during its liquidation i.e. assuming that it has failed to meet its objectives and creditors force it into liquidation.

In Zambia, the process of winding up of a bank or any Financial Institution is regulated by two statutes or statutory instruments, namely, the **Banking and Financial Services Act**⁵ and the **Companies Act**⁶. This is so, because when a bank comes into being, it does so as a company and as such, it is under a legal obligation to fulfill all the

¹ Bagrol, Ashok, K. Company Law. 10th ed (1948) Vikas Publishing House

² Gower L.C.B., The Principles of Modern Company Law, 3rd ed. P.647

³ (1871) LRSS HL 176

⁴ Bagrol, Ashok, K. -Company Law, 10th ed. 1948. Vikas Publishing House.

⁵ Cap 387

⁶ Cap 388

requirements of the Companies Act relating to company formation⁷. In other words, they are incorporated as companies ‘*first*’ in accordance with **Part II of** the Companies Act of the laws of Zambia and then as Financial Institutions ‘*second*’ under the Banking and Financial Services Act, and therefore ordinarily are expected to always comply with all the provisions of the two Acts under which they are incorporated. The requirement for a license from the Registrar of banks and Financial Institutions is largely due to the nature of its business i.e. financial intermediation. The Registrar of banks and Financial Institutions is a senior officer of the Central Bank, in this case the Bank of Zambia, “BOZ”.

Section 2 of the BSF Act, defines a Bank as a ‘*Company*’ that holds a banking license. A company means a *body corporate* incorporated under the Companies Act or the Co-operative Societies Act. It can therefore be submitted at the outset that Banks in Zambia do not entirely fall under the B&FS Act. The question one would ask is; if that is the case, how then do liquidators deal with the issue of the company which legally speaking remains in existence after the bank is wound up? Do they liquidate the two legal entities at the same time or separately or better still; does the remaining entity die a natural death without having to go through the motions of legal extinction? **Dr Kenneth Mwenda**⁸ comments on the issue of the dual existence of a bank as follows: “*Stating clearly in its definition ...defining a bank as simply a company that holds a banking license raises a number of illogical difficulties...the Companies Act does not place any statutory obligation on the companies, either at incorporation or at any other time, to furnish the Registrar of Companies with a Memorandum of Association.*”⁹ *One of the consequences of this feature is that it is not easy to tell what the objects of the company/bank are. Indeed the objects could be anything but paddling in ‘illegal’ waters. We are therefore left to look at evidence as to whether or not the company had as its substantial business the activities of ‘banking’. The problem is thus circular.*”¹⁰

What the above submissions imply is that, it is perfectly valid for a bank to be multifunctional, and engage in other businesses unrelated to its core-banking function in Zambia. However, the problem that this raises is at liquidation. When we review the

⁷ PART II-INCORPORATION AND MODIFICATION OF COMPANIES of the Companies Act 1994

⁸Mwenda K.K Banking Supervision and Systematic Restructuring-Cavendish Publishing Ltd.[2000] At pg 6

⁹Kaoma Mwenda- Banking Supervision and systematic Restructuring. P.6.

¹⁰Kaoma Mwenda- Banking Supervision and systematic Restructuring. P.6.

provisions of the law as they stand now, there is no provision to deal with the Company that remains after the bank has ceased to exist in the Banking and Financial Services Act. This definitely raises a practical difficulty for the liquidator who is in the process of liquidating a bank and is aware of the legal issue. What currently obtains is that, if the bank is not engaged in other ventures, the liquidator simply winds up the bank and that ends the liquidation process. But if it is found that it was involved in other ventures as a company as well as the bank, he will bring to an end the activities of the bank and hand over the remaining business to the shareholders who may then carry on the trading, and of course, they will not be allowed to refer to themselves as a 'bank' as that has ceased to exist.¹¹ For this reason, the process of bank formation as is the case now needs to be reviewed. Therefore, in view of the above, the correct procedure when liquidating would seem to be to simultaneously liquidate both legal entities.

1.1 THE LIQUIDATION PROVISIONS FOR A BANK

The liquidation provisions for a bank are covered under **Part XIII** of the Companies Act and **Chapter VII** of the Banking and Financial Services Act. **Section 86** of the Banking & Financial Services Act stipulates that for a bank to be classified as insolvent, it must cease to be able to meet its obligations as they fall due (liquidity insolvency) or when its assets are technically capital insolvent. In **Re Debtor**¹² it was ruled by Goff J. that, it is only the debts presently payable which shall have to be considered for the purpose of determining inability to pay debts. Any other view would lead to absurdities. A man is not unable to pay his debts because at some future time he will have to pay a debt which he would be unable to meet if it was presently payable. Therefore, this situation can only be determined by the court. Thus in **Re J. P. Swain Ltd** it was held that whether it is proper to make an order for the compulsory winding up of an insolvent company is entirely within the discretion of the court and its decision will not be interfered with unless he has erred in principle.¹³ Furthermore, it has also been held that neglect to pay after a demand by a creditor is cogent evidence that the company is unable to pay its

¹¹ section 117 of Banking and Financial Services Act.

¹² No 17, 1996 in Goode M R (1990), Principles of Corporate Insolvency Law at p. 32

¹³ (1965) 2 AllER 761

debts but a company will not be deemed unable to pay its debts where the relevant debts are not yet due for repayment.¹⁴ The court's discretion in this matter is limited to determining whether or not the creditors have proved a bona fide debt and once that is recognized, the court has no further discretion in the matter and must grant the petition for winding up of the company or bank as the case may be. This was settled in the case of **Re Chapel House Colliery and Company** where the court held that: "There is no case in which a petition by a bona fide creditor for winding up an insolvent Company has ever been dismissed."¹⁵ In the case of **Bowes V. Hope Life Insurance and Guarantee Co. at page 402**, Lord Cranworth had this to say: "...it is not a discretionary matter with the court when a debt is established, and not satisfied, if there be a valid debt established, valid both at law and in equity. One does not like to say positively that no cause could occur in which it would be right to refuse it, but, ordinarily speaking, it is the duty of the court to direct winding-up."

In the matter of the **Companies Act Cap 388 and Re Supreme Furnishers**,¹⁶ it was stated that the practice and procedure to be followed under the Companies Act for winding-up of a company are those under the **English Companies Act of 1929**.¹⁷ In other words, the **Zambian Companies Act** should be read together with the Winding up rules of 1929 of the English Companies Act.¹⁸ The same practice and procedure are also adopted when Banks are being wound-up. The adoption of the English Companies Act into our laws has been provided for by **section 10 of the High Court Act, Cap 27** which provides guidance for the court as to procedure and practice to adopt where it is found that there is a lacuna in our own Rules, the procedure and practice to be adopted for the time being is that which is observed in England. In the case of **Dean Mungomba & 2 others V. Peter Machungwa and another and the Attorney General**¹⁹, the above procedure was formerly adopted by the courts. And in this case, the Supreme Court held that, once it is accepted that our Rules do not provide for the practice and procedure...we

¹⁴ Re Bryant Investment Co. Ltd (1974) 2 AllER 683

¹⁵ (1883) 24 CH.D. 259

¹⁶ 2003/HP/0354

¹⁷ Zikonda J. in Supreme Furnishers Ltd (in liquidation)

¹⁸ Rule 31 of the Companies Winding-up rules 1929

¹⁹ SCZ No 3, 2003

adopt the practice and procedure followed in England. Our Rules are for the purposes of...completely discarded and there is a strict following of the procedure and practice of the Rules of the Supreme Court. Indeed, section 10 of the High Court has been used as the conduit through which English laws are adapted to our Zambian jurisdiction.

1.2 LIQUIDATION OR REHABILITATION?

The problems that arise from an insolvent bank do not always present themselves as legal problems because economics are often interwoven with the cause and effect of insolvency. Thus it has long been recognized that the necessity of some form of collective effort in dealing with the voluntary or involuntary insolvent banks must be put in place. Not only the insolvent banker, but also his creditors must decide whether liquidation or rehabilitation best serves their respective interests. Adverse though their relative positions may appear, there are factors that may be conducive to meeting on a common ground. Like the saying goes, “running the ‘Race of Diligence’ may receive legal sanction, but it creates inequitable and wasteful results.”²⁰ In other words, liquidation must not be the first choice but the last resort. In effect, what happens to deposits once a bank is declared insolvent is that, short-term, liquid deposits are suddenly involuntarily transformed into long-term, illiquid deposits.

In arriving at a choice between liquidation and rehabilitation, the causes of the insolvency are an important but not necessarily the only factors to be considered. Many factors enter into a realistic solution of the question. These factors will not be discussed here but will be discussed in Chapter three of the essay. However, suffice to say that with banks so highly geared, the value obtained at any time from liquidating the asset portfolio by calling in loans and realizing assets at distress prices is likely to be less than the total deposit liabilities. Should the bank have to be wound-up, depositors would receive less than 100% compensation. This is the reality which must be taken into consideration when arriving at a decision.

²⁰ See Glenn, “Liquidation” (ed. 1935) 9-10

1.3 DUTIES AND RESPONSIBILITIES OF A LIQUIDATOR

The duties and responsibilities of the liquidator are clearly spelled out and are his or her terms of reference. The liquidator is appointed either by the Courts or by the creditors in the case of Involuntary Liquidations [which situation is of concern in this essay because it is applicable to most banks whose liquidations in this country have been involuntary or compulsory]. The Bank of Zambia tries as much as possible to avert bank failures right from the issuance of a licence by the Registrar. One of the methods used is by controlling the quality of people who manage commercial banks or by requesting for periodic reports or on-site inspections.

(i) QUALITY CONTROL

It is at this stage of seeking a banking license that the bank to be is subjected to quality assessment in terms of the suitability of its directors to operate a bank. The experience and character of its chief executive and chief financial officer are also scrutinized. This assessment also extends to looking at the adequacy of the start-up capital of the business. Where in the opinion of the Registrar the applicants are deficient and/or the business plan as submitted does not convince him, the application is rejected.²¹ However, this is subject to an appeal to the Minister of Finance. Where however the application is successful, the license is then issued to operate the bank. This registration process of the 'would be' commercial bank is supposed to eliminate potential liquidation risks arising from poor bank oversight and inexperience. This process is very necessary but it does not take away the risks completely because people react differently when subjected to different levels of business risks and stress.

To ensure that directors and managers are able to exercise their duties in the best interest of commercial banks, it is a requirement that any person who has control of one bank cannot have control in another bank. Naturally, the implication is that, controllers of one bank cannot be major shareholders nor have executive responsibilities in any other bank. This is meant to check the problem of conflict of interest. The Companies Act does not

²¹ Under Part I, 7 (b) and (c)

necessarily expressly prohibit cross-directorship but has provided that any such restrictions on the appointment of directors can be provided for by the company itself if it so requires.²² To this effect, the B&FS Act has tried to come in and provide some kind of safeguard under **Part I**. But quite clearly from what we see on the ground, the provision is not sufficient to restrain bad elements from entering the sector.

The provision²³ to appeal against a decision made by the Registrar who is considered to be the most qualified personnel in this sector to the Minister has been a major drawback and source of worry to most people. The initiative closely related to this aspect of supervision control is that, if people who are considered to be potential risks are not eliminated at inception, then the likelihood of having more bank failures will be high. The intended purpose of the provision was to assist those applicants who had been unfairly treated by the Registrar. But it has ended up introducing into the system decisions which are based on political considerations rather than the provisions of the Act. An ideal situation would be for the establishment of a quasi-tribunal composed of qualified personnel as is the case for the Lands Act. This body if constituted would be an authority on licence related problems and its decisions would be final and binding.

According to **Mr. Mlutula Chilufya** who is the former liquidation manager of Prudence bank, “*quality control if extended to those who join banks after it has been in business would greatly reduce the risk of bank failure.*”²⁴ He further submits that; “*the risk of loss or Bank failure usually arises from two types of bankers. First, there are the ‘fly-by-night’ operators with no intention of looking after depositors’ money but to use it for their own selfish ends. Secondly, there are those honest bankers whose activities involve a degree of risk but are prudent enough not to let down their depositors. The former should be eliminated from the system at all costs...certainly; fraud by bank officers and staff has been a major cause of most bank failures in Zambia.*”²⁵

There are a number of directors who have been known to be in the centre of bank failures but have gone on and found themselves in other banks at the level of management

²² Part X-section 207 (4)

²³ Section 31 (I) of the Act

²⁴ Former Liquidation Manager of Prudence Bank and Consultant Receiver for Union Bank-in an interview

²⁵ Mr Mlutula Chilufya-former Liquidation Manager for Prudence Bank.

contrary to the B&FS Act and most of these banks have later on collapsed. Mr. Islam, who was the former General Manager of BCCI left after it collapsed, he then went and joined Union Bank which also later went under. Next example would be Mr. Muntanga who was a Deputy Managing Director of Africa Credit Bank which also went under and after its demise; he obtained a license to run a Bureau, which he is still operational at the time of writing this essay (2005).²⁶ Lastly but not the least, the case of Faustine Kabwe, the former senior manager of Meridian bank who later on went and started Access Financial Services which is now being investigated for financial irregularities and money laundering to mention just a few.²⁷ In the matter of **Section 84 of the B&SF Act & Access Financial services Ltd**, the Bank of Zambia cited among other things breaches of the law including engaging in unsafe and unsound practices as the grounds for taking possession of the company (which is the equivalency of liquidation).²⁸

(ii) *THE JOINT OVERSIGHT*

The joint oversight makes reference to the conflict that arises when the bank is finally being wound up. After the promoters have received a banking license, they come directly under the supervision of the “BOZ” and the provisions of the Banking and Financial Services Act become paramount. **Chapter VII, paragraph 85** states that “*In the event of a conflict between the provisions of this chapter and those of any other law of Zambia, the provisions of this chapter shall prevail to the extent of inconsistency.*” It therefore means that where there are ‘gaps’ in the Banking and Financial Services Act regarding liquidation provisions, then the Companies Act can be used and will carry the same legal force as the former. This situation is very clear in the description of the duties and responsibilities of a liquidator, where for example the Companies Act is more detailed than the other in one instance, and the Banking and Financial Services Act is more specific in other areas and vice versa. As an example **section 85** of the B&FS Act, a bank is insolvent when it ceases to be able to meet its obligations as they fall due or when its assets are insufficient to meet its liabilities.²⁹ But under the Companies Act, the

²⁶ Unifinance Bureau.

²⁷ 2003/HPC/0144

²⁸ This was a measure taken in order to protect the integrity and stability of the financial services system.

²⁹ Section 86 of Chapter VII, part 1

situation is even more detailed that apart from failing to honor its obligations, a company can be wound up for failing to commence its operations within 12 months after its incorporation.³⁰ Clearly, the B&FS Act is restricted to banks and financial Institutions and as such its provisions are specifically related to problems common to the financial system.

Under the Companies Act, **section 289**³¹, the liquidator may carry out the following responsibilities;

- Carry on the business of the company in as far as is necessary for the beneficial winding-up thereof. The liquidator is expected to carry on the business of the Company but this '*business*' is neither defined nor specified in the Act. It would have been helpful if a definition was put in the Act and/or limitations placed upon it. Otherwise, one is forced to assume that it would be up to the subjective determination of the liquidator himself and basically that's where the problem arises from. The question is how far may one push this provision before his actions can be said to be ultra vires? It may be argued that the Bank of Zambia is very particular about the people that it appoints to carry on the liquidation process; however, fraud is an element that one cannot just wish away. As submitted above, people tend to react differently under certain conditions. In the disposal of property, a dishonest liquidator may sell assets to himself if he so wished. Besides, in both Acts, such an action is not expressly forbidden and as such, the restraint on him is merely a moral one. However, it has been ruled in the case of **Re Wreck Recovery & Salvage Co** that, how far it is necessary to carry on the business for the beneficial winding-up of the company is a matter to be determined by the court.³² Also in **Re Great Eastern Co. Ltd.**, it has been held that 'the carrying on the business could be so long as the liquidator bona fide and reasonably formed the opinion that the carrying on of the business was necessary for the beneficial winding-up of the company, the fact that he was

³⁰ Section 272 Of the Companies Act

³¹ (2) (a) of Companies Act

³² (1880) 15 Ch.D 353

wrong does not mean that he was at fault.³³ Furthermore, the liquidator has power to pay off all classes of creditors in full subject to ranking.³⁴

- Make any compromise or arrangement with creditors or persons claiming to be creditors or persons having or alleging to have any claim against the company, whether present or future, certain contingent, ascertained or sounding only in damages or whereby the company may be rendered liable.³⁵ Make agreements on all questions in any way relating to or affecting the assets or the winding up of the company. Take any security for the discharge of any such debt, liability or claim and give a complete discharge in respect thereof.³⁶

Secondly, in accordance with the third provision, he has power to compromise a debt if he so decides.³⁷ The problem with this provision is that, it does not stipulate any guidelines or give any formula which he is supposed to adhere to when modifying the debt but it is left for him to decide. This provision may be used as a leeway to forgive some debtors especially if they are known to the liquidator. To counter-check this, the Bank of Zambia has created an in-house Liquidation Committee to monitor the use of these powers through regulations that have limited and curtailed the powers of the liquidator³⁸. To this effect, the liquidator does not act independently. While these regulations are welcome, it can be submitted that they lack generality because they are issued as a reaction to certain situations and most of the time on a trial and error basis.³⁹ As a consequence, it has been found that too many regulations have been issued to the consequence of stifling and slowing the liquidation process. For instance, some debtors do not have the means of paying off their debts. In that case, it may be appropriate for the liquidator to get security instead of insisting on money even if that security will not expunge the debt completely, especially where the debtor has failed to pay off a debt due to the high interest rates. Sometimes, he may just need to settle for the principle and

³³ (1941) Ch. 241

³⁴ (2) (b) “

³⁵ (2) (c)

³⁶ (2) (d)

³⁷ Subsection (2) (c) of Companies Act

³⁸ . Legally speaking, there is no provision for this Committee but one can assume that it exists because 'BOZ' has recognized the weaknesses in the Acts

³⁹ Mr. Chilufya, former Liquidation Manager for Prudence Bank.

forego the interest, if pursuing both proves to be uneconomical. This would help him to collect more in the long run.

- For the purposes of winding up the affairs of the company and distributing its assets, the liquidator may bring or defend any action or other legal proceedings in the name and on behalf of the company.⁴⁰
- The liquidator is also authorized to compromise any debt due to the company, other than a debt due from a member, where the amount claimed by the company to be due to it does not exceed fifty monetary units.⁴¹
- Sell the real and personal property and the things in action of the company by public auction, public tender or private contract either by transferring the whole thereof to any person or company or selling the same in parcels. Execute in the name and on behalf of the company, all deeds, receipts and other documents and for that purpose use when necessary the company Seal⁴².
- Prove, rank and claim in the bankruptcy of any member or debtor of any balance against his Estate and receive dividends in the bankruptcy in respect of that balance as a separate debt due from the bankruptcy and rate ably with the other separate creditors.⁴³
- Draw, accept, make and endorse any bill of exchange or promissory note in the name and on behalf of the company with the same effect with respect of the liability of the company.⁴⁴
- Take out letters of administration of the estate of any deceased member or debtor, and do any act necessary for obtaining payment of any money due from the debtor or his estate which cannot be conveniently be done in the name of the company, in which case, for the purposes of enabling the liquidator to take out the letters of administration or recover the money, the money due shall be deemed due to the liquidator himself.

⁴⁰ 289 (3) (a) of Companies Act

⁴¹ 289 (3) (b) of Companies Act

⁴² 289 3 (d) of the Companies Act

⁴³ 289 3(e) of the Companies Act

⁴⁴ (f)

- Appoint a legal practitioner to assist him in his duties, appoint an agent to do any business which the liquidator is unable to do himself,
- Give notice of the winding up in any jurisdiction where the company does business and do all such things as are necessary for winding up of the company and distributing its assets.⁴⁵

1.4 THE LIQUIDATION PROVISIONS IN THE BANKING & FINANCIAL SERVICES ACT

These provisions are covered in **Chapter VII** and they cover *Voluntary* winding up and as well as *Compulsory* liquidation by Bank of Zambia. In this essay we shall concentrate on Compulsory Liquidations by Bank of Zambia. The powers and duties of the Bank of Zambia as liquidators are covered in **Section 104** and these cover a wide range of powers. Under this Act, the Bank of Zambia may exercise any of the powers of the bank, whether express or implied, except that it shall obtain approval from the court for any of the following actions; sale of any assets of the bank having a value in excess of five million kwacha or such higher amount as the Minister may by statutory Instrument prescribe⁴⁶.

- The creation of a security interest in any asset of the commercial bank in favor of a creditor who extends new credit to the institution in an amount exceeding five million kwacha or any such higher amount as the Minister may by statutory instrument prescribe.⁴⁷
- The compromise or release of any claim if the amount of the claim exceeds five hundred thousand kwacha or ...The payment of any claim other than a claim in respect of an obligation incurred by the Bank of Zambia in the exercise of its powers in liquidation before the liquidation schedule filed with the court has been approved by the Court.⁴⁸

Within a period of six months after the date of its order for compulsory liquidation of a commercial bank, the Bank of Zambia may terminate all the contracts of employment of

⁴⁵ “ (h) and (I) respectively

⁴⁶ Section 104 (1) (a) of Banking and Financial Services ACT 1994

⁴⁷ “ (b) “ “

⁴⁸ “ (c) and (d) respectively of the same Act

any such person with the bank, any contract for services to which the bank was a party or any obligation of the bank as a lessee of real property.⁴⁹ This is because the bank has failed to perform and as such it is incapable of maintaining any standing obligation. Besides, some of these employees may have been party to the running down of the bank and thus may be classified as security risks. The letting off of the workers is a serious matter as the harm that they can cause in certain cases is very high. When Mr. Mulutula Chilufya was appointed as curator for Prudence bank, some former directors of the bank organized some thugs to attack him.⁵⁰ But when this failed, they connived with some former workers to steal the bank documents where they were implicated and thereafter burn the bank.⁵¹ This greatly reduced the recovery rate of the Liquidator who had to painstakingly reconstruct all the records. Bank of Zambia responded by mounting a 24 hour security over the curator and the bank.

The protection of employees' raises the larger issue of when reliance on the insolvency law should be avoided altogether so that certain public policy objectives can be achieved. For instance, to limit unemployment or rescue enterprises that are engaged in important national activities, the authorities may prefer to address the problems of a troubled company through various measures that will involve an extensive use of public funds and give the beneficiaries a substantial advantage over their less-favored competitors.

- Additionally, as soon as possible after the decision to liquidate a bank, the Bank of Zambia shall take any necessary steps to terminate all fiduciary functions performed by the bank, return all assets and properties held by the bank as a fiduciary to the owner thereof, and settle its fiduciary account.⁵²
- Send by registered mail, at the address shown in the commercial bank's records to all depositors, other creditors, safe keeping services customers and bailers of property held by the commercial bank a statement (in this part called "the

⁴⁹ " (2) (a) (b) and (c) of the Act

⁵⁰ October 1997- there is a Police Report to that effect which confirms the reason for attack.

⁵¹ Society House was burnt and it was proved that it was arson and the fire was started in the secretary's office. She was interviewed and arrested. But it looks like she bought her way out as nothing further came out of her arrest.

⁵² Section 104 (3) (a) of Banking and Financial Services Act 1994

Customers’ Statement”) of the nature and amount for which their claim is shown in the records.⁵³

The customer’s statement shall note that any claim must be filed with the Bank of Zambia before a specified date not earlier than sixty days thereafter and shall call upon safe keeping services customers and bailers to withdraw their property.

- Any property held in safe-keeping on the premises of the Bank that has not been withdrawn before the date specified in the customer’s statement shall be taken possession of by the Bank of Zambia in the manner prescribed by the regulations.⁵⁴
- Any unclaimed funds and property held by the Bank as a bailee together with inventories pertaining thereto shall be deemed to be unclaimed funds for the purposes of the provisions of the Act dealing with unclaimed funds and shall be dealt with accordingly.⁵⁵

No action of the Bank of Zambia that is otherwise valid shall be invalidated by reason of a failure to obtain any approval of the court under this section.⁵⁶ **Section 105** deals with Limitation of Filing of claims while **section106** deals with objections to liquidation schedule by any depositor, creditor or owner of a bank and any other interested party to the court. **Section 107**⁵⁷ deals with the Priority of creditors and it states that in any compulsory liquidation of a bank, there shall be paid in priority to all other debts in the following order:

- a. Necessary and reasonable expenses incurred by the Bank of Zambia in the application of the provisions of this part. These would include emoluments for the re-employed staff, office rentals, telephone, electricity and water bills, legal expenses and all the other operational costs facilitating the liquidation process. These bills are paid as they fall due to ensure the smooth running of the liquidation process.

⁵³ “ “ (b) “
⁵⁴ (4) “
⁵⁵ Section 104 (6) of the Banking and Financial Services Act 1994
⁵⁶ “ (7) “
⁵⁷ Financial Services Act 1994

- b. Taxes and rates due, whether payable to the Government or to a Local Authority. This includes corporate tax and is only relevant if it is established that the bank made some profit which has not been settled with the government. But if it was making a loss, then it will not be charged. Furthermore, Zambia Revenue Authority is sometimes compelled to refund any interest that it had been earning on withholding tax by dealing in treasury bills prior to the closure of the bank.
- c. Wages and salaries of officers and employees of the bank for the three months period preceding the effective date of seizure, within the limit of an amount not exceeding one hundred thousand kwacha per person or such higher amount as may be prescribed by regulation. After liquidation is invoked, the ex-employees do not get anything from the bank.
- d. Fees and assessments due to the Bank of Zambia.
- e. Deposits up to an amount not exceeding five hundred thousand kwacha per depositor or such higher amount as may be prescribed by regulation. This provision is intended to ameliorate the suffering of the depositors after the closure of the bank. Whether it achieves its intended purpose at all will depend on the amount of money that one has locked up and his individual needs.
- f. Other deposits or
- g. Other claims against the bank in such order of priority as the Court may determine upon application by the Bank of Zambia. This class of depositors may include the Bank of Zambia if it lent money to the Bank before it collapsed other creditors, contingent liabilities and equity capital. Being at the end of the list in ranking means that they will be last to be considered for payment. Most likely, they usually go away with nothing. In an effort to save Union bank from collapse, Bank of Zambia disbursed **K8, 241,776,611-27**

through an overdraft as lender of the last resort. It was an unsecured creditor and as such, when the Bank was liquidated, it got nothing.⁵⁸

However, there is a school of thought that criticizes this section by alleging that in terms of ranking, it is more tilted in favor of Bank of Zambia rather than the depositors. They also claim that the provisions of the section are too broad and as such they can cover any loss that may be incurred by Bank of Zambia including such losses as arising out of negligence. These criticisms are justified especially when one considers subsection (a) and (d) which are very broad indeed.

If depositors are not paid the full value of their claims immediately, some or all of the deposits are effectively temporarily "frozen". In the absence of an efficient secondary market for frozen deposits, both protected and unprotected depositors will experience losses in liquidity and, in addition, protected depositors will experience present value losses if they are paid the value of their claim after the date of resolution without interest. Thus, it would have been prudent for the Bank of Zambia not to take such a prominent role on the distribution list and to ensure that a system was put in place that covered losses arising out of lengthy keeping of depositor's money. Even though one would want to argue that the issue of covering for losses that may arise out of length keeping of investors' money is unattainable since the bank which is supposed to cater for that is not in a position to earn money because of its incapacity, there is another way of going around this problem. Indeed, it must be understood that, in seeking profits, banks lend on the basis of their customers' deposits, but not all deposits can be lent out. A certain share must be held in reserve at the Bank of Zambia. It is from that share where a depositor should recover the difference in value.

Because of the pivotal role of banks and their vulnerability to unusual risks, there seems to be good reasons to protect deposits through an appropriate scheme and, in this way, to protect both the bank and the banking system.⁵⁹ However, apart from the requirement for a reserve, the Bank of Zambia hasn't really come out on what type of scheme it would

⁵⁸ Union Bank Liquidation schedule as at 31 march 2001

⁵⁹ e.g., Benston and Kaufman, 1997 and 1998

want to adopt. But from the provisions under section 83, one gets an impression that the Central Bank would want all commercial banks to come up with their own kind of insurance like self-insurance schemes that may be approved by the Central Bank and others managed by the Central Bank itself. Whether this is workable remains to be seen. This is because the nature of such activities is precisely that they provide insurance against 'normal risks'. Any attempt to self-insure against abnormal risks like a bank run would involve foregoing normally profitable activities to hold large amounts of liquid assets.⁶⁰ A government run deposit scheme would have been a preferred option. Re-insurance of deposits with government-sponsored insurance funds has a special feature. Unlike conversional insurance, the main aim is not so much to recompense people after the loss of deposits, but to maintain confidence in banks so that they can continue with their 'normal' business.

Recently, experts have found evidence that delays in recovering the value of assets of failed banks in the 1930's and in reimbursing the depositors had strong and lasting effects on the persistence of the Great Depression in the U.S.⁶¹ Thus, the way depositors are treated at insolvent stage in terms of the magnitude of the losses they may incur and their access to the value of their deposit claims has important public policy implications. Accordingly, the ability and willingness of governments to quickly liquefy deposits at failed banks, as well as to keep deposit credit losses small through the appropriate implementation of prompt corrective action and least cost resolution strategies, significantly eases their ability to avoid too-big-to-fail (TBTF) or too-many-to-fail rescues of insolvent banks.

And in conclusion of this chapter, it must be made clear that the protection of depositors is a distinct economic policy of the state. The object of this economic policy may be said to have been established for the benefit of the depositors and creditors of the insolvent bank. Avoiding or minimizing depositor illiquidity at failed banks is a prerequisite for resolving insolvent banks efficiently. For the objective to be successful it needs to be implemented by vibrant well paid personnel. The personnel must be given the discretion

⁶⁰ Lewis M.K. and Davis K.T.-Domestic and International Banking [1987] PHILLIP ALLAN

⁶¹ kaufman, Loyola University Chicago and consultant to the Federal Reserve Bank of Chicago

as well as the teeth to bite where necessary. But putting at the apex a man who has a passing interest and knowledge in matters of banking is self defeating. Even though this is the chosen method of dealing with ailing banks in Zambia, it is doubtful whether it is the best method. Take an example of Meridian Bank, the government through BOZ tried to keep the bank running by pumping into it a large sum of money, but that action unfortunately did not keep it from going under. It is on this basis that Bank of Zambia has been accused of failing in its supervisory role and allegations of kick-backs have been leveled against it from several quarters.

Collaboration between auditors and regulators to conceal financial institutions' poor condition in order to maintain public confidence in the health of individual banks or banking system is not unique to the Zambian situation. At an international level, the danger of such a situation is still being unraveled in the BCCI case. After the UK was informed by Price Waterhouse in 1989 of the possible suspected fraud at the BCCI, the UK regulators wanted the 1989 BCCI audited accounts to be published with an unqualified audit opinion and this was done⁶². **Young** (1995) documented a similar political use of accounting in the case of the US savings and loan industry where accounting rules were changed to conceal the poor condition of the S&Ls in order to "buy time" for the industry to work out its problems.⁶³ This financial deception by politicians and bank regulators raises serious questions about accountability and the potential abuse of power. It can therefore be concluded that political pressure by the government can in most cases lead to undesirable results. Banking is a fragile business and is better left in the hands of the professionals.

⁶² Bingham, The Right Honorable L J, [1992]. Inquiry into the Supervision of the BCCI, London, HMSO

⁶³ Young J.J. [1995] getting the Accounting 'Right': Accounting and the Savings and Loan Crisis, Accounting, Organizations and Society 12:1.pp. 55-82

CHAPTER TWO

2.0 THE CAUSES OF BANK FAILURE

The causes of Bank failure in Zambia are many. Bank failure is not a phenomenon only peculiar to Zambia but it is a worldwide problem. By far the most famous episode known in human history was during the depression years in the USA where, in the four years from 1930, **9,096** bank suspensions occurred, imposing losses on depositors, shareholders and creditors alike to the tune of **\$2.5 billion**, and bringing about a sharp contraction in the money supply.⁶⁴ In Zambia, we have had our own share of bank failures. In the past 13 years or so, slightly over 10 banks have been closed. This was after the banking sector was liberalized and all restrictive Acts repealed.

While acknowledging the impact that deregulation of financial markets has had in the way banking is done, it has also contributed to new risks in a number of ways. This is because the ranges of activities permitted to banks have generally been expanded.⁶⁵ Rapid swings in energy and agricultural prices have exposed banks with large portfolios of loans to these sectors. In 1999, Bank of Zambia disbursed a lot of money through commercial banks under the Crop Marketing Fund, which were never paid back. While Bank of Zambia recovered by debiting the disbursing banks, clients in most cases never paid back to the commercial banks, thereby opening up a large stock of bad debts. Through Union Bank under the Crop Marketing Credit Revolving fund a total sum of **K417, 500,000-00** was lost by Bank of Zambia on account of bad servicing of debt by the Bank's customers and the eventual going under.⁶⁶

Another observed characteristic of the banking system, in the absence of a perceived guarantee of deposit safety is the vulnerability of individual banks to 'runs' and the contagious nature of the 'run' mentality. This may arise from instability in the macro-economy from technological changes, swings in investment expenditure and sometimes internal strife. Real sector disturbances can be magnified by 'overtrading' and the under-

⁶⁴ See Domestic and International banking by M.K. Lewis & K.T. Davis, Phillip Allan, 1987 at p. 129

⁶⁵ Domestic and International banking by M.K. Lewis & K.T. Davis, Phillip Allan, 1987 at p. 129

⁶⁶ Union Bank Liquidation schedule of 29th march 2001, p. VII

(iii) OPERATIONAL RISK- It is when the risk of running the bank is higher than the net income, i.e. over recruitment, allowances and higher salaries, etc. This risk may also arise from fraudulent employees, poor record keeping especially in the area of security documents. This risk is human centered and can be very difficult to manage where employees are poorly trained and recruited.

(iv) CONGLOMERATE RISK- This arises in situations where the bank is owned by a holding company whose activities co-mingle with those of the bank, like depositing and getting loans from the same bank without any meaningful security. Meridian Bank and the Chibote group of Companies is an example. Money and salaries were being paid from the bank on unsecured loans and at very low and uneconomical rates. Prudence Bank which was also linked to Magic Carpet, Prudence Bureau De'change and Devalia's Emporium is another example. In the case of Prudence bank, it is a fact that it disbursed unsecured loans to Devalia Emporium in the tune of K157, 500,000-00, Magic Carpet Travel obtained a loan of K489, 300, 000-00, Prudence bureau-K373, 300, 000-00, Musi Fashions-K94, 600, 000-00. All these companies were run by the Mr. Devalia who also was chairman for Prudence bank. These loans apart from being unsecured did not have interest calculated on them. All what was required was for the chairman to return the initial amount borrowed.

(vi) WITHDRAWAL RISKS- This is the ultimate risk in banking where the customers lose confidence in the bank and withdraw their money. No bank can withstand such a risk without support from the Central Bank and other players in the financial system. This usually arises from fear by depositors of having their money locked up and to avoid such an eventuality, they choose to withdraw their money at face-value under the first come first served fixed price rule of deposit contracts. This risk can sometimes be activated by careless reporting in the newspapers. Take an example Prudence bank; an article that appeared in the Chronicle newspaper sometime in 1995 started the speculations about the soundness of the bank. Just before receivership, this rumor had

grown to an extent that there was an actual run on it which severely caused liquidity problems.

All banks that have been liquidated in this country faced most of these risks and could not ably contain them. It is always said that banks are businesses like any other and should not be treated differently but experience has shown that banks occupy a very special place and play an important role in the economy of the nation and therefore should be handled differently. Next, we discuss the supervisory response to bank stress.

2.1 SUPERVISORY RESPONSE TO BANK STRESS

BOZ has been entrusted with the function of continuous supervision and periodical examination of all banking institutions. To this end, executive powers relating to inspections have been conferred on BOZ. They produce inspection reports and these are discussed with the concerned banks. Accordingly, a special dept of bank supervision has been set up. The “BOZ” has a method of assessing bank stress and insolvency through their on-site and off-site inspections. Banks are required to comply with requests for information and they may be required by law to furnish periodic returns on their activities or confidential and detailed statements of their operations and if required, to furnish explanations of the statements. Where however counseling and moral suasion fails the BOZ responds in the following manner:

Under **section 81, subsection 2**⁷¹ of the Banking and Financial Services Act, the Bank of Zambia may take the following supervisory actions: - **a)** take possession of the commercial bank; **b)** suspend its license for a period not exceeding six months; **c)** restrict its licence and **d)** revoke the licence. This is a departure from the old procedure which required the process to be done in stages i.e. appointment of a curator first followed by a receiver. The effect of possession needs to be analyzed properly as it entails the shareholders losing their tangible and intangible rights in the bank.

⁷¹ (as amended by Act no. 18 of 2000)

Furthermore, when we consider subsection 2(b) which stipulates the suspension of a licence for a period of 6 months, difficulties of how this is going to work come to mind. It is very difficult to suspend a licence and resume operations at a later stage as this will definitely have a negative impact on the confidence of the peoples in that particular bank. With the sad history of recent closures in the minds of the people, they will simply make a run on it which will eventually lead to a final chapter in the history of the bank. Banks are not like other companies which one can close and reopen with new stock and new management.

Subsection 4 states that the Bank of Zambia shall in writing inform the Minister, regarding the state of affairs of a bank in respect of which it intends to take action under this section. This provision was not there in the original Act. What used to exist then was that, not as a matter of right but out of good will, the governor used to consult the Minister or any other person he thought had an interest, before making a final decision concerning the bank. In other words, it existed as a custom in an implied way but he still had the power to make the final decision. However, this provision is now expressly stated and it is a mandatory provision. The implication of this section is that in the final analysis, it is a political decision that will be made rather than one entirely based on professional considerations. The professionals have been reduced to playing an advisory role only. The minister who is a political appointee is not a professional and therefore should not be given the power to make such important decisions. Like it has already been stated, banks are special in nature and need to be handled by people who understand the risks better. While the Minister is given advice about the options available to him by Bank of Zambia, his decision is normally going to depend on the political as well as the social considerations pertaining in the country. It will have very little to do with the professional advice that has been given to him.

In his decision, he is going to consider the effect of closure on the people that are going to vote for his party. Is the decision going to cost them votes or not? In other words, the fear of depositors experiencing inaccessibility to their funds may likely have important political as well as economic consequences that are going to have a compelling effect on the decision that the Minister is going to finally make. Affected depositors are more

likely to demand full and immediate access to their funds and the Minister and the government are likely to bow to the political pressures and both delay official recognition of insolvency (forbear) and fully provide protection for the depositors (too big to fail principle) before insolvency is finally declared. At the same time, the government itself is likely to view any loss in depositor liquidity as potentially detrimental to the aggregate economy and may be reluctant to permit conditions that would trigger this loss. Thus, it may maintain insolvent commercial banks in operation and protect all depositors and possibly other creditors in full by pumping in money. Such response further reduces market discipline and encourages additional moral hazard behavior by the banks.

Another negative effect that is likely to arise from this is the discouragement of the professionals from doing their jobs professionally. This is because the provision has deprived them of the power to sanction any commercial bank that refuses to comply with their orders. In other words, they have been made toothless without any legal muscle to compel a bank to obey their directives. The banks with political connections will simply use their political links to shift the pressure from their necks. Internationally we are reminded of Bank of Credit and Commerce which used its political connections to evade any inquiries into its operations wherever it operated. Even though the bank was insolvent, it still managed to open up branches in UK as well as America where it could not have been allowed to do so if it did not use its connections. Even now, its ramifications are still being felt.

Bank of Zambia being the official receiver has only such powers, rights, duties and functions as are conferred upon it by statute, rules, orders or decrees of the authority appointing it.⁷² It is appointed to take over the overall management of the bank and the powers include but not limited;

- a. To continue or discontinue any operations.
- b. To borrow money, whether on the securities of the assets of the bank or otherwise. The money should be for the preservation and management of

⁷² Davis V. Gray 16 Wall (US) 203

property in receivership. Such power conferred on the receiver to borrow should be exercised cautiously. It should only be exercised for the best interest of the bank and all persons interested therein.⁷³

- c. To stop or limit the payment of any obligation. The fundamental purpose of every receivership is to place the property involved in litigation under the control of the court so that it may be preserved and held ready for disposal in accordance with the final adjudication of the rights of the interested parties
- d. To employ or re-employ any necessary officer, employee or professional adviser.
- e. To execute any instrument in the name of the bank and to initiate or defend in any legal proceeding. A Receiver has powers and rights exclusively and it is his duty to collect and recover assets of receivership. He may maintain appropriate legal proceedings to such end. Where there is cause to believe that assets of a party are contained in a safe deposit box in a bank within the jurisdiction of the court, the court may grant the receiver permission that the box be opened and that he may be permitted to examine the contents and make inventory of it. The court may also allow the receiver to inspect the box for information concerning transactions relating to the property.
- f. To terminate the employment of any director, chief executive as the case may be.
- g. To terminate the interests of the shareholders at a value to be determined by the court.
- h. To enforce the individual liability of the directors and of the shareholders of the bank incurred in the ordinary course of business and on unpaid shareholders.

Upon seizure of the bank, the Bank of Zambia⁷⁴ may do the following;

⁷³ Bard V. Forbes State Bank 64 ND 239

⁷⁴ under Part II of the Banking and Financial Services Act, section 84

- i. Post in each branch of the bank a notice announcing its actions and specifying the date, hour, and minute at which the possession takes effect and if it's due to insolvency, the Bank of Zambia is required to send a notice to the court.
- ii. **Under section 84A** the Bank of Zambia shall be vested with full and exclusive powers of management and control of the bank which are basically the powers to liquidate the bank.
- iii. Under **section 84B**, the bank of Zambia where the bank it has taken possession of is found to be solvent can **restructure it, sell it, close it or take any action** which is necessary to enable the Bank of Zambia to carry out its functions under the Act.

Re-organization under the Act may be related to negotiations being carried out with big depositors of the ailing bank to stop them from pulling out when the bank is finally re-opened as it might lead to a complete collapse of the bank. When the bank starts operating, the creditors become an integral part of the business. Like in Commerce bank, most of the big creditors became shareholders and were asked to bring in additional capital. These were the big financial institutions like NPF, ZSIC and other insurance companies. But it still went under because the people had already lost confidence in it. Capital bank was reconstructed with new shareholders through a scheme of arrangement where original shareholders became minority shareholders and big depositors became bondholders to create confidence and delay the outflow of money. This scheme of arrangement is the only one that has worked so far.

Where depositors and creditors refuse a restructuring or reorganization plan prepared by the Bank of Zambia, the Central bank shall **modify the plan or order for compulsory liquidation** in accordance with **chapter VII** of the Act.

2.2 COMPULSORY LIQUIDATION

The Bank of Zambia in the final analysis may order a compulsory liquidation under **chapter VII** of the Banking and Financial Services Act. It was held in **Lees V.**

Industrial Trust Co.⁷⁵ that a receiver ordinarily should not be authorized and he should not continue to operate a business at a continuing loss unless the expenses of the business are guaranteed. In these circumstances, the receiver should speedily close the business. When such a decision is reached, all affected persons, shall be notified and these shall have liberty to appeal to the courts of law *within 21 days* of the decision to require the Bank of Zambia to show cause why the possession should not be terminated.⁷⁶ However, the section itself does not provide how the process is to be commenced, but this was decided by the Supreme Court in the case of **Access Finance Limited V. Bank of Zambia**⁷⁷, where it was decided that even though section 84 C does not provide how proceedings are to be instituted, this does not end the matter. Under **Order VI** of the High Court rules, it is stated that, unless otherwise provided by any written law or the Rules, every action in the High court is commenced by a Writ of Summons endorsed and accompanied by a full statement of claim. And so Order VI of the High Court was embraced by the Court as providing an answer to the difficulty.

Upon taking possession of the bank, the business of running it becomes vested in the Central bank or the liquidator that is appointed. Any term whether contractual or statutory shall be extended by 6 months. Basically under **section 84D**, the Bank of Zambia simply secures its interests by cutting down on the liabilities and improving on the security of assets. The effect of Sections **81 and 84 A** of the B&FS Act relating to taking possession is that the possessed institution for all intents and purposes becomes the property of the receiver and as such he only can bring an action in the name of the company.⁷⁸ These powers include initiating or defending and conducting of any proceedings. It would seem from the provisions above that only the Bank of Zambia has the authority to maintain an action in the name of the bank after it has been placed under liquidation. Other people could not be allowed to do so. This was further emphasized in the case of **Access Finance Services Ltd & another V. Bank of Zambia**⁷⁹ where the court held that the position of the bank possessed by the bank of Zambia under the B&FS

⁷⁵ 137 ACR 1174

⁷⁶ previously the time allowed was 30 day

⁷⁷ SC Case No 7 2005

⁷⁸ so held in *Magnum[z] Ltd V. Basit Quadri (in receivership) and Grindlay Bank [1981] ZLR 141*

⁷⁹ SCZ No 7 [2005]

Act is in the same position as an ordinary company placed under receivership and as such it cannot sue or be sued in its own name. On the basis of that and the purported authority in the Avalon case, the court dismissed the appeal. Having read the case of Avalon several times, I have failed to reconcile the ruling and the purported reliance on the Avalon case because the principle that was established in that case was quite different from what the court relied on in the Access Finance Case. The Avalon case as it has been shown below established the principle that shareholders and directors can bring an action against the receiver in the name of the company if it is evidenced that there is grave misfeasance, gross negligence or anything amounting to fraud and other breaches. That is the state of the law that was established in this case and it is strange that the Supreme Court should depart from this principle without overruling it.

Therefore in **Avalon Motors Limited (in receivership) V. Bernard Gadsden and Motor City Limited**,⁸⁰ in which the company had borrowed money from a bank and upon defaulting the bank appointed a receiver who it was alleged that he had conducted himself in a delinquent manner to the serious disadvantage of the company, the shareholders and all concerned. After he was removed, another receiver was appointed and an action was commenced against the first receiver. Such action was commenced by the shareholders and the director in the name of the company to which an objection was taken that the as director and shareholder, they were not entitled to sue in the name of the company; only the receiver can do so. **Chief Justice Ngulube** (as he was then) held that, *whenever the receiver is the wrong doer, as where he acts in breach of his fiduciary duty or with gross negligence or where the directors wish to litigate the validity of the security under the which the appointment has taken place or in any other case where the vital interests of the company are at risk from the receiver himself or from elsewhere but the receiver neglects or declines to act, the directors should be entitled to use the name of the company to litigate. However, the circumstances when this will be permitted should be limited.*

Indeed, having read carefully the two cases and the provisions of the Act, the only rational interpretation that one can come up with which seems to reconcile the two positions without contradicting them would be that the shareholders have a right to bring

⁸⁰ [1998] SJ 26

an action only where it is evidenced that the receiver is in gross breach of his fiduciary duties. But if he is doing everything possible without any negligence on his part in accordance with the law, then the shareholders will be estopped from suing in the name of the bank by section 84A. Like in the Avalon case, there was evidence before the court that the receiver through the second respondent sold the company's property and assets at a grossly undervalued or give-away price.

The Bank of Zambia as the regulator of commercial banks makes tremendous efforts to save the operations of the stressed banks. The reasons for such efforts include the following Vis:-

- To protect the interest of depositors and the other creditors
- To maintain stability and efficiency of the financial sector
- Channeling of savings from savers to the productive sector
- Banks are conduit for conducting monetary operations

For the four reasons banks are accorded a higher degree of official supervision and regulations than other types of business.

CHAPTER THREE

3.0 THE WAY THE PARTIES ARE TREATED IN THE LIQUIDATION PROCESS

This chapter examines both the problems and implications that parties face in bank resolutions, in particular post-resolutions due to delays in paying the parties in failed banks the full value of their claims in a timely fashion after a bank is officially declared insolvent and resolved. Although there are losses in value to depositors' money at the time of resolution, the effect of much of the losses in liquidity are felt after the resolution has been implemented, in particular, the losses that arise from a delayed depositor access through the freezing of guaranteed and/or un-guaranteed accounts. Bank runs and crises are not zero-sum games where some players gain at the expense of others, but involve substantial social costs. These costs go beyond the losses to depositors, shareholders and creditors of part of their wealth.

Therefore, the paper will examine the position of the Bank of Zambia, the *shareholders* and the *depositors/creditors*. And lastly, the position of the *workers* in a failed bank will be considered.

Banks are a crucial component to a country's economy; they serve as the focal point of the exchange of money throughout the economy. They gather savings from small and large depositors, make loans, run the payments system, and coordinate financial transactions. In developing countries, they usually are the heart of the financial market and in industrial countries with complex financial markets they still have a role as primary providers of financial services. It is difficult for the layman to know if a bank is financially solid. Banks may appear more solid than they really are. A bank that has loaned money to a borrower who is unable to repay may keep the bad loan on its balance sheet as long as possible, though the loan might never be paid back. Moreover, bank deposits are also somewhat precarious. A bank normally cannot refuse to accept deposits, but if, for whatever reason, its depositors lose confidence in the bank's soundness, they

may withdraw their funds not only from that bank but also from other, perfectly sound banks.

When we look at a bank's profit and loss statement of account, it is common knowledge that a bank's liabilities have always formed an active part of its business operations, and its borrowing and interbank funding activities reflect among other things the banks' central role in the payment system. Suddenly freezing the repayment of liabilities at one or more big banks could have immeasurable consequences for the banking system as a whole. In part, both the protected and/or unprotected depositors may not receive full and immediate access to their claims on the insolvent banks at the time it is declared insolvent and placed in receivership. That is, they may suffer post-resolution losses in addition to any loss at the time of resolution.

The issue is not so much the fear of a domino effect where the failure of a large bank would create the failure of many smaller ones; The fear is rather that the need to close a bank for several months to value its illiquid assets would freeze a large part of deposits and savings, causing a significant negative effect on national consumption.⁸¹ The fear is not just limited to the depositors alone but is also extended to the Central Bank as the main supervisor of all the Banks in Zambia. **Kaufman and Seelig**⁸² (2002) note that, if there is a threat of serious loss of depositor liquidity in bank failures, bank regulators come under intense pressure both from the depositors and from macroeconomic policy-makers to keep the insolvent banks operating by extending guarantees to some or all stakeholders, particularly if a large bank is failed or a number of smaller banks are failed simultaneously so that the aggregate money supply may be significantly diminished by the effective lengthening of the maturities of the deposits. That's how Bank of Zambia in all the cases of liquidation has been sucked into the creditor/debtor relationship of with ailing banks. Because when we look at the banker/depositor relationship, it's one that is based and grounded on consent. Both parties go into the relationship voluntarily but for

⁸¹ Kaufman at Loyola University Chicago

⁸² Kaufman is at Loyola University Chicago and consultant to the Federal Reserve Bank of Chicago and Seelig is financial Sector Advisor in the Monetary and Reserve Bank of Chicago. 2002.

1. The International Monetary Fund. -Indebted to George Benston (Emory University), Daniel Nolle (Office of the Comptroller of the Currency), and Yuri Kawakami (IMF) for helpful comments on earlier drafts

the Bank of Zambia which was not party to the initial contract is forced into it by the operation of the law. And as such one can understand the reasons why the Central Bank has tried so hard to secure its position on the priority list.

The magnitude and the timing of losses to depositors in bank liquidations are in a large measure under the control of the Bank of Zambia or the government and as such both the secured and the unsecured depositors need to be paid the value of their claims in record time. But in reality, this is not the case. Rather, like in most other developing countries, the depositors are paid the value of their claims only through time. These delays may at times stretch many months for secured deposits and many years for unsecured deposits. In Accordance with section 104(c)⁸³, the liquidator is permitted to compromise or release any claim if the amount of the claim exceeds five hundred thousand kwacha [K500, 000-00], or such higher amount as the Minister may by statutory instrument prescribe.

3.1 THE OBJECTIVES OF BANK OF ZAMBIA IN THE LIQUIDATION PROCESS

Mr. Chisunka had alluded to the fact that the primary objective⁸⁴ and the overriding principle of the Bank of Zambia in the liquidation process is not to protect the depositors but to protect the financial institutions from grounding to a halt due to one failed bank. To put it more specifically, the mandate of the Central bank is not geared towards the depositors that have lost their money in the defunct bank but towards the financial market. Its duty is to make sure that the loss does not spread in a domino fashion to other banks and it's from that position that it will get involved with the bank that has fallen. In other words, it cares less for the depositors and creditors whose money is locked up in the defunct bank. For this reason, it has a primary purpose to make sure that it maintains depositor confidence in the banking system. Accordingly, it will do all those things as are necessary to make sure that the depositors and creditors in other solvent banks remain happy and do not lose confidence in their banks.

⁸³ Of B&FS Act

⁸⁴ Interviewed at Bank of Zambia in Sept. 2005

The basic premise of this approach is the presumption that the depositor who has put his money in a bank that is financially unsound should share in the loss. He should have in the first place when selecting his bank been careful to shop around for a financially sound bank, instead of choosing one which did not have the financial strength. The fact that he didn't is proof enough that it mattered less to him in the final analysis whether he lost his money or not. He was negligent and so must pay for his negligence. It was his duty to look at the financial statements that are published in the newspapers by the shareholders as they reveal the financial standing of the banks. This is in accordance with the requirements of the Bank of Zambia and its purpose is to help the intending depositors make an informed decision on which bank to put his money into. This information is always in the public domain and all one needs to do is ask for it probably but not necessarily at a small fee.

The above analysis assumes that the depositor operates in a perfect competitive market where information is readily available for his consumption and that the financial market is adhering to the principle of full disclosure. Definitely, the principle that *caveat emptor*- "let the buyers beware"- should not be allowed to apply to the depositors who are unable to assess the safety of depository institutions. For the most part, an average depositor has little chance of reading and interpreting those statements that are printed in the papers as they are too technical and require one with a background of accounts to understand them.

Secondly, not everything of relevance is revealed in the statement. Given the above scenario, it is not strange in the circumstances to find that *Prudence bank* was allowed to continue to operate whilst insolvent in contravention of section **86 and 87** of the B&FS Act with a capital deficiency of **K19.0 billion**.⁸⁵ This was a problem largely caused by those who were tasked with supervision. The question is, why was this information not released to the public? Mr. Chisunka at page 14⁸⁶ puts it in a clearer picture on the difficulties faced by small depositors to get useful information in a way in which they will understand. He uses a paradigm of a used car market to explain the problem of

⁸⁵ pg 15 of Liquidator's Report 1998 for Prudence Bank

⁸⁶ Banking Rescues and Solvency In Zambia-Submitted as fulfillment for an award of LL.M Degree-Sept. 2000

information asymmetry that obtains in the financial market and its effect on the depositor:-

“The essence of the problem caused by information asymmetry is best illustrated by the classical paradigm of the used car market. In the used car market, the seller knows more about the quality of the car than the potential buyer. The buyer will not be able to assess the quality of the car without running it for some time. Given the inability of the buyer to tell the quality of the used car, all cars of the same type will sell at the same price regardless of whether it is a good car or not. As a result, the risk of buying a poor quality car will lower the price the buyers are willing to pay for a car and because prices are low, people with good cars will not have an incentive to put them on the market. There will therefore, be fewer car sales with the result that the used car market will then function poorly, if at all.”⁸⁷

He goes on to illustrate the above paradigm in the following manner relating it to the banking industry:-*“In relation to the banking market, the imbalance in information is reflected in the following instances: I. Banks know more about their soundness than the depositors. It is difficult for depositors to assess the soundness of banks and their risk-taking behavior... III. Banks generally know more about their own operations than do outsiders including their supervisors and the market as a whole. It is difficult to assess the solvency of banks and to do so supervisors turn to the banks themselves to provide information.”⁸⁸*

Given these problems, it is imperative for the Bank of Zambia to re-analyze their objectives in order to equitably serve all the players in the field. While Mr. Chisunka maintains that the overriding interest for Bank of Zambia is to maintain the system, one can look at this principle in a different way and put up an argument that in trying to pursue the same principle, bank of Zambia has ended up losing a lot of tax-payer's money as it does not know when to stop trying to keep the bank afloat. It usually takes a political decision to put an end to the course embarked on by Bank of Zambia. To put it even more clearly, the examples below will tell just how much money has been lost in just two banks that have been reviewed. We haven't even looked at the other banks. The question is, what is the effect of that on the economy and how is that money accounted for?

In the failed Prudence Bank, bank of Zambia is expected to lose close to **K6 billion** in debts. This was from the total debt of **K13.5 billion** unsecured/ under secured loans to the bank to keep it afloat. It is common knowledge that Prudence Bank operated without

⁸⁷ Known as the lemon problem. The model was popularized by George Akerlof in 1970 in an article 'The market for lemons: quality uncertainty and the market mechanism'

⁸⁸ pg 15 of footnote number 3.

a budget since inception of the bank in 1994 until 1997.⁸⁹ Under the same arrangement as Lender of the Last Resort, Bank of Zambia allowed the amount of over **K8 billion** to be over-drawn in an attempt to save Union Bank from collapse. Bank of Zambia was an unsecured debtor and so it might lose all these monies.⁹⁰ This bank also went under and the decision to put it under liquidation came from above rather than from the Central Bank which had the mandate to do so. Not only that, a lot of money was also lost in Meridian Bank⁹¹ and up to now, that is a political embarrassment that no government wants to discuss. Therefore, we see that for each bank that has gone under, the Bank of Zambia has been a victim of its own policies. Perhaps, it is time for it to rethink the whole plan.

3.2 THE DEPOSITORS

While the law relating to winding-up of a company gives preference to a creditor to petition for the winding up of a company in which he has a debt, this is not so with the commercial banks. No creditor for the purposes of enforcing his debt can bring a petition for winding-up against any commercial bank in Zambia. The reasons for this position have already been discussed in detail in chapter II and are basically to do with the nature and the role that banks play in society. Such an action can only be commenced by the bank of Zambia. In other words, the *locus standi* of the creditors/depositors of the bank becomes enforceable only after the Bank of Zambia has decided to bring the bank under Chapter VII of the Banking and Financial Services Act, CAP 387.

The relationship between a banker and a customer is fundamentally that of a debtor [banker] and creditor [customer] and is not **FIDUCIARY**.⁹² When a client deposits money in a bank, this money is under the control of the banker and becomes his property⁹³ and he can deal with it as he pleases, but he has an obligation in connection with it. The case of Foley V. Hill⁹⁴ puts the issue very clearly. The issue in that case

⁸⁹ Corporate Governance, pg. 20- Prudence Bank's Receiver's Report 1997-98

⁹⁰ Morris Mulomba. Union Bank Receiver's Report- page VII-Liquidation Manager for Union Bank-2001

⁹¹ What has been mentioned is about \$90,000-00

⁹² Shukla M.C. Pg. 299 of mercantile Law, chap. 10A by -S Chand & Co. Ltd. 2004 reprint. 13th Edition

⁹³ Rodgers A.W-Falconbridge Banking and Bills Of Exchange, 7th edition.1969 Canada Law Books Ltd.

⁹⁴ [1848] 11 HLC 27

was whether the relationship between banker and customer was fiduciary, so as to give rise to a right to take account in equity, or was governed entirely by common law. The Lord Chancellor, **Lord Cottenham**, said at page 36:

“Money, when it is paid into a bank ceases altogether to be the money of the principal; it is then money of the banker, who is bound to return an equivalent by paying a similar sum to that deposited with him when he is asked for it. The money paid into the banker’s, is money known by the principal to be placed there for the purpose of being under the control of the banker; it is then the banker’s money; he is known to deal with it as his own; he makes what profit of it he can, which profit he retains to himself, paying back only the principal, according to the custom of banker in some places or ...the money placed in the custody of a banker is, to all intents and purposes, the money of the banker, to do with it as he pleases; he is guilty of no breach of trust in employing it. He is not answerable to the principal if he put it into jeopardy; if he engages in a hazardous speculation;...but he is of course answerable for the amount, because he has contracted, having received that money, to repay to the principal, when demanded, a sum equivalent to that paid into his hands.”

The foremost obligation of the banker therefore is to repay the whole or part of the money so deposited upon presentation of the customer’s written authority [i.e. the cheque], during business hours at the branch where the account is kept. In Canada, this deposit is treated as a loan, and specifically as a loan for consumption or *mutuum*, as distinguished from a loan for use, or *commodatum*.⁹⁵ And in accordance with the rule in Clayton’s case, payments to and drawings upon the current account are *prima facie* taken to be set off against each other automatically, the earliest drawing against the earliest payment and so on.⁹⁶ *The rule does not apply to a case where there is no current account between the parties or where a contrary intention appears from the circumstances.* In Henry V. Hammond,⁹⁷ **Channel J** at page 521 differentiated the different ways in which the bankers receive money from their clients:

“It is clear that if the terms upon which the person receives the money are that he is bound to keep it separate, either in a bank or elsewhere, and to hand that money so kept as a separate fund to the person entitled to it, then he is a trustee of that money and must hand it over to the person who is his *cestui que trust*. If on the other hand he is not bound to keep the money separate, but is entitled to mix it with his own money and deal with it as he pleases, and when called upon to hand over an equivalent sum of money, then in my opinion, he is not a trustee of the money, but merely a debtor.”

⁹⁵ Nicholls, *The legal nature of Bank Deposits in Quebec* {1935} 13 Can. Bar Rev. 635

⁹⁶ *Devayness V. Noble*, *Claytons case* [1816] 1 Mer. 572

⁹⁷ [1913] 2 KB 515 at page 521

The essential question to determine in all the circumstances of the case is not just the arrangements as to how the money was held but whether it was held on trust. Therefore, in **Re Hallett's Estate**⁹⁸, a solicitor whom having in his possession bonds of a client of the value of ***pounds 2100 and 2200 pounds***, wrongfully sold them and deposited the proceeds in his general account in a bank. He afterwards drew cheques for his own purposes, and deposited other money of his own, and at his death there was a balance of over ***3000 pounds*** at his credit.

The court discussed the applicability of the Clayton's case, and held that the client was entitled to a charge on the credit balance in the bank. In effect, the client was entitled to follow or trace his property into the hands of the bank, although the balance in the bank was no longer identifiable as the proceeds of the client's property. In more sober terms **Lord Green** M.R. said in **Re Diplock**⁹⁹ that, "at common law when the money of B became mixed with the money of A, its identification in a physical sense became impossible; owing to the fact of mixture there could be no question of ratification of an unauthorized act, and the only remedy of B, if any lay in a claim for damages. *Equity adopted a more metaphysical approach. It found no difficulty in regarding a composite fund as an amalgam constituted by the mixture of two or more funds each of which could be regarded as having, for certain purposes, a continued separate existence.*"¹⁰⁰ *"...but if in 1815 the common law halted outside the banker's door, by 1879 equity had had the courage to lift the latch, walk in and examine the books."*¹⁰¹

As a result, it may appear from an account rendered or other circumstances that the creditor intended not to make any appropriation, but to reserve the right.¹⁰² This position is not different from the Zambian situation and indeed elsewhere. It follows that upon insolvency of the bank, the customer as a general rule, has a right of merely proving his debt as an ordinary creditor and if he is not an ordinary creditor, he needs to prove to the liquidator in which capacity the bank was holding his money. This is because banks also

⁹⁸ [1894] 2 QB 237

⁹⁹ [1948] Ch. 465

¹⁰⁰ Rodger A.W-Falconbridge Banking and Bills of Exchange, pg 285, Para 2

¹⁰¹ Banque Belge pour l'Etranger V. Hambrouk [1921] 1 KB 321

¹⁰² Rodger A.W-Falconbridge Banking and Bills of Exchange, 7th edition, 1969, CANADA LAW BOOK LTD-page 281.

perform other roles for their customers apart from that of the business of banking in the normal sense.

The Banking and Financial Services Act has defined a deposit as an amount of money paid to the bank, trust funds received from or held by a bank, money received or held by a bank or its equivalent held in due course of business for a specific purpose including scroll funds, funds held as security for an obligation, funds deposited by a debtor to meet maturing obligations, funds held to meet its acceptances or letter of credit but does not include funds which are received by the bank for immediate application to the reduction of an indebtedness to the receiving bank, outstanding drafts, cashiers cheque, money order or other officer's cheque, or such obligations of a bank as the Bank of Zambia may prescribe from time to time. From the list above, it is obvious that the Central Bank has included scroll funds and trust funds but whether the courts will look at these funds as part of a deposit remains to be seen. But like we shall find later, the court has refused to follow the statutory provision and has passed a ruling that money held in a suspense account cannot be part of the liquidation process.

Nonetheless, several considerations come into play whenever a bank is forced into liquidation. *Whom does it settle with first? What about those having several deposit accounts in the same bank some of it overdrawn or in credit? What is the significance of the money received in trust?* The relevancy of these questions will be shown as we start looking at the way depositors are treated on the priority list. What we must concede is that there are many types of depositors and the distribution of assets will follow the list in accordance with how they are classified. *Are they secured depositors or unsecured?* Within the class of secured, another class has been created. Those that are referred to as preferred depositors who defy both the *pari passu* principle and the priority list.

More recently, the Supreme Court was compelled to override the provisions of section 107 of the Banking and Financial Services Act in the case of **First Merchant Bank Ltd (in liquidation) V. Al Shams Building Materials Company Limited, Jayesh Shan and the AG.**¹⁰³ In this case, the first respondent who maintained an account with the appellant

¹⁰³ [2000] SCZ Judgment no 37

had a balance in his account to the credit of **US\$1, 013, 973 -91**. This money was later on seized by the Drug Enforcement Commissions and the account was frozen. The money was held in the suspense account and no withdrawals were allowed. Later the bank went into receivership and liquidation. The respondents challenged the seizing and freezing of the money. The court held that the seizure was unlawful and illegal and that the respondents' status as depositors changed with the wrongful seizure of their money and that they be paid their money in preference to other creditors. It was argued *inter alia* by Mr. Wood on behalf of the appellant that at law, in any liquidation, only secured creditors are paid first and unsecured creditors' claim rank *pari passu* and not in priority to other creditors claims. He further argued that the respondents were unsecured creditors who should be treated as ordinary creditors and that the court below erred in disregarding the priority list in **section 107** of the B&FS Act. The Supreme Court **Judge Muzyamba** held that the money which was put in the suspense account was no longer part of the general depositors' account and that for that reason it could not be used either by the bank or the respondents. The money remained in the suspense account until the bank was liquidated and did not therefore form part of the liquidation process. Therefore, the money could not be part of the priority list under section 107 and should be released to the respondents.

This was a landmark decision for the banking sector and it has punched a hole in the statutory provision of section 107 of the same Act. The case has stated the rule that money held on trust, scroll accounts, suspense account etc overrides the priority list and must be dealt with first before the priority list is even considered. The negative effect is that it puts all the other creditors in a quandary. This is because such a situation has got the potential of wiping out the whole fund to the disadvantage of the other parties including the Bank of Zambia which is the Lender of the Last Resort. Indeed, like it has been shown above, Bank of Zambia tries a lot to keep the financial market afloat and it does this mainly through the disbursement of funds into an ailing bank. All this money will be unsecured when it comes to depositors as the ones we have discussed above. And lastly, if a customer keeps several accounts at a bank, they may be treated as one by the

bank for the purposes of setting off a debt balance in one against a credit balance in another.

(i) EFFECT OF DELAYED ACCESS TO FUNDS

It is sad to see that up to now, there is no success story to talk about as having completed the liquidation process. The first bank to have been placed under liquidation is till being liquidated. With the high inflation being experienced in Zambia, it has reduced all those funds to zero.

George Kaufman, who is a professor of finance and economics at Loyola University in his presentation at a conference on Public Regulations of Depository Institutions, identified two sources of depositor losses after a bank has been placed under compulsory liquidation: “The two sources of depositor losses after the bank has been placed under compulsory liquidation arise from the failure to recover the full value of their deposits. In the absence of an efficient secondary market, delay in offering depositors full access to their permissible funds decreases the value of their deposits and their liquidity and, in the absence of interest payments; it also affects their current values of the deposit claims and greatly intensifies the public fears and the actual costs of bank failures. Really from an economic point of view, this is a disaster which should be avoided”.¹⁰⁴

(ii) SOURCES OF POTENTIAL LOSSES TO DEPOSITORS

1. *THE POOR CLOSURE RULE* -Embedded losses from a delay between the time when a bank becomes economically insolvent (where the market value of the assets declines below the market value of the liabilities to the present value of the maturity value of the deposits and other debt) and the time it becomes eligible to be declared legally insolvent. The first loss arises from a poor legal closure rule that focuses on book or regulatory values that often overstate bank assets and understate bank liabilities compared to their economic or market values. In the United States, banks (although not bank holding companies), unlike other corporations, are not subject to the jurisdiction of

¹⁰⁴ Kaufman G. Banking Failures, Systemic Risk, and Bank Regulation- Koc University, Instabul, Turkey, November 1995. (A presentation made at Koc University)

the bankruptcy process and courts. Rather, they are resolved by their primary federal regulator.

2. REGULATORY FOREBEARANCE -Embedded losses from a delay in the time from when a bank becomes legally eligible to be declared insolvent and the time it is actually resolved or declared insolvent by the regulators or other authorized party (official recognition of the insolvency), a receiver appointed, and the existing owners removed. The second loss reflects regulatory forbearance from fear of imposing losses and injuring favored parties associated with the insolvent bank (e.g. shareholders, management, other employees, borrowers, or uninsured depositors), injuring other financial institutions and the macro economy, or injuring the regulators' own reputation as public guardians against bank failures.

3. BAD MARKET CONDITIONS AFTER THE RESOLUTION TO CLOSE. –These are losses (gains) arising from delay by the receiver selling the bank as a whole or parcels of its assets and deposits after the bank is declared legally insolvent either because of operational problems or awaiting for a better market. The third source of loss could be reduced by careful monitoring by the banking agency that appoints the receiver of the receiver's motivations or justification for delaying selling bank assets. This monitoring would verify both that the probabilities are sufficiently high that relevant asset markets are only temporarily depressed and may be expected to recover shortly and that the assets can be managed efficiently in the meantime, so that the present value of the projected sales proceeds to depositors and the deposit insurance agency will be higher than without a delay. Recent experience in most countries, including the United States, suggests that delay in asset sales, although often politically popular, rarely produce financial gains (Kane 1990 and Gupta and Misra, 1999). Thus, it may be desirable to specify timely sales schedules.

4. INEFFICIENT RECEIVER- Losses from delay in the receiver distributing the proceeds from the sales to the unsecured depositors. The fourth source of loss could be reduced by requiring receivers to distribute their proceeds more quickly as they are received and monitoring and enforcing their compliance with this policy.

These potential losses occur sequentially. The first two sources of losses occur before the date of resolution because economically insolvent banks are permitted to continue to stay open and operate under their existing owners and managers.

In addition, until the date of official recognition of the insolvency and resolution of the bank, embedded losses from the continued operation of insolvent banks are not booked and accrue only to the deposit insurance agency. Both secure and unsecured depositors can withdraw their maturing funds from these banks at par value. Because they are not officially booked, the embedded losses to the liquidator are generally difficult for much of the public to recognize and easy for regulators to disguise, hide, and deny. Only at and after the date of official recognition of insolvency are the total embedded losses booked and visible to all and a pro-rata share imposed on the remaining unprotected depositors. This encourages regulators to delay closure.

The costs of a poor closure rule and forbearance include not only increased credit and market losses, but also increased losses from fraud and asset stripping, which is more likely at insolvent or near-insolvent institutions, and misallocating financial resources leading to misallocations of real resources and reductions in aggregate economic welfare. The final two sources of loss occur after the date of official resolution and the institution is put in receivership. Losses to depositors from delay in liquidating bank assets may be either or both credit/market losses and/or present value losses. This delay generally arises because of time necessary to determine who are the depositors and certification of their claims and attempts, legitimate or not, by the receiver to avoid fire-sale losses or depressing asset prices further by selling quickly into perceived temporarily weak markets and waiting for stronger markets, from self-dealing by the receiver, or legal obstacles that prevent the receiver from disposing of assets quickly. The fourth and last source of loss from delays in distributing the funds from the sale of the bank is primarily a present value loss to depositors from operational inefficiencies.

What could be seen from the above grim picture is that it is better to prevent a bank from being liquidated than to allow it to go into liquidation because at the end of the day, whichever way one looks at it, it is the depositors who suffer the most. And as such Bank of Zambia as the supervisor should play a leading role in bank supervision and take responsibility when a bank which is under their care right from inception fails. They owe a duty of care to the depositors as well as the shareholders.

In UK, the Bank of England after the BCCI SA bank collapsed was sued for negligence on its part for failure to supervise the bank properly resulting in the large loss of deposits by depositors. The action has been discussed extensively in this paper as it brings out the issue of responsibility which the Bank of Zambia has tried to evade under the immunity clause in the B&FS Act, **section 123**:

“If such a test was to be allowed to survive, it will enable a banking regulator who deliberately and knowingly does not supervise a bank as it should do, with resulting damage to its depositors, to defeat a misfeasance claim simply by saying ‘because I did not make any inquiries that I should have done, I did not suspect that the plaintiff would probably suffer loss.’ In short, it enables a banking regulator to rely on its own deliberate and knowing illegality as a justification for its lack of foresight that it would cause damage. If ‘policy’ and ‘principle’ were invoked, it must be against providing such an incentive to a banking regulator or any public body exercising a supervisory function over institutions in the interest of persons for whom they provide a service, not to do their duty.”¹⁰⁵

Therefore, in “**Three Rivers District Council V. The Governor and the Company of England**;¹⁰⁶ leave was granted by the House of Lords against the Bank of England to allow the case to proceed to full trial even though the Lords conceded to the lengthy and complexity of the case. The case fell into two distinct parts. The first question was whether the plaintiffs had pleaded a reasonable cause of action and the second was whether the cause of action was an abuse of the court process as the cause had no realistic

¹⁰⁵ BCCI[2000] 2 WLR 15

¹⁰⁶ [2001] UKHL 16

prospect of succeeding. The first appeal related to the ingredients of the tort of misfeasance in public office on which the plaintiff's first ground of action depends. The question in short was whether "the order of the Court of Appeal upholding the order of Clark J that the action is struck out should be upheld on the ground that the plaintiffs have no reasonable prospect of succeeding on the claim at the trial." On 1 Oct 1979, BCCI SA applied to the Bank of England for recognition as a bank under the Act but this was refused but instead it was given a licence as a deposit taker.

The claimants' case was that when the Bank granted the license, (a) it did so knowingly, deliberately contrary to the statutory scheme or (b) it was recklessly indifferent to whether it was acting in accordance with the scheme or (c) it wilfully disregarded the risk that it was not acting in accordance with that scheme (i) in bad faith and (ii) (a) in the knowledge that the likely consequences were losses to depositors and potential depositors or (b) that it wilfully disregarded the risk of the consequences or (c) that it was recklessly indifferent to those consequences. The claimants' case was that despite the Bank knowing the illegalities of the bank and the likelihood of losses to depositors, it failed in bad faith to take steps to revoke the license under section 7 of the Banking Act 1979 and as such the Bank failed in its responsibilities as a supervisor to take decisions that would protect the interests of the depositors. The question was, based on what the Bank of England knew of the BCCI SA at various times, should they have done more or acted differently? In the Court below, Clark J held that on the basis of the evidence that was available to him, the claim was bound to fail and hence an abuse of the court process.

The House of Lords went on to consider what constituted a *tort of misfeasance* in a public office. First, there must be an unlawful act or omission done or made in the exercise of power by the public officer. Second, as the essence of the tort is an abuse of power, the act or omission must have been done or made with the required mental element. Third, the act or omission must have been done or made in bad faith. Fifth, as causation is an essential element of the cause of action, the act or omission must have caused the claimants' loss. The Bank accepted that it was capable of being liable in tort to the claimants who were potential depositors in the BCCI SA but refused that it was capable of causing loss to the depositors where the proximate cause of the loss was the deliberate

act of the third party – and in this case, fraudulent acts of individuals in BCCI. However, the House of lords held that, given the fact that the Bank knew before the grant of the full licence that it was not entitled to rely on the Luxembourg regulator, the claimants had a real prospect of proving that the Bank knew that their initial act in licensing BCCI was unlawful, that its licence and the licence and authorisation remained unlawful throughout the remaining three periods and that all subsequent omissions to revoke the licence and authorisation were effected by the same illegality. Therefore, the case was allowed to go to a full trial. The case has not yet been concluded and so we await the outcome of the case as it will raise some interesting points and at the same time it will change the role of the regulator in banking.

Similarly, in the *Zambian case of **International Group Limited and Others V. BOZ***,¹⁰⁷ an action was brought against Bank of Zambia by the shareholders alleging among other things (a) damages in negligence for breach of statutory duty in possessing the United Bank of Zambia. The contention was that Bank of Zambia was negligent in that it failed to carry out proper and required supervision of the operations of the bank and as a result of such failure, the plaintiffs lost K1, 876, 755, 000-00 in form of treasury bills etc. The Bank of Zambia contended that on the proper reading of the Banking and Finance Services act, the duty imposed on the Defendant was that of regulating and providing safeguards for all the parties to whom the Act applies. It further argued that the Act did not create such a duty or liability and as such the claimants could not support their claim under that Act.

The court in its ruling found that the Bank of Zambia had fulfilled its expectant statutory duties by taking possession of the bank and so could not be accused of negligence. The implication of the ruling even though the plaintiffs lost the case is that the court overrode the submission by the Bank of Zambia that it had no statutory duty under the Act by considering the allegation of the tort of negligence and holding on the basis of the evidence available to the court that he could not found any action or omission that supported and pointed to the ground of negligence. In other words, Bank of Zambia has a

¹⁰⁷ [2002] HPC/0372

statutory implied duty to take care due to the depositors and the shareholders. Whether this can be extended to the workers is another thing.

3.3 THE SHAREHOLDERS

A share is a right to receive a certain proportion of the profits of the company and of the capital of the company when it's wound up.¹⁰⁸ Before liquidation, every shareholder has a right to transfer his shares, and the transfer will be good even if made to a man of straw, when the company is in difficulties, for the purpose of avoiding liability.¹⁰⁹ In banks however, such transfers have been restricted by the Banking and Financial Services Act.

Once the court has made an order that the bank be wound up, the effect of such an order against the bank is that: (i.) the whole of the insolvent bank property shall now vest in the liquidator and becomes divisible among the creditors. (ii.) The bank is deprived of all power to enter into transactions which will bind its creditors in respect of its property. After adjudication only the receiver can deal with the property in the manner that he deems fit, and every transaction by the insolvent is void against the receiver.¹¹⁰

The reason why there is a marked demarcation between the shareholders of the bank and the operations of the bank in liquidation goes back to its incorporation. Like we indicated at the beginning of the paper, a bank comes into operation first as a company and then as a bank second. This simply means that by virtue of its incorporation as a company, it is able to exist as a legal person in its own right and its existence is distinct from that of the existence of the shareholders. Accordingly, it can sue and be sued in its own name, acquire assets and liabilities. This is the principle of limited liability.

This principle which is so deeply embedded in business culture and the law defines how much the corporation and its shareholders should be protected from financial liability. Thus the bank is an entirely different person from the shareholders, even though they started it, and managed it. The property is the property of the bank and not of the

¹⁰⁸ Topham, Principles of Company Law, Butterworth's & Company, 1924, 6th edition.

¹⁰⁹ De Pass' Case [1859] 4 De G&J 544

¹¹⁰ Shukla MC-Mercantile Law-12th edition, S. Chand & Company, 2004

shareholders. As a result, the shareholders are not liable for debts incurred in the operation of the firm.

Thus, shareholders losses are limited to the amounts invested by them, that is, to the amounts originally invested in the firm at the time of the stock purchase¹¹¹. Thus, a person by buying shares becomes entitled to participate in the profits when the bank decides to divide them, and is at liberty to dispose of them whenever he likes, and if anything goes wrong with the bank, his liability is limited by the nominal amount of the shares held by him.

This principle was established in the case of Salomon V. Salomon¹¹² where the House of Lords ruled in favour of leather merchant that had transferred his assets into a limited liability company, that the legal identity of the company, and the “*corporate veil*” of the protection that it offered to its directors, was firmly established in the law. Furthermore, once the company is incorporated, it must be treated like any other independent person, and the motives of those who promoted it are irrelevant. Having said that, what then is the extent of the legal interest that shareholders can claim in an insolvent bank as opposed to a solvent one? The legal personality and the limited liability features of the bank define the entitlement of the shareholders of the bank.

Therefore, when a bank is in financial problems, it is presumed that by the time it is being declared insolvent, it has lost its capacity to make profits for its shareholders and it has similarly eaten away its share capital. In other words, the shareholders have lost both their dividends and the value of their contribution in form of shares in the bank. In actual fact, the capacity to declare dividends in the insolvent bank is lost much earlier. This is in accordance with section 69 (3) and (4) of the Banking and Financial services Act, where it is stated that no bank shall be allowed to declare a dividend if to do so would result in an impairment of the reserve account. Technically, with the loss of the investment, there is nothing left for the shareholders in the insolvent bank.

¹¹¹ Tunstall V. Steigman [1962] 2 AllER 417

¹¹² [1893]AC 22

It would therefore be mischievous for the shareholders to try and bring an action against the liquidator of the bank that they have been deprived of their property rights in the bank whether tangible or intangible without compensation. This is because like it has been stated above, the only right that a shareholder has in the bank or company is limited to his investment and the dividend that is declared at the end of the financial year. If then the bank starts failing to declare a dividend and eats away its share capital, it should just be taken as a bad investment and the shareholders must accept this. It is with that in mind that the bank of Zambia under **section 84A (g)** shall terminate the interests of the shareholders at a value to be determined by the court. In other words, it's up to the shareholders to move the court to have what has remained of their share value be determined. The bank's property will be protected by the receiver.

As a legal person, it cannot allow any other person to take away its assets or deal with it in any way without leave of the appointed agent and in this case, the Bank of Zambia. Notwithstanding that however, the shareholders may in certain situations be allowed to bring an action to claim a residue of the share capital after all the creditors have been paid if it is found that there was something that was left over. As a result and for the purposes of the above, the Banking and Financial Services Act has provided that **section 110** is invoked where all claims have been paid off but certain assets have remained. The remaining assets shall be distributed among owners in accordance with their respective rights and interests.

Furthermore, there are situations when the bank is possessed for a very different reason other than being insolvent and in that case then, the shareholders may subsequently have a bigger claim in the bank which they will need to enforce and claim. A good example would be the case of Access Financial Services limited which was possessed by the Bank of Zambia for unsound practices like money laundering. Undeniably, the balance sheet of the institution could have been said to be sound at the time of closure of the institution and as such the decision to possess it was based not on the status of the balance sheet but was based on account of some breach of the law. Therefore, in accordance with section 84 (g) above, the shareholders could bring an action for compensation. This is in line with the requirements of the **Constitution of Zambia Article 16** which protects private

property from appropriation by any law without adequate compensation being paid to the owner of the property.

3.4 THE EMPLOYEES

The benefits of a successful commercial bank are a profitable continuation of the business of banking and the maintenance of jobs. And in any liquidation process be it of a company or a bank anywhere in the world, it is the workers who pay the price of shut down of the work place. Currently, there are no obligations in legislation that require an employer to notify employees or their trade union (if they belong to one) that the organisation is in financial distress or that it is insolvent and may be placed under liquidation. Consequently, it is generally an unexpected blow with disastrous results because employees cannot take steps to lessen the impact. Not only do the employees lose their jobs and their source of income, they also lose salaries that they have not been paid, vacation pay and severance pay.

When we look at the Act regulating financial institutions, it is clear that its intended focus is on the directors and business operations, including areas of risk exposure. There is also a greater focus on the need controls and procedures, reporting at intervals etc. This focus is intended to build strong corporate values and integrity. As a result, there is very little legal provision that has touched on the needs of workers per se and regrettably has done very little in ameliorating the plight of the workers.

Likewise, one of the first courses of action that is undertaken by the liquidator is to terminate all employment contracts. For that reason, **section 104**¹¹³ is invoked in particular **subsection (2) (a)** which terminates every contract of employment with effect from the date on which the order for compulsory liquidation or other measure was undertaken by the Bank of Zambia.

The question is, how has the Banking and Financial services Act addressed the issue of protecting the interests of the workers in a failed bank. Are the benefits enough that they receive under the Act? It is generally accepted that employees are vulnerable creditors

¹¹³ Of the Banking and Financial Services Act 1993

who are unsecured. **Section 107 (1) (c)** stipulates that the wages and salaries of officers and the employees of the bank for the three month period preceding the effective date of seizure, within the limit of an amount not exceeding *one hundred thousand kwacha per person* or such higher amount as may be prescribed by regulation. Once this amount is paid, it would seem like it relieves the liquidator of his duty towards the workers unless and until such a time that all the other creditors have been paid and a residue has remained.

The other options remaining that one would like to look at are the *employment Act* and the *Industrial and Labour Relations Act*. A look at the Acts does not throw any light on the plight of the workers as the Acts have not addressed themselves to the plight of workers in compulsory liquidations. Besides, for the purposes of banking business and anything that has got to do with commercial banks the Banking and Financial Services Act is the law that regulates the system. This means that anything not contained in the Act does not apply and so it can be argued that looking at them is a futile efforts. But for the purposes of exhausting the matter, it would be good to take a look at what is provided in the Acts. Besides, ZUFIAW which is a union regulating collective agreements of all the workers employed in the financial institutions is bound by the Industrial and Labour Relations Act. The B& FS Act does not provide any special protection for unpaid contributions to pension plans and so it is doubtful whether the collective agreements would be recognised under compulsory liquidation.

Section 26 of the employment Act provides that an employer who dismisses an employee summarily and without due notice shall within four days of such dismissal deliver to a labour officer in the District in which the employee was working a written report of the circumstances leading to and the reasons for such dismissal. Whether or not such a provision is workable in the banking sector is a moot point which the courts alone can decide. **Section 26B (4)** exempts the employer who has been placed under liquidation from section **26B (1)**. The latter section guides the employer in the treatment of his workers whom he decides to lay off by redundancy.

When it comes to the Industrial and Labour Relations Act, it would seem like the status of the employee is different. Like it has been stated above, ZUFIAW in Zambia is a union that negotiates on behalf of the workers in all the financial institutions and should have come up with collective agreements that addressed themselves to this issue.

Employees who are covered under the collective agreement must contact their union for assistance in recovering wages. A collective agreement is a contract between the company and a union and not its employees or its shareholders and so it does not terminate on the bank being taken possession of by bank of Zambia. In accordance with the B&FS Act, possession of a bank for the purposes of liquidation does not always involve insolvency. Employees must find out for sure if their bank was really insolvent. If the bank has been possessed for another reason other than being insolvent, the employees could still recover all their allowances due to them by filling in a proof of claim with the liquidator.

In other jurisdictions, the employees are treated differently and their laws have addressed themselves to the plight of the workers. Like in Canada, the *Bankruptcy and Solvency Act* provides a measure of protection to wage earners. It has provided wage claims of up to \$2000 as preferred claims. Furthermore, the amount of wages having priority over the claims of all other non-secured creditors of an employer was increased from \$2000 to \$10,000.¹¹⁴

It would seem from the above discussion that employees in Zambia who find themselves in the position like the one under discussion have very little protection in form of laws. This could be as a result of our economic as well as political development. Having had a booming mining sector with socialist ideals, no body saw the need to enact laws relating to worker protection arising from liquidations. But when the economy was liberalised, the need for such laws is a reality and we hope the legislature is doing something about it. They need to look at other jurisdictions and see what their counterparts are doing. Not only that, the courts in Zambia in the meantime need to make in-roads in this area and come up with principles that will help the plight of workers.

¹¹⁴Yosie Saint-Cyr, Editor at HRinfodesk-Canadian payroll and Employment law. www.HRMGuide.net. May 2005.

In UK, in the case of **BCCI V. Sultana Runi Khan & Others**¹¹⁵ the employees sought to claim damages caused to them by their association with the bank, the stigma of which association was said to handicap the employees in obtaining other employment. Such damages were attributed to the bank's breach of an implied duty owed to employees not to carry on a dishonest or corrupt business. It was also contended that the employees had been induced to work for the bank by the false representation that it was an honest and creditworthy financial institution. The liquidators rejected the employees' claims for stigma damages and misrepresentation and their rejections were upheld by the courts until in the case of **Mahmud V. BCCI SA**¹¹⁶ in which the House of Lords ruled that such a claim was sustainable in principle but that the claims could find it difficult to succeed as they will be subjected to the formidable practical obstacles of principles of causation, remoteness and mitigation. In both the above cases and some other three cases that were tried, none of the employees succeeded in their claims.

Therefore, we can conclude that the parties to the whole process of liquidation are affected differently and each of them requires different remedies. Sadly, those who could come through for them have their own interests to serve and as such the remedial measures that are usually undertaken are only topical and do not reach the root of the problems. Therefore in the next chapter, an attempt has been made to uplift that weakness identified in the liquidation process and then possible solutions are also suggested.

¹¹⁵ [2001] UKHL 8

¹¹⁶ [1998] AC 20

CHAPTER FOUR

IDENTIFIED WEAKNESSES IN THE LIQUIDATION PROCESS, POSSIBLE RECOMMENDATIONS AND CONCLUDING REMARKS

While the preceding chapters in this essay focussed on conceptual and practical legal issues facing the liquidation process of banks in Zambia, at this stage, this paper shall provide an overview of the problems raised. Secondly, an attempt to re-enforce the arguments has been made to provide some legal advice on what the writer thinks should be done to overcome the challenges identified in the paper. At the end of the paper, the writer concedes that the subject of liquidation is wide and this paper is not exhaustive of the subject matter.

As a result, the paper will proceed by looking at the difficulties identified in the liquidation process starting with the Bank of Zambia, then the depositors, shareholders and lastly the workers. In the same vein, we shall also look at other jurisdictions and borrow from them some of the principles which we think could improve our laws. This will be included in our recommendations

(i) BANK OF ZAMBIA

- The main weakness that was identified under this head is basically the question of when the winding up process is brought to an end. At what point do you foreclose the bank and get a court order to bring the whole process to an end. The question may sound simple theoretically but in practice, it is not a simple question. The reason why it is not easy to answer this question conclusively is because of the complexity of the matter. In Zambia, most of the debtors of the banks usually borrow money from the bank with not intention of repaying back the loan. As a result of that, they usually provide poor collateral security or none at all. Accordingly, when it comes to liquidating the loan, the bank ends up with an asset on the paper which has no value at all. On paper, this may reflect a large amount uncollected. The problem is that the shareholders would want to satisfy

themselves that you have collected all the money. The same to be applicable to the creditors and the workers. It is the duty of the liquidator to do that. On the other hand, the liquidator might find it uneconomical to pursue those debts and may wish to write it off. The government on the other hand may not want to look as if it does not care about the plight of the stakeholders, some of whom may be important to them politically. On the other hand, there is the issue of not wanting to send the wrong signal to other debtors of the other banks in liquidation who might be reading the signs and alive to everything that is happening to their fellow debtors in other banks. If it is seen that the other group have been released, they automatically use that as an incentive not to service their loans in the hope that eventually they will be released too. And so, no one wants to take the responsibility to end the process. That's why in Zambia, no bank has been completely liquidated.

- Basically the failure by the Bank of Zambia to enforce **section 31 (1) (g) of the Act** has had a negative effect on the credibility and competence of the Bank to supervise the financial sector. The intended purpose of such a provision was essentially to act as a sieve to eliminate undesirable characters. But the Regulator has failed to enforce in certain circumstances this provision. The problem lies with the fact that the final decision upon which a licence is granted must be done in consultation with the minister. This is a great imperfection and must be removed from the statute. Let the professionals handle the decision making process from beginning to the closing stage without bringing into the decision making process political overtones.
- **Article 18 (6)** of the Constitution states that “No person shall be convicted of a criminal offence unless that offence is defined and the penalty is prescribed in a written law. On the other hand, there is a provision in the Act which makes certain actions or omissions offences. Like section **36 (b) (ii)**¹¹⁷ makes it an offence for a director to obstruct inspection or gives false statements, **section 37(3)** makes it an offence for a director or chief executive officer to fail to take all

¹¹⁷ Banking and Financial Services Act 1993 as amended

reasonable steps to secure compliance with the requirements of the Act in the management of the bank. The problem with the way these provisions are phrased is that they are too wide and do not specify the nature of behaviour that constitutes an offence. Therefore, any omission or action may constitute an offence. If that is the case, then there is a gap between the offence, the Constitution and the law enforcer. The reason is that the officers of the Bank of Zambia are not prosecutors or politicians. Their training does not prepare them for that kind of job of collecting forensic evidence. Therefore, even though the law has made a provision for that, it has not been possible for them to enforce it for the above reasons just mentioned. What is required is a system in place specifically tasked with the assignment of investigating and prosecuting the directors. Constitutionally, the elements of the offences must be certain and specific in the Act so that everybody knows what kind of behaviour constitutes an offence. They must be 'defined'; meaning clear or distinct as against the current situation where no one knows exactly what offence has been committed and the nature of the offence but all they know is that an offence has been committed. This situation is unattainable.

The World Bank has developed certain insolvency principles and one of them has re-enforced the above recommendation of criminalising certain acts of the managers of banks. **Principle number 25** has the following observation:

“Under the more exacting provisions of insolvency law, conduct and transactions that occurred before the start of formal insolvency proceedings (in some cases, several years before) can be reexamined in light of what subsequently transpired. Not only may certain transactions be impeachable (even at the expense of disrupting commercial certainty), but managers may be held personally responsible for part of the company's losses. In serious cases, managers may even be subject to criminal liability and possibly barred from managing companies for a prescribed period. These sanctions—*whose elements and operation vary considerably from system to system*—supply a necessary backbone to the proposition that the limited liability and greater access to credit enjoyed by companies are

balanced by corresponding responsibilities imposed to maintain public confidence in the credit culture in which companies operate”¹¹⁸

- The other problem that this paper has raised concerning the operations of the bank of Zambia is the failure by the Supervisor to come up with a viable plan in the management of the banks in liquidation. Under prompt corrective action, The Bank of Zambia as a bank examiner and supervisor is effectively required to progressively increase its familiarity with a bank as soon as its financial situation deteriorates to the extent that it becomes classified as undercapitalized, including increasing the frequency of on-site visits. The point to take note of is when the decision to finally take possession of the bank is made. **Section 81 (4)** of the Act states that the Bank of Zambia shall in writing inform the Minister regarding the state of affairs of a bank in respect of which it intends to take action under this section.¹¹⁹ By this requirement, it is meant that the Bank of Zambia cannot move promptly to serve the property of the depositors from being siphoned by taking possession of the Bank immediately the danger is recognized. They have to wait upon the go ahead from on high and meanwhile, money is being stolen, the culprits are running away etc Like in United Bank of Zambia, over **\$2, 426, 445-00** was externalized mysterious circumstances and the former UBZ branch manager of Ndola and Kitwe, Mr. Vikas Tandon fled the country.¹²⁰
- The provisions under **section 4 (1)** of the Act are not relevant as they bring into the picture the very same political considerations which we have already alluded to. The requirement that the Registrar, in consultation with the Minister, may grant a licence authorizing the applicant to conduct banking business is retrogressive and should be amended. At this point of making a decision, the Registrar who is a professional should be allowed to decide on these issues alone or better still, it can be made in consultation with a tribunal or Commission like it is in the Judiciary.

¹¹⁸ THE WORLD BANK-Principles and Guidelines for Effective Insolvency and Creditor Rights Systems April 2001

¹¹⁹ section 81 (4) of the B&FS Act

¹²⁰ International Group Ltd V. BOZ [2000] HPC/0372

- Bank holding companies should not be allowed to venture into other businesses which are not regulated by the Banking and Financial Services Act, like when a bank is involved in corporate bonds or insurance. It would mean that some banks would fall under two laws like in this case the B&FS Act and on the other hand the Securities Act 1993. The danger is that a repeat in the form of the BCCI disaster is a likely consequence. It is not a question of if but when it will happen.
- The other missing link that the Bank of Zambia needs to push for is the establishment of a Deposit Protection Scheme. Zambia currently does not have such a scheme and yet this has been on the books for a long time and a provision for it in the Banking & Financial Services Act.¹²¹ Insurance Schemes are in existence in almost all developed world jurisdictions and all the fears that were at first associated with them have been proven to have been without basis. The Act seems favor self-insurance or to put too much reliance on deposits maintained with Bank of Zambia. But if this was safe-proof as it is meant to be believed, then we wouldn't have had the failures or near failures that we have experienced.
- The other area of concern is the failure by the system to provide damage control measures in form of information management. Information dispersal in this line of business is very crucial. If wrong information is disbursed, it puts the system at risk like it happened in the case of two commercial banks that went under due to rumors. It is common knowledge though that the Governor does hold monthly meetings with the media to tell them about what is happening in the financial sector etc. But this is not enough as so much can happen within a short space of time that can have an impact on the banking sector and damage the stability of the financial market. The Bank of Zambia need to come up with a crisis communications committee which will work closely with other agencies like the ACC, the Police, DEC, the Media and other stakeholders in order to put a clamp on what goes out to the public. It should develop a policy dealing with damage control and responses, specifically ongoing feedback and communications

¹²¹ Section 82 (b) of the Act

services designed to preserve and rebuild the integrity of the banks. The system should be able to manage and control what is fed to the public considering the fragility nature of banks and the risks they face. This committee should act as an overseer or surveillance unit of the whole banking sector.

A look at other jurisdictions will show us that the law in this area is continuously being grown and refined in order to make sure that all the players in this sector are adequately addressed. Following a different approach, some countries that have recently revised their bankruptcy laws have introduced "unitary" proceedings as an alternative to separate, self-contained proceedings. For example, under the revised law of Germany, all insolvencies are conducted initially under the same rules and, for an initial period of up to three months, there is no presumption as to whether the enterprise will be rehabilitated or liquidated. The proceedings only separate into liquidation proceedings and rehabilitation proceedings once a determination has been made as to whether rehabilitation is, in fact, possible. The procedural simplicity of such an approach may have advantages, particularly where the capacity of the institutional infrastructure is limited.¹²²

The U.S. at the moment appears to be one of the very few countries that currently does not freeze accounts at failed banks and provides all depositors immediate and full access to the value of their claims, so that there is no loss of either liquidity or present value.¹²³

Under French law, to facilitate the conclusion of an amicable settlement with its creditors, a debtor may ask the court to appoint a "conciliator." The conciliator has no particular powers but may request the court to impose a stay of execution against all creditors if, in his or her judgment, a stay would facilitate the conclusion of a settlement agreement. During the stay, the debtor may not make any payments to discharge prior claims (except salaries) or dispose of any assets other than in the regular course of business. The procedure ends when agreement is reached either with all creditors or

¹²²Kaufman, George G., "Are Some Banks Too Large to Fail? Myth and Reality," *Contemporary Policy Issues*, October 1990, pp. 1-14.

¹²³ George G. Kaufman and Steven A. Seelig* POST-RESOLUTION TREATMENT OF DEPOSITORS AT FAILED BANKS: IMPLICATIONS FOR THE SEVERITY OF BANKING CRISES, SYSTEMIC RISK, AND TOO-BIG-TO-FAIL

(subject to court approval) with the main creditors; in the latter case, the court may continue the stay against nonparticipating creditors by providing a grace period of up to two years to the debtor.¹²⁴

(ii) THE DEPOSITORS/CREDITORS

In this inter-play, the ultimate losers have been the depositors of the bank. The identified weaknesses in the system are many but solutions are not that easy to come by. It is a fact that the system has failed to address the many problems that depositors of a failed bank are faced with. We can come up with solutions that can address their problems but are they attainable? We must not lose sight of the fact that the depositors' main interest is to get out with their money under their belts as soon as the bank is closed and any law or policy that will realize this interest will adequately address all their problems.

Indeed, most of the solutions for the depositors are inter-linked with what the Bank of Zambia is allowed to do. The fact that there is no time framework within which proven funds could be distributed is a big disadvantage. Up to now, there is no bank that has been completely liquidated.

Another problem is the lack of an Insurance Scheme. This has already been mentioned before but such a scheme would pay off all claims and then start recovering from debtors of the bank through the doctrine of indemnity. If this was established, there would be no need for systemic failures as depositor confidence would be insured. Besides, the end result will be growth in the industry as no funds will be locked up in any bank which has failed.

The other loss comes from the loss in value of the locked up funds. By principle, when the bank is placed under liquidation, the money locked up stops earning interest and as such any fall in the value of the locked up money is the loss to the depositor alone. Therefore, a law that took into consideration this difficulty will be beneficial. But this is not practicable as the money is not readily available and as such an insurance scheme

¹²⁴Kaufman, George G., "Are Some Banks Too Large to Fail? Myth and Reality," *Contemporary Policy Issues*, October 1990, pp. 1-14.

would be the only viable means. The reluctance by the banks to run some sort of self insurance scheme is that it entails having a lot of money locked up doing nothing but waiting for some eventuality instead of being invested in some viable business.

Kaufman and Sigmund indicated in their paper that America is the only country in the world so far that has implemented a legal framework structured towards eliminating depositor losses after a bank has failed. This post-treatment of depositors ensures that depositors whether insured or uninsured get their money within a specified time period and the goal is to give them the money in full. Here below is a brief account of how American depositors are treated after the bank has been placed under receivership.

“...When a bank is legally failed and resolved so that it is placed in receivership, depositors at domestic offices of the bank makes claims on the insurance agency equal to the par value of their deposits up the maximum de jure insurance coverage. For amounts above this ceiling they make their claims on the designated bank receiver, generally the Federal Deposit Insurance Corporation (FDIC), equal to the prorata share of the amount of funds recovered from the sale of the bank or its assets... In this case, the uninsured depositors (or other creditors) and the FDIC, which stands in the shoes of the insured depositors, are entitled to the proceeds as they are collected and distributed by the receiver. But, if asset sales are partially or totally delayed or distributions of funds to claimants are delayed, there is a potential loss in liquidity to both insured and uninsured depositors. *However, although the FDIC may not obtain funds from the asset sales immediately, unlike most other insurance companies, e.g., automobile or fire insurers, it attempts to pay the insured deposits as promptly as possible to reduce depositor illiquidity...* Insured (FDIC) and uninsured deposits have equal priority. Thus, these deposits do not experience a significant liquidity loss.

To facilitate this policy, insured banks are currently generally failed and placed in receivership on Thursdays or Fridays and the insured deposits made available close to the next business day – Monday – either at the bank that assumed the deposits or at a designated paying agent. The weekend generally provides the FDIC with time to obtain information from the failed bank’s records on the identification of the insured depositors

and the amount of the eligible insured deposits. In most instances, additional time is provided as the FDIC is notified by the bank's primary federal regulator when or before a bank becomes classified as "critically under-capitalized" according to the tripwire definitions of prompt corrective action under the FDIC Improvement Act (FDICIA) of 1991.⁴ At this point, resolution is generally required within 90 days, although extensions up to 270 days are permitted. The FDIC reimburses itself for the advances of the recovery amounts from the proceeds of the later asset sales. Errors in estimating the recovery amount affects only the size of the insurance loss, not the size of the payments to insured depositors...¹²⁵

From the above account, at least we can see that our counterparts have gone very far in mitigating the losses that are usually incurred in such circumstances. We should also strive to do the same.

(iii) THE WORKERS

The problem of workers does raise interesting legal, ethical and practical issues. On the 19 hours news on 6th August 2005, there was a bulletin that the former Premium Oil workers which has been placed under receivership had gone to the Ministries of Finance to try and make him intervene in their plight or if possible pay them their benefits from the government coffers. The Minister's response in this matter was very swift and to the point and I quote, "...Government is only responsible in matters that pertain to civil servant and it is not responsible for those workers (Premium Oil Workers)...they should go and see their employer."¹²⁶

The weakness of the position of the workers is as a result of the failure by the government to come up with a policy that places an obligation on the legislator to require him to enact a law that takes into consideration the payment of the benefits to the

¹²⁵ George G. Kaufman and Steven A. Seelig* POST-RESOLUTION TREATMENT OF DEPOSITORS AT FAILED BANKS: IMPLICATIONS FOR THE SEVERITY OF BANKING CRISES, SYSTEMIC RISK, AND TOO-BIG-TO-FAIL- Policy Issues, October 1990, pp. 1-14.

¹²⁶ The 19hrs bulletin News from ZNBC

employees as a matter of priority even before government levies or taxes are paid off to the government.

The Trade Union need to negotiate on behalf of the workers that in case of liquidation, the employer shall pay off the terminal benefits of the workers even before the priority list is considered unless it is found and proved that the workers concerned contributed to the closure of the bank. This requirement should be reflected in the Banking and Financial Services Act. If nothing is done to improve the position of the workers, the situation will remain as pathetic as it is now and nothing will stop the employees in taking the law in their hands by paying themselves off handsomely and then sabotaging the data like it was the case in Prudence Bank and many other banks under liquidation.

4.1 CONCLUSION

This essay on involuntary bank liquidations in Zambia has tried to look at the causes of these bank failures and the causes of action available to the participants. I have noted from the onset that the banks are companies first formed under the Companies Act and then licensed and regulated by the Banking and Financial Services Act. This in itself is not a burden to the parties concerned where these companies sole objective is banking, but it may prove problematic where other objects are in view and this is commonly the case with bank holding companies who by the requirement of the law consolidate their financial activities in one profit & loss balance sheet thereby blurring the individual weaknesses. My recommendation is that these holding companies should be discouraged until later in future when our reporting and information standards can be understood by the participating public.

The paper also recommends the need to seriously consider rehabilitation of the institutions concerned as opposed to early liquidations. The concern here, as it is in the rest of the paper is to minimize the cost of closure. Unfortunately, the history of rehabilitations in this country is mixed except for the rehabilitation of Capital Bank. All other attempts have not succeeded, mainly because of the erosion of confidence by the public and the inadequate resources to weather the ensuing deposit withdrawals. My view is that, no rehabilitation should be attempted without showing that capital exists to allow for a possible full withdrawal of money by depositors; especially those not covered in the scheme of arrangement(for rehabilitation).

The other conclusion that I have arrived at is that, bank failures are caused by economic as well as risks inherent in running the banking business. Most of these can be mitigated by proper recruitment and licensing of investors who understand banking business and how profits are made in this business.

I have also noted that when bank stress occurs in the sector, the Bank of Zambia undertakes several steps to correct and admonish the concerned management. It has however been noted that it is impossible for inspectors to fully appreciate the risk behaviour of the managers. The managers whose motive should be profit maximization are expected to safeguard the interests of their organization over the long haul, but unfortunately, some of these managers undertake risks whose dire consequences are firstly hidden from the regulators and secondly, even to the directors and shareholders of the bank concerned. The solution to this lies in the proper selection and recruitment of senior staff and continuous training of those joining the financial sector.

I have observed that there are five parties to the liquidation process:

- The liquidator (BOZ)
- The Courts of Law
- The shareholders
- The depositors and
- The employees.

The liquidator in this case does not suffer losses except where in the case of Bank of Zambia it advances money to the stressed bank in the hope of resuscitating it. The role of the courts is to interpret the law and presently there is no evidence to prove that the courts have failed in this matter.

The case of the shareholder has been concluded already as a hopeless one in the case of insolvency. The only situation where an argument can possibly be raised in their favor is where the bank is liquidated for any other reason.

The depositors are the only group which is truly disadvantaged as they suffer loss occasioned by others in whose hands they had entrusted their savings. As discussed in detail in this essay, consideration should be given to setting up an insurance scheme.

And lastly but not the least, employees suffer loss of wages and salaries. This cannot be remedied easily and efforts should be made to mitigate their loss. This is an area of future research and thought.

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