Cyprus Insolvency Law; the concept of Fraudulent Trading

By Dr. Pavlos Neofytou Kourtellos

Fraudulent trading constitutes a departure from the rule established in Salomon v. Salomon & Co. (1897) that the company has a separate legal personality from its members and directors that no-one is liable for the debts of the company except the company itself.

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.

Section 311 of the Cyprus Companies Law provides that if a company is in the course of winding up and it appears that any of its business has been carried on with the intention to defraud the creditors of the company or for any fraudulent purpose, then the Court may declare that any persons who were knowingly parties to the fraudulent trading to be personally liable for all or any debts or other liabilities of the company to the extent that the Court might direct. Such a petition (application) to the Court can be made by the official receiver, the liquidator, any creditor or contributory (member).

Unlike fraudulent trading adopted by Cyprus law the English concept of wrongful trading (under s. 214 Insolvency Act 1986) needs no finding of 'intent to defraud' (which requires a high burden of proof). Wrongful trading is therefore easier to pursue than fraudulent trading.

For fraudulent trading, it is necessary to first establish dishonest intention. This can be proven where for example, the directors caused the company to incur further debts at a time when they knew that there was no reasonable prospect of those debts being paid. This is a proper inference of dishonesty as seen in the English case R v. Grantham (1984). In this case, the directors ordered goods on a month’s credit at a time then they knew that payment would not be forthcoming at the end of the month (the company was hopelessly undercapitalized at the time and so there was no good reason for the directors to believe that the goods would eventually be paid for). However, if the directors honestly believed that the debts would have eventually been paid there will be no intention to defraud established. An example of this, which derives again from the English case law, is the case of EB Tractors Ltd (1986). In this case the company was unable to pay its debts as they fell due however, the directors honestly believed that the Company would have been able to survive and pay its debts and so the directors were not held liable in this case.

Like other legal systems the Cyprus law recognizes 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.

Furthermore, a shareholder cannot be made personally liable for a company’s debts by an order of the Court, however large his holding, simply because he was in a position to influence the conduct
of its affairs, or merely because he nominated or procured the appointment of directors who are guilty of fraudulent trading. To impose liability on a shareholder it must be shown that he took part in making management decisions which were intended to defraud the creditors or were known to be likely to cause them loss, or that he gave instructions to the directors which he knew would produce such results and to which the directors submitted.

In practice, applications for orders in respect of fraudulent trading are rare because of the high burden of proof associated with fraud. Where applications are brought for fraudulent trading it is usually because when the trading occurred, the company was not insolvent at that time (insolvency at the time of the trading is normally a requirement to establish wrongful trading, but not fraudulent trading).

For further information on this topic please contact Dr. Pavlos Neofytou Kourtellos at P. N. KOURTELLOS & ASSOCIATES LLC, by telephone: +357 25 745575 or by fax: +357 25 755525 or by e-mail: pnk@kourtelaw.com

Disclaimer

This publication has been prepared only as a general guide and for information purposes. It does not constitute or should not be read as a legal advice. One must not rely on it without receiving independent advice based on the particular facts of his/her own case. No responsibility can be accepted by the authors or the publishers for any loss occasioned by acting or refraining from acting on the basis of this publication.