Fraudulent Trading: Characteristics and deficiencies

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In tandem with the legal position under English law, albeit with certain structural variations which will be addressed in this article, fraudulent trading in Cyprus is both a civil and criminal concept which, in effect, circumvents the principle , as propounded in *Salomon v Salomon [1897] AC 22*, that a company has an artificial legal personality which is separate and distinct from that of its shareholders (suffice it to remind ourselves that the doctrine has historically evolved to also encompass directors, by virtue of the fact that in small private companies, or so-called quasi-partnerships, there is, more often than not, no substantive delineation between ownership and management).

In this context, what is poetically referred to as the "veil of incorporation", is statutorily lifted by the Cyprus Companies Law (CAP113) to by-pass the well-established notion that shareholders (and directors) cannot, from a general standpoint, be rendered legally responsible for liabilities incurred by the corporate entity over which they ordinarily enjoy management and control.

At the outset, it would be appropriate to address the current legislative framework and applicability of fraudulent trading in Cyprus, with a view to assessing its practical efficaciousness in seeking and securing appropriate redress from delinquent directors (and indeed other offending parties), who persist in engaging in business activities whilst the company seemingly finds itself in a financially precarious position, on the slippery path to insolvency.

S311 (1) CAP113 provides that if in the process of corporate liquidation, it transpires that:

"any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court, on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper to do so, declare that any persons who were knowingly parties to the carrying on of the business in the manner aforesaid , shall be personally responsible, without any limitation of liability for all or any of the debts or other liabilities of the company as the Court may direct"

A brief analytical breakdown of the composite requirements of this provision, would be useful in determining its utility value and its practical effectiveness in deterring or preventing directors or other persons from continuing to trade (in prescribed circumstances), with a view to minimising losses which might otherwise be sustained by the company's creditors.

It is clear that for the purposes of activating S311 of CAP113, the corporate entity's business may be carried on where only a single transaction is involved, for case authority suggests that there is no need to establish that the company was engaged in a series of irregular dealings before liability may ensue *(Re Gerald Cooper Chemicals Ltd [1978] 2 All ER 49).*

With regard to the expression "any persons who were knowingly parties" this would, needless to say, effectively encompass anyone, (such as a director, auditor, creditor, banker, adviser etc.), who has played a tangible part in perpetrating or facilitating the fraudulent activity in issue. Thus, in *Re Maidstone Building Provisions Ltd (1971),* whilst a company secretary could, in principle, be caught by the provision, his omission in alerting the directors that the company was insolvent, did not suffice, on the facts, to render him liable under S213 of the Insolvency Act 1986 (IA 1986) - the latter being the corresponding statutory provision under English law. As previously mentioned, the wording of S311 Cap 113 leaves no doubt that a party need not necessarily be engaged in the management or business activities of the company, so that a creditor whose debt is discharged by payment from funds generated by the directors' fraudulent actions, is likely to be caught by the provision in question *(Morris v Banque Arabe et Inter-nationale D'Investissement SA (No 2) (2000) The Times, 26 October*). The broad ambit of the section's wording was aptly illustrated and addressed by the Court in *Morris v Bank of India [2004] EWHC 528 (Ch)*, in circumstances where the liquidators of BCCI were able to substantiate that a course of financial dealings between the latter and the Bank of India were fraudulent, and that certain bank employees who were involved in these transactions, were in fact aware that they were defrauding the company's creditors. The nature of the bank personnel's participation was such that it sufficed to render them personally liable, even though they were not employed by the company, and notwithstanding the fact that they had no connection with the entity's management or control – a stark reflection of the extent to which the statutory provision will apply to draw in, and render liable, those parties who are not an integral human resource component of the corporate structure.

In England, under S213 IA 1986, a declaration of civil liability may only be sought by the liquidator, whereas per S311 Cap 113, the official receiver, a contributory (shareholder) or creditor, is at liberty to do so. Whilst this has always been the position under Cyprus law, the range of potential applicants under English law was reduced following the recommendations of the Cork Committee which, however, subsequently came under criticism for restricting such applications to liquidators. Following this change, civil liability for fraudulent trading under S213 IA 1986, cannot therefore flow from any action where steps are taken to defraud a single creditor – an issue which came to light in *Morphites v Berlusconi [2003] 2 BCLC*, where the company's lessor was precluded from doing so, notwithstanding the fact that he was defrauded in connection with outstanding rental payments. A further point that merits mention is that, under English law, any funds that are harnessed pursuant to an order made under S213 IA 1986, must necessarily be integrated with the general assets of the company and made available to the liquidator (as opposed to any affected party). In this context, and in view of the fact that in Cyprus, S311 Cap 113 has retained the broader range of potential applicants (a hangover from S332 of England's Companies' Act

1948), it would perhaps be prudent to refer to the court's approach in *Cyona Distributors Ltd [1967] Ch 889*, a case which preceded the changes occasioned by the Insolvency Act 1986, and which addressed the matter of creditors' rights. During the course of his judgment, Lord Denning declared that whilst creditors themselves were, at the time, entitled to initiate a fraudulent trading claim, the courts nevertheless had a wide discretion as to who might benefit from any ensuing order (it is interesting to note that in the key pre-1986 case of *Re Patrick and Lyon [1933] Ch 786,* the relevant application was in fact lodged by the company's creditors and not the liquidator).

As mentioned in the preceding paragraph, the narrowing down of potential fraudulent trading applicants in England, did not meet with universal acceptance and one can only speculate as to what prompted the Cork Committee to propose the change in question. Commentators have, perhaps justifiably so, suggested that this may have been inspired by an attempt to pre-empt any disruption or distortion of the workings of the insolvency regime which entailed a regulated and systematic process of seeking to ensure an equitable distribution and allocation of funds to those properly entitled thereto under the prescribed mechanisms of liquidation proceedings. This aspect might perhaps be worthwhile bearing in mind, having regard to the fact that the range of potential applicants in Cyprus remains unaltered from the previous position existing under the 1948 Companies Act in England.

It is evident that judicial definitional requirements for establishing fraudulent trading, call for a particularly stringent standard of proof which inevitably operates to hamper or restrict the applicant's prospects of successfully securing a declaration for the imposition of civil liability on the part of offending parties. In this context, and in the absence of any statutory definition which might otherwise have cast further light, or offered some clarity on the issue, one is constrained to resort to case authority for guidance. In this regard, fraud has been described as "*real dishonesty involving, according to current notions of fair trading among commercial men ……., real moral blame" (*per Maugham J in *Re Patrick and Lyon Ltd [1933])*. In essence, nothing short of proving actual dishonesty would suffice in order to render someone liable (*Welham v DPP [1961]*). However, and despite efforts to provide some clarification as to what might conceivably constitute an intent to defraud, judicial pronouncements have been somewhat erratic in coming up with a consistent line of approach. In any event, and "adding fuel to fire", the demanding standard of proof required to establish fraudulent intent, is a key prohibitive factor in efforts to establish liability, a position which was borne out by the fact that proceedings instituted under the operative statutory regimes in England and Cyprus, have rarely produced the desired results for applicants seeking recovery through a successful judicial outcome. Whilst this legally impotent state of affairs prompted the promulgation of an alternative statutory device, under English law, in the form of the concept of wrongful trading (further addressed below), there has however been no corresponding legislative initiative in Cyprus, to counter the perceived weaknesses or apparent deficiencies of current statutory provisions governing fraudulent trading.

It is evidentt that the element of criminality which is attached to the concept of fraudulent trading has done little to facilitate the effectiveness of the civil liability

aspect. Indeed, one might go so far as to say that it has effectively contributed towards hampering its utility value because of the underlying penal element which is reflected by S311 (3) CAP 113, a provision which, as reflected from the following wording thereof, is essentially inextricably aligned to the same constituent components of the civil law provision S311 (1) CAP 113.

"Every person who is knowingly a party to the carrying on of the business in the manner aforesaid, shall be liable on conviction to imprisonment not exceeding three years or to a fine ……..."

It inevitably follows from the foregoing that, having regard to the fact that fraudulent trading is also a criminal offence, the standard of proof in civil proceedings would thereby be difficult to attain. In this context, it should be noted that under English law, the civil and criminal concepts were duly separated in 1985 and, in due course, the former concept was incorporated per S213 IA 1986, whereas the latter subsequently made its way into S993 CA 2006, under which (unlike the unchanged CAP113 provision S311 (3), in Cyprus), the criminal law concept (which is otherwise almost identical to the civil law concept under S213 IA 1986), may now also be applicable in circumstances where the company is not embroiled in, or subject to an insolvency process.

As previously mentioned, in the light of the relatively stagnant English legal landscape regulating fraudulent trading (in essence attributable to the prohibitive factors addressed in this article), S214 IA 1986 introduced an alternative civil law concept, that of wrongful trading which, as the present law stands, does not have the benefit of a corresponding statutory provision in Cyprus. The concept was primarily brought to the fore with a view to requiring a significantly lighter burden of proving negligence (thereby circumventing the cumbersome evidential task of establishing dishonest intent), whilst effectively leading to the same consequences as fraudulent trading, which nevertheless continues to remain on England's statute books per S213 IA 1986.

The wrongful trading concept may conceivably present valuable food for thought for the legislature in Cyprus, as was indeed the case with other jurisdictions which were inspired to adopt a similar or analogous regulatory position to that prevailing in English law. From one standpoint, wrongful trading , unlike its fraudulent counterpart, has a narrower application in that it only applies to directors, to whom it essentially conveys a clear message to ensure due caution is exercised prior to conducting business as usual, in a seemingly desperate or "last ditch" effort to get back on the proverbial road to recovery. From another perspective, this concept has a broader application for it departs from an intention to defraud, to a position where liability would ensue where directors negligently opted to carry on trading at a time when they knew or ought to have known that there was no reasonable prospect of the company recovering (in terms of avoiding insolvent liquidation). In this regard, a court must be convinced that the director concerned did not adopt the measures which he ought to have done so as to limit the potential loss to creditors. This particular requirement, in effect, raises two questions, namely what a reasonably diligent person exercising such functions

would have done under the circumstances (an objective notion), and the additional subjective criterion pertaining to such person's general knowledge skill and experience. In essence, the objective standard is to be regarded as constituting a minimum benchmark, below which liability would be forthcoming. This statutory indicator however, may conceivably be elevated to a higher level of expected competence, so that a stricter standard is effectively established if, in the particular circumstances, relevant subjective considerations so dictate.

The foregoing seeks to raise some of the difficulties encountered in relation to the current fraudulent trading regime in Cyprus, within the legislative framework of CAP 113, and with reference to the past and present position under English law. As a starting point, and as a basis for producing a more efficacious legal mechanism for dealing with delinquent trading within a financially vulnerable corporate environment , the time may perhaps be appropriate to give some thought to the formulation of a concept akin to that of the wrongful trading provisions under S214 IA 1986 which, interestingly, and as a reflection of their broader acceptance as a corporate barometer for managerial competence under English law, were adopted verbatim by S174 (1) of the Companies Act 2006, as the applicable test for determining the requisite standard to be attained by directors when ordinarily discharging their duty to exercise reasonable care, skill and diligence, while executing their day-to-day directorial functions. Whilst this core duty continues to remain in the common law domain in Cyprus, it is likely that this useful statutory criterion for determining negligent corporate conduct in general, will conceivably have an authoritative persuasive impact, in circumstances where such an issue presents itself before the island's courts.