WRONGFUL TRADING

By Chris Iacovides

Wrongful trading is an action that can be taken only by a company's liquidator, once it has gone into insolvent liquidation. (This may be either a voluntary liquidation - known as Creditors Voluntary Liquidation, or compulsory liquidation).

"The court may if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business of an insolvent company, shall be personally responsible without any limitation of liability, for all or any of the debts of the company as the court may direct".

Under Section 311(1) of CAP 113 of the Laws of Cyprus, a director or the directors of a company in liquidation, may be ordered by the court to contribute personally into its assets, so as to enable the liquidator to make a distribution to creditors for their losses.

"The court may if it thinks proper so to do, declare that any persons, who were knowingly parties to the carrying on of the business of an insolvent company, shall be personally responsible without any limitation of liability, for all or any of the debts of the company as the court may direct". The court will make such an order if the director or directors, knew or ought to have known, that the company was going to go into liquidation and yet, he or they, decided to carry on trading. This is called wrongful trading unlike fraudulent trading; wrongful trading needs no finding of 'intent to defraud' (which requires a high burden of proof). Wrongful trading is therefore easier to pursue than fraudulent trading.

An action for wrongful trading may be brought not only against de jure directors (that is directors who were formally appointed and their appointment was registered with Companies House). It can apply to de facto directors (that is people who assumed the role of director of a company without being appointed), or shadow directors that is people in accordance with whose direction the de jure directors were accustomed to act.

In order to establish liability, the liquidator needs to demonstrate, using the civil burden of proof (i.e. on the balance of probabilities) that the directors continued trading the company beyond a point in time when they knew, or ought to have ascertained, that insolvent liquidation was inevitable.

The facts that a director ought to have known were those which a reasonably diligent person having both the skill and experience possessed by a reasonable director, together with the skill and experience actually possessed by that individual. This means that there is a two-fold test for knowledge. There is a general level of skill required for all directors under the first part of the test. Under the second, a higher standard of knowledge is required by those with specialist skills. (These are likely to be accounting or legal skills).

The normal approach to wrongful trading actions is that the liquidator will try to establish a date at which the company can be shown to be balance sheet insolvent, and then show why it was unreasonable for directors to continue to trade after this. Contrary to many misconceptions, it is not an offence to trade a company while it is insolvent. Indeed in some situations, if the directors genuinely believe that the position will be turned around and the position of creditors will improve, it is the correct thing to do. When it becomes wrongful trading is when it should have been realised that the position of the creditors would likely deteriorate from that position onwards and the company would proceed into liquidation. Once a director realises that his or her company is insolvent, one important thing for them to do is to seek immediate professional advice.

Many legal systems (including Cypriot law) recognize the *blue sky* defence; which broadly provides that, if the directors in good faith believed that the company was just about to turn the corner, and things would soon improve, then they would not normally be held liable for continuing to trade. Liability only attaches when the company has no realistic prospect of avoiding insolvent liquidation.

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The Court has wide discretion over the contribution that it can require. Traditionally this has been compensatory, rather than punitive. The starting point for assessing the appropriate amount was the difference between the net assets of the company at the date that the directors should not have traded beyond, and the net assets at the date of liquidation.

The Court however has wide discretion, and may award just a percentage of this.

As is often the case, a company in liquidation has no assets with which to bring an action for wrongful trading. How can the liquidator bring, or fund an action? Can the liquidator sell or assign the claim to a specialist litigation company?

Because a claim for wrongful trading is a personal action brought by the liquidator, it follows that if it is unsuccessful; the liquidator is personally liable for the legal costs of the defendants.

It is now usual practice for liquidators to enter into conditional fee arrangements with lawyers and have insurance against adverse costs in place in the event that he is unsuccessful. The liquidator is able to assign the action regardless of the normal rules relating to champerty and maintenance. (He is empowered by statute to sell any of the company's property). As an alternative, there are commercial litigation funding organisations which will take over the management and funding of the entire claim, and pay the liquidators a percentage of any recoveries.

In recent days, it is becoming increasingly popular for Liquidators to negotiate After the Event Insurance ("ATE") whereby, underwriters may agree to fund the entire costs for an agreed deferred premium payable only in the event of a successful outcome.

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