FRAUDULENT TRADING: THE FOUR PRINCIPLES

Consumer Crime Cases

The Home Office, in its "Explanatory Notes" to the Fraud Act 2006, sets out four principles which it says are derived from the relevant case law relating to comparable companies legislation. But, are all those principles accurately stated? A shortened version of this article was first published in the Criminal Law & Justice Weekly (2012) 176 JPN 27 and 41.

Fraudulent trading by a company is outlawed by s 993 of the Companies Act 2006 ("CA") and fraudulent trading by an unincorporated business has an equivalent offence provision in s 9 of the Fraud Act 2006 ("FA"). S 993(1) CA provides: "If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, every person who is knowingly a party to the carrying on of the business in that manner commits an offence." Under s 9(1) FA: "A person is guilty of an offence if he is knowingly a party to the carrying on of a business to which this section applies. S 9(2) provides that: "This section applies to a business which is carried on

(a) by a person who is outside the reach of [s 993 CA] (offence of fraudulent trading), and

(b) with intent to defraud creditors of any person or for any other fraudulent purpose."

The explanatory notes which relate to the CA, and which were prepared by the Department of Trade and Industry, simply note that s 993 CA, apart from an increased penalty, restates s 458 of the Companies Act 1985. The explanatory notes which accompany the FA, however, and which were prepared by the Home Office "in order to assist the reader in understanding the Act", are more extensive and, whereas they expressly state that "they do not form part of the Act and have not been endorsed by Parliament" they are clearly intended to be influential. Paragraph 30 of those notes on s 9 FA states:

"A person commits the offence of fraudulent trading under the companies legislation if he is knowingly party to the carrying on of a company's business either with intent to defraud creditors or for any other fraudulent purposes. This section creates a similar offence that applies to persons knowingly party to the carrying on of non-corporate businesses in either of those ways. Fraudulent trading is in effect a general fraud offence, comparable to conspiracy to defraud, but requiring the use of a company instead of the element of conspiracy. The case law has established that:

- dishonesty is an essential ingredient of the offence;
- the mischief aimed at is fraudulent trading generally, and not just in so far as it affects creditors;
- the offence is aimed at carrying on a business but can be constituted by a single transaction; and
- it can be committed only by persons who exercise some kind of controlling or managerial function within the company.

It is intended that these principles should apply to the new offence in section 9 too."

Although the Home Office has set out four bullet points indicating principles which it says have been established by case law, it does not cite any authorities for them. It is submitted here that the third point is wrong as being couched too widely and the fourth point is wrong as being too restrictive.

The Home Office is doubtless right in saying that the case law relating to the similarly worded companies legislation, is applicable to the interpretation of both s 993 CA and s 9 FA. This includes not just the case law on the former s458 of the Companies Act 1985, but also that on the civil and criminal provisions in the former s 332 Companies Act 1948 and the civil provisions in the current s 213 of the Insolvency Act 1986. The latter provides:

> *"(1) If in the course of the winding up of a company it appears 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 following has effect.*

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper."

So far as the meaning of "fraudulent purpose" is concerned, s 9(5) FA states that it has the same meaning as in s 993 CA. However, anyone expecting to find a definition of "fraudulent purpose" in s 993 CA will be disappointed. It is therefore necessary to look at the case law. In ***Re Patrick & Lyon Ltd*** **[1933]** Ch 786 at 790, Maugham J said:

"I will express the opinion that the words 'defraud' and 'fraudulent purpose,' ... are words which connote actual dishonesty involving, according to current notions of fair trading among commercial men, real moral blame.".

In ***R v Grantham*****[1984]** 1 QB 675, [1984] 3 All ER 166 ("*Grantham*"), Lord Lane CJ approved a passage from the summing up of the trial judge, in relation to an offence under s 332 Companies Act 1948, in which he said an intent to defraud arises when a trader *"knows he is stepping beyond the bounds of what ordinary decent people engaged in business would regard as honest."*

As for the meaning of "knowingly"; in ***Morris v State Bank of India*** **[2003]** EWHC 1868 (Ch), Patten J said:

"Knowledge includes deliberately shutting one's eyes to the obvious, provided that the fraudulent nature of the transactions did in fact appear obvious ... It is well established that it is no defence to say that one declined to ask questions, when the only reason for not doing so was an actual appreciation that the answers to those questions would be likely to disclose the existence of a fraud."

In ***Manifest Shipping Company Limited v Uni-Polaris Company Limited*** **[2003]** 1 AC 469, Lord Scott of Foscote said:

"In summary, blind-eye knowledge requires, in my opinion, a suspicion that the relevant facts do exist and a deliberate decision to avoid confirming that they exist. ... the suspicion must be firmly grounded and targeted on specific facts. The deliberate decision must be a decision to avoid obtaining confirmation of facts in whose existence the individual has good reason to believe."

The four Home Office principles are now considered seriatim.

1) Dishonesty is an essential ingredient of the offence

Although the word "dishonesty" does not appear in s 993 CA or s 9 FA, there can be no doubt that it is an ingredient of offences under those provisions. Indeed, this was held in relation to the companies legislation in ***R v Cox and Hodges*** **(1982)** 75 CR App Rep.

In ***Grantham***, *ante*, Lord Lane CJ said that it was possible for the jury *"if they thought fit, to come to the conclusion that the appellant was acting dishonestly and fraudulently if he realised at the time when the debts were incurred that there was no reason for thinking that funds would become available to pay the debt when it became due or shortly thereafter".*

In ***Morris & Ors v State Bank of India,*** *ante*, Patten J said that the words *"'intent to defraud' ... obviously do connote actual dishonesty ... But in the case of a secondary party, sought to be made liable under s 213(2), all that is in terms required is that that party should have knowingly participated in the carrying on of the business with intent to defraud. It is difficult to see how, in practice, a conscious decision to participate in transactions which are known to be fraudulent does not constitute dishonesty ..."*

2) The mischief aimed at is fraudulent trading generally, and not just in so far as it affects creditors

This proposition is correct and is, in essence, what was held by the Court of Appeal in ***R v Kemp*** **[1988]** 1 QB 645, in rejecting an appeal under s 332 Companies Act 1948 on the footing that the relevant victims were customers not creditors.

In ***Morphitis v Bernasconi*** **[2003]** EWCA Civ 289, Chadwick LJ said: *"It is not, in my judgment, a pre-condition of finding the relevant intent to defraud creditors or other fraudulent purpose, that there has been an incurring of credit. The relevant detriment, as in Kemp, may not involve the incurring of credit and indeed the relevant intent may not, in a given case, succeed. The obtaining of credit can be relevant intent to defraud or relevant fraudulent purpose but it would be wrong to elevate the obtaining of credit to a requirement of liability under s 213 [Insolvency Act 1986]."*

Although the Home Office has stated its second principle correctly and, in its preamble, recognised that there are two ways in which the offences can be committed, it has throughout the wording of its four propositions referred to "the offence" as though s 993 CA and s 9 FA each create just one offence.

In *Kemp*, *ante*, the argument that the words "any fraudulent purpose" should be construed *ejusdem generis* with "intent to defraud creditors" was rejected. In ***R v Inman*** **[1967]** 1 QB 140, the Court of Criminal Appeal said that there were "quite plainly ... two different types of offence" and that, had both types been alleged in a charge, it would have been bad for duplicity. It is a failure to differentiate between the two types of offence which causes the Home Office's next principle to be misleading.

3) The offence is aimed at carrying on a business but can be constituted by a single transaction

Whereas there is authority for the proposition that the offence of fraudulent trading with intent to defraud creditors can be constituted by a single transaction, the case law does not extend to fraudulent trading for any other fraudulent purpose. In ***Re Gerald Cooper Chemicals Ltd*** **[1978] Ch 262, [1978]** 2 All ER 49 ("*Cooper*"), a creditor applied, under s 332(1) Companies Act 1948, for a declaration that an outsider company and its directors were knowingly parties to the carrying on of the "Cooper" business, which was in creditor's liquidation, with intent to defraud creditors and for other fraudulent purposes. Templeman J held:

> *"[Cooper] was carrying on the business of selling indigo. In my judgment, they carried on that business with intent to defraud creditors if they accepted deposits knowing that they could not supply the indigo and were insolvent. They were carrying on business with intent to defraud creditors as soon as they accepted one deposit knowing that they could not supply the indigo and would not repay the deposit. It does not matter for the purposes of s 332 that only one creditor was defrauded, and by one transaction, provided that the transaction can properly be described as a fraud on a creditor perpetrated in the course of carrying on business. If [Cooper] had fraudulently supplied sub-standard indigo [they] would have committed a fraud on a customer, but by accepting a deposit knowing that they could not or would not supply indigo, and by using the deposit in a way which made it impossible for them to repay ... [they] committed a fraud on a creditor."*

It will be seen that Templeman J differentiated between that which constituted a fraud on creditors from that which was only a fraud on a customer who was not a creditor. He did so in order to distinguish ***Re Murray-Watson Ltd*** **(1977)** unreported, April 6, in which Oliver J said:

> *"[S 332] is aimed at the carrying on of a business ... and not at the execution of individual transactions in the course of carrying on that business. I do not think that the words 'carried on' can be treated as synonymous with 'carried out', nor can I read the words 'any business' as synonymous with 'any transaction or dealing'. The director of a company dealing in second-hand motor cars who wilfully misrepresents the age and capabilities of a vehicle is, no doubt, a fraudulent rascal, but I do not think that he can be said to be carrying on the company's business for a fraudulent purpose, although no doubt he carries out a particular business transaction in a fraudulent manner."*

Templeman J was left free to hold that, in the different scenario in *Cooper*, where there was intent to defraud a creditor, rather than a fraudulent purpose, a single transaction could suffice. It follows that *Re Murray-Watson Ltd* is authority for the principle that a single fraudulent transaction does not cause a business to be run for a fraudulent purpose whereas *Cooper* is authority for the principle that a single fraudulent transaction can cause a business to be operated with intent to defraud creditors.

In ***Morphitis v Bernasconi*** **[2003]** EWCA Civ 289, Chadwick LJ accepted that *"a business may be found to have been carried on with intent to defraud creditors notwithstanding that only one creditor is shown to have been defrauded, and by a single transaction."* However, he went on to say:

> *"But, if (which I doubt) Templeman J [in Cooper] intended to suggest that, whenever a fraud on a creditor is perpetrated in the course of carrying on business, it must necessarily follow that the business is being carried on with intent to defraud creditors, I think he went too far. It is important to keep in mind that the pre-condition for the exercise of the court's powers under s 332(1) of the 1948 Act - as under s 213 of the 1986 Act - is that it should appear to the court 'that any business of the company has been carried on with intent to defraud creditors of the company'. Parliament did not provide that the powers under those sections might be exercisable whenever it appeared to the court 'that any creditor of the company has been defrauded in the course of carrying on the business of the company'."*

It follows that, although it may be true to say that there is a principle that the offence of fraudulent trading can be constituted by a single transaction, it does not apply where the offence is based on a fraudulent purpose other than the intent to defraud creditors and, even then, a single transaction will not suffice in every case. Common sense dictates that a business cannot be properly characterised as having a fraudulent purpose when but a single transaction was carried out fraudulently, unless perhaps it can be shown that the business was only set up in order to perpetrate that single fraud.

It is pertinent to note that ***Archbold: Criminal Pleading, Evidence and Practice 2012***, at paragraph 30-118, states:

> *"A single large transaction may constitute the carrying on of a business for the purpose of the Act: [Cooper] although the section is primarily aimed at the carrying on of a business and not at the execution of individual transactions. Misleading one creditor over a short period in relation to one debt was held not to be fraudulent trading under the similarly worded Insolvency Act 1986, s 213: Morphitis v Bernasconi [ante]."*

Archbold, therefore, does not improve much on the Home Office in making it clear that a single transaction may only suffice if the fraudulent trading is based on an intent to defraud creditors. As for the reference to a single transaction having to be "large", this proposition does not derive in terms from *Cooper*. However, particularly in the light of *Morphitis v Bernasconi*, a single *small* transaction is unlikely to be considered sufficient.

It should be remembered that, even if a single fraudulent transaction by a business does not fall foul of s 993 CA or s9 FA, a party to that fraud may have committed the offence of fraud contrary to s 1 FA whether or not the business is incorporated.

4) The offence can be committed only by persons who exercise some kind of controlling or managerial function within the company

It may be that the undisclosed authority for this, the Home Office's fourth principle, is ***Grantham*** and ***R v Miles*** **[1992]** Crim LR 657 ("*Miles*"). Indeed, *Archbold* states, at paragraph 30-119: *"In [Miles] the Court of Appeal approved the words of Lord Lane CJ in [Grantham] that the section is intended to cover those who are 'running the business', meaning exercising a controlling or managing function."* However, in ***Banque Arabe et Internationale d'Investissement SA v Morris*** **[2001]** 1 BCLC 263 ("*Banque Arabe*"), Neuberger J said he did not consider that the decisions in *Grantham* and *Miles* assisted the proposition being made in that case. That proposition was all but identical to the Home Office's fourth principle.