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The Truth About Dishonesty in Fraudulent Trading Under English Law

By Howard Morris, Sonya L. Van de Graaff, and Edward Downer*

A recent decision of the English High Court has found a director guilty of fraudulent trading under Section 213 of the Insolvency Act 1986. The Court held that the question of dishonesty involves, firstly, determining as a question of fact the defendant's actual knowledge or belief as to the facts *and, secondly, establishing whether the defendant's conduct was dishonest according to the* objective standard of ordinary people. *The authors discuss the decision and its implications.*

A recent decision of the English High Court (the "Court"), *Pantiles Investments Ltd & Anor v Winckler*,[1] has found a director guilty of fraudulent trading under Section 213 of the Insolvency Act 1986 (UK) (the "Insolvency Act"). Section 213 is a ground of liability rarely invoked, yet it is an important remedy for insolvency practitioners, particularly since it can be raised where the insolvent company's assets overall have not been diminished in the course of trading—in contrast to "wrongful trading" under Section 214 of the Insolvency Act.[2] Following *Morris v Bank of India*,[3] the Court accepted that, although the term "dishonesty" is not used in Section 213, dishonesty is a requisite component in establishing liability.

In the first application of Section 213 since the Supreme Court's decision in *Ivey v Genting Casinos (UK) Ltd* ("*Ivey*"),[4] the Court held that the question of dishonesty involves, firstly, determining as a question of fact the defendant's actual knowledge or belief *as to the facts* and, secondly, establishing whether the defendant's conduct was dishonest according to the *objective standard of*

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[1] *Pantiles Investments Ltd & Anor v Winckler*, [2019] EWHC 1298 (Ch) (23 May 2019), https://www.bailii.org/ew/cases/EWHC/Ch/2019/1298.html.

[2] *Re Ralls Builders Ltd*; *Grant v Ralls* [2016] EWHC 243 (Ch).

[3] [2004] BCC 404.

[4] [2018] AC 391.

ordinary people. In arriving at a finding of guilt, the Court quoted the following excerpt from the Supreme Court in *Ivey*:

> The reasonableness or otherwise of his belief is a matter of evidence . . . going to whether he held the belief, but it is not an additional requirement that his belief must be reasonable; the question is whether it is genuinely held. When, once the actual state of mind as to knowledge or belief *as to facts*, is established, the question whether his conduct was honest or dishonest is to be determined by the fact-finder by applying the (objective) standards of ordinary decent people. *There is no requirement that the defendant must appreciate that what he has done is, by those standards, dishonest*.[5]

The law has thus moved away from the further requirement, previously accepted,[6] that the defendant *must realize* that what he or she was doing was, by the standard of reasonable and honest people, dishonest.

The Court also considered whether there is fraudulent trading if a company incurs a new liability in circumstances in which the liability provides no benefit to the company and which liability the company has no intention of servicing or repaying.

This article is relevant to companies in financial stress, as well as to directors, corporate advisors, creditors, and insolvency practitioners.

WHAT IS FRAUDULENT TRADING?

When a company is wound up, the individuals who ran the company are scrutinized. As part of this process, anyone who knowingly carried on the business with intent to defraud either the company's creditors *or* the creditors of another person may be ordered to contribute to the company's assets.[7] Fraudulent trading is both a criminal offence and a civil liability.

Section 213 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

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[5] Emphasis added.

[6] *R v Ghosh* [1982] QB 1053.

[7] Insolvency Act 1986 Section 213.

> 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.

Following *Morris v Bank of India*, the Court accepted that the liquidator was required to show knowledge that the transaction was entered into to defraud creditors, that such knowledge was contemporaneous with the alleged conduct (subsequent knowledge based on hindsight being insufficient) and that "blind-eye" knowledge is sufficient.

THE FACTS OF THE CASE

The liquidator of Pantiles Investment Limited ("Pantiles") brought an application against Ms. Winckler, the former sole director and shareholder of Pantiles, for fraudulent trading under Section 213 to recover from her a contribution to the assets of Pantiles in a sum equal to the deficiency to its creditors. The liquidator also brought other claims against Ms. Winckler, including fraudulent breach of trust and breach of her director's duties. This alert focuses on the claim for fraudulent trading.

There was no argument that Pantiles was incorporated for the purpose of purchasing a property from Ms. Winckler's long-standing friend and employer, Mr. Goldbart. Ms. Winckler had told the Court that the purchase was made as a "buy-to-let" investment to help fund her retirement. The transaction took place on February 15, 2011 for a purchase price of £500,000. The details of the transaction are as follows.

Neither Ms. Winckler nor Pantiles provided any equity contribution towards the purchase price. Ms. Winckler's annual income was approximately £17,000 and she had limited financial resources. No "high street" lender would lend the purchase price to her. Ultimately, Pantiles was incorporated and the purchase was funded entirely by way of various specialist short-term, high-interest rate loans incurred by Pantiles. One of these loans was made by Goldbeck Investment (2009) Limited ("Goldbeck (2009)"), whose director was Mr. Goldbart's wife (Ms. Iwamoto). The evidence established to the Court's satisfaction that Goldbeck 2009 never actually funded its loan. Mr. Goldbart and Ms. Iwamoto did not vacate the property on completion of the purchase but instead entered into a rental agreement with Pantiles whereby they were to rent the property at a monthly rent significantly below monthly interest payments due on the loans. Pantiles was wound up in 2015 following a petition from HMRC for unpaid tax.

The Court found that Ms. Winckler had executed a declaration of trust to

hold the shares in Pantiles as bare trustee for Mr. Goldbart, so that at no time would the beneficial interest in the property depart from Mr. Goldbart. The Court also found that Ms. Winckler had permitted Mr. Goldbart to operate Pantiles' email account as his own and that she effectively ran Pantiles on his instructions.

Mr. Goldbart was made bankrupt on October 5, 2011 and his trustee in bankruptcy was appointed on January 5, 2012. Ms. Winckler's evidence as to her awareness of Mr. Goldbart's financial difficulties was inconsistent and, the Court found, unreliable.

Pantiles sold the property to a third party on June 12, 2012 for £899,000. A proportion of the sale proceeds were paid to Goldbeck 2009. A portion was paid to Mr. Goldbart's trustee in bankruptcy in settlement of the trustee's claim that Mr. Goldbart's sale of the property to Pantiles was a transaction at an undervalue.

THE COURT'S FINDINGS

The Court found that Ms. Winckler's account of the purchase of the property as a buy-to-let investment was inherently improbable, holding "it could never have worked as an investment" since it was wholly implausible and inconsistent to fund the purchase entirely from loans, to lease the property back to Mr. Goldbart and Ms. Iwamoto for an amount significantly less than the monthly interest charges on the loans, and with no ability to repay the loans in accordance with their terms.

The Court reasoned that the more inherently improbable a defendant's explanation of his or her behavior, the stronger the evidence required to establish it. In this case, there was simply no cogent evidence to support Ms. Winckler's explanation that the purchase was an arm's length buy-to-let investment transaction. The Court found that, while Ms. Winckler might "lack commercial experience, she is an intelligent woman who was able to, and did, appreciate the nature and effect of the documents that she signed on behalf of Pantiles and the lack of commercial reality behind them at the time."

Pantiles' repayment of the "Goldbeck (2009) loan" was held to be a device to cause Pantiles' proceeds of sale to be paid to Mr. Goldbart's associate for his own benefit. The Court also found that Ms. Winckler had taken steps to conceal the fact that she was aware of Mr. Goldbart's forthcoming bankruptcy; she knew that Pantiles was being operated to keep the value of the property out of the hands of Mr. Goldbart's trustee, and she facilitated that by allowing Pantiles to be directed by Mr. Goldbart and giving her approval to the purchase from Mr. Goldbart at an undervalue.

Ultimately, the Court found that the transaction had been carried out with intent to defraud Mr. Goldbart's creditors and that Ms. Winckler knew this. The Court therefore found Ms. Winckler liable for fraudulent trading, as a knowing party to the use of Pantiles for the purposes of defrauding Mr. Goldbart's creditors from the outset.

Separately, the Court found that Ms. Winckler had caused Pantiles to become liable for a £70,000 loan at 18 percent interest, whose proceeds were solely for the benefit of Ms. Iwamoto; Pantiles did not benefit in any way from the loan. The Court held that the creation of a liability for the sole benefit of Ms. Iwamoto and the distribution of the proceeds of sale to an entity Ms. Winckler knew to be connected with Mr. Goldbart, thereby rendering Pantiles insolvent (because it would be unable to pay the tax that she knew would fall due), was dishonesty by "any objective standard."

Ms. Winckler was also found liable for misfeasance under Section 212 of the Insolvency Act. The Court ordered a separate hearing to establish the appropriate form of relief. It is expected that the liquidator's costs will be included in the order since, but for the fraudulent trading, Pantiles would not have gone into liquidation.

KEY TAKEAWAYS

This case provides clarity regarding the components required to meet fraudulent trading, specifically the "dishonesty" components. The test for dishonesty in fraudulent trading is now the same whether it is a claim for civil liability or when charged as a crime. The "holistic" approach taken by the Court to the evidence will undoubtedly be welcomed by liquidators.

The case also shows that, when causing a company to incur liabilities, directors must take care to understand whether the obligations benefit the company and whether the company has the resources to repay its current and new creditors. Where a company continues to trade with a view to minimizing loss to its creditors, the directors thus aiming to fulfil their duty under Section 214, they may nonetheless, depending on the purpose for which a new liability is being incurred, be incurring debt for the company that they know the company cannot repay and thereby stray into fraudulent trading.

Note also that a claim for fraudulent trading under Section 213 may arise not only against directors but also corporate advisers when new liabilities are being incurred.