Piercing the corporate veil: when LLCs and corporations may be at risk

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Abstract

Purpose – The purpose of this paper is to examine the available judicial precedence using both the United Arab Emirates and UK laws to bring up a much broader understanding of wrongful and fraudulent trading concepts and provide a critical analysis of potential personal liabilities of directors in the UK and UAE jurisdictions for the acts of fraud and mismanagement.

Design/methodology/approach – This paper seeks to understand corporate fraud from the aspect of trading. It will take an in-depth look into wrongful trading and fraudulent trading in the UAE and UK jurisdictions while analyzing the punishment for the same. The study will also look at famous cases for the same while seeking to understand the mitigation measures undertaken in various nations across the world.

Findings – The author studies the contents and provisions of the UK Insolvency Act 1986, truly the concepts of wrongful trading and fraudulent trading are not explicitly mentioned in the UAE Law, but the said terms associated with "lifting of corporate veil" are notionally existent under the UAE Federal Law No2/2015, otherwise known as Companies Law (Articles 84 and 162-1), and under the UAE Bankruptcy Law (Federal Decree Law No. 9 of 2016), which provides legislation governing trading while the company is insolvent.

Originality/value – In the current paper, the author is keen to examine the available judicial precedence to bring up a much broader understanding of the mentioned concepts and provide a critical analysis of potential personal liabilities of directors in the UK and UAE jurisdictions for the acts of fraud and mismanagement.

Keywords Lifting the veil of incorporation, Fraudulent trading

Paper type Research paper

Introduction

The number of cases of corporate fraud has risen in the recent past despite the best efforts by organizations to mitigate these incidents. In most cases, fraud was seen as a low-level threat in organizations, which involved junior employees in most cases. However, these cases have evolved in complexity, roping in senior management and even directors as perpetrators and accomplices. The case at Enron continues to emerge as one of the most famous where the senior management, in cohorts with employees, was deeply engaged in accounting fraud. This saw the manipulation of the company's earnings, as well as share price, despite the organization's poor performance. In a more recent case, billionaire Bernie Madoff ran a Ponzi scheme in which he paid some of his early investors with deposits made by some of his recent investors despite his company not making any earnings from business activities. These cases have continued to emerge across the world from Brazil to South Africa, Middle East and even Asia (Krambia-Kapardis, 2016).

The global financial crisis of 2008-2009 played an important role in highlighting fraud in the financial markets. Since the crisis, major banks, from Credit Suisse to Deutsche to Goldman Sachs, have been slapped with billions of dollars in fines attributed to wrongful trades or fraudulent trades in the financial markets. The majority of these trades resulted

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from offering misleading information to investors about various asset classes that were risky (Iwanicz-Drozdowska, 2016). At the same time, some of these banks manipulated the futures market, as well as the currency markets, with the view of making profits. In the UK, traders from Barclays Bank, Citibank and Royal Bank of Scotland colluded to rig the London Interbank Offering Rate and as such made tidy profits.

Regulators have taken firm actions to reduce the occurrence and end these cases by requiring banks and publicly traded institutions to create risk management and compliance divisions. The risk management divisions analyze the positions held by organizations to gauge their exposure levels and how these may impact their balance sheet. The goal of such a move is to ensure that wrongful trades do not affect the overall going concern. The compliance division, on the other hand, fends off fraud by ensuring that the business does not make wrongful or fraudulent trades. The compliance division will, for instance, blow the whistle on any actions that contravene set out requirements on trading[1].

This paper seeks to understand corporate fraud from the aspect of trading. It will take an in-depth look into wrongful trading and fraudulent trading in the UAE and UK jurisdictions while analyzing the punishment for the same. The study will also look at famous cases for the same while seeking to understand the mitigation measures undertaken in various nations across the world.

Companies and liability

A company refers to a legal entity created by individuals with the intent of undertaking commercial projects or dealings. Companies are often created with the intent of achieving a common goal or purpose where the parties involved will often marshal their resources together to achieve this goal. A company is deemed as a separate legal entity and as such registered as their own person and can end as their own person in the event of insolvency or decision to dissolve the business.

One of the most important aspects of a company revolves around liability. Liability refers to the extent of independence of an established company. Across the world, companies are formed based on the Companies Act, which defines the extent of a legal person by the company. As such, a company may be limited by shares or by guarantee (Mancuso, 2016). Limited by guarantee refers to a company created with the view of pursuing non-commercial interests. In this case, the members who have a shared interest in the company will pay a specific amount of money toward keeping the company solvent but do not harbor any economic interests arising from its operation. Companies limited by guarantee include country clubs or non-profit organizations.

Companies limited by shares refer to organizations in which the owners or shareholders have limited liability based on the number of shares an individual owns in the organization. In this regard, a company limited by shares may either be a public traded company or a private company. A public company refers to a corporation in which the general public owns a stake and whose shares trade on the stock exchange. On the other hand, a private company refers to a company that does not offer its shares on the stock market, but rather, the stock is privately owned by a select number of individuals, and any trading takes place between the select number of players involved. A limited liability company (LLC) refers to an organization in which the management of owners has limited control to exercise over the transfer of ownership. At the same time, the company owners will not be held liable in the event of losses or insolvency by having some of their assets auctioned to offset the costs.

For the longest time, companies and their directors have exercised the limited liability clause with the view of avoiding prosecution for some of their actions regarding the companies. For instance, if a company files for bankruptcy, this clause protects them from

possible prosecution or even having some of their assets auctioned to pay back some of the liabilities. The clause has also been invoked with regard to keeping some of the management and even directors free from prosecution for actions undertaken during management (Phillip and Pamela, 2014). These individuals will often argue that the business exists as its own person and as such shields these individuals from liability as they acted for the person or business. The clause was subject to abuse and manipulation but continues to change owing to compliance and the rising role of risk management in the business.

The corporate veil

The concept of lifting the corporate veil has gained prominence in the recent past as one way of dealing with regulatory and legal issues regarding the management of a business. Lifting the corporate veil refers to the actions undertaken to treat the duties and rights of a company as those of the shareholders. In most cases, the company gets treated as a separate legal entity with its own personality, where it accumulates liabilities and pays for the same. In most countries, including the UK and the UAE, where some laws were created as a result of a common law, this has been the *modus operandi*. However, in some instances, the corporate veil has been removed, allowing for the shareholders or owners of the company, as well as the entity of the company, to get treated as a single entity.

One of the most prominent examples emerges in non-compete clauses. A director or member of a senior management in an organization usually signs a non-disclosure agreement with these businesses that once they leave their role in the company, they cannot join a rival or set up a similar organization. (Schall, 2016). However, this is not always followed through, and in some cases, these individuals may set up their own businesses. If the issue escalates to the court of law, the individual will face prosecution for his/her actions, not as the company they launched, but as a person for their act, and as such, the corporate veil has been lifted in this case.

In most cases, it has been assumed that the limited liability aspect in a company begins as soon as the business organization forms a company. The assumption then moves toward the belief that the liability part extends because the business exists as a separate legal entity. However, this emanates from statutes placed in English common law. The statutes offered that in certain cases, including partnerships, individuals may be liable for some of the actions they take that may lead to obligations being meted against them (Liptrap, 2017). The lifting of the corporate veil has in most cases applied to private companies but has since seen its use case extend to all other companies. The use case of the same has been particularly helpful in dealing with companies and individuals seeking to use the corporate law as a means of sidestepping their legal requirements and obligations.

Lifting the veil of incorporation is therefore used in the UK and the UAE company laws to show that the rights and the duties of a company or corporation are in principle not the responsibilities of the owners and the employees of the company. This means that these rights and duties are a responsibility of the company alone. To put this in perspective, it is good to think of a company as a person. Just like one person cannot be legally liable for the conduct of another person, the "veil of incorporation" principle recognizes the company as a separate entity when it comes to wrongful or fraudulent trading activities. In some instances, however, this veil of incorporation can be lifted, and according to the UK and the UAE company laws, this can only be done when the person in question expressly or implicitly assumes the responsibility, indemnifies and guarantees the other person or company. For companies, the directors and employees cannot, therefore, be bound by the rights and duties of a corporation, and this concept has been likened to a "veil," where the

lawyers separate the company's legal entity from the real people who invest or work for the company.

The law is capable of lifting this veil in some circumstances, and this is what has been coined as "lifting the veil of incorporation." When this happens, the people who invest or run the company operations are treated as being liable for any debts or profits associated with the company. This only happens in very limited circumstances, mostly when there is wrongdoing by the individual(s) in control. This is crucial mostly when the company becomes insolvent to protect the unpaid creditors. A good example can be taken from *Prest* v. *Petrodel* [2013] UKSC 34, where the supreme court issued a decision to confirm that the UK law permits the claimant to ignore the separation of the legal entities and instead "pierce the corporate veil" in some circumstances. In *Salomon* v. *Salomon and Co* [UK 1897], Saloman was a sole trader who had set up an LLC, which later became insolvent. The company creditors went to court seeking to hold Saloman liable for the company's unpaid debts. The court allowed for the separation of the person from their business interests, where the individual was as such viewed as their own person and that their person could not interfere with the interests of the person. The case was a landmark with regard to the opening and operating of companies across the world, serving as an important case law reference. The other recent case that emerged, allowing for the separation of person and commercial interests regarding a company, was the case of *Bank of Tokyo Ltd* v. *Karoon* [1987] AC 45n, which reaffirmed the earlier ruling on the separation of the commercial and legal interests in a business organization. These rulings created a buffer for business organizations and individuals and their businesses (Liptrap, 2017)[2].

However, there has been the need for the court and legal institutions to define the power of this legalese. For instance, business organizations and, in some cases, their managements have the power and ability to undertake different actions with the knowledge that they cannot get prosecuted or charged for these actions. As a result, the courts have in two ways sought to affect the corporate veil. The first case of the same relies on case law in which the supreme court delivered a ruling in the UK. The case was *Prest* v. *Petrodel Resources Ltd* [2013] UKSC 34. The other case of lifting the corporate veil was through an act enacted in 1981, which provided for the use of the court and judicial system. The court noted that the corporate veil may be subject to abuse and as such allowed for the use of the same through an act passed in the UK in 1981. The act allowed the courts to overlook the corporate veil in certain cases, especially those involving fraud or failure to respect contracts.

Wrongful trading and fraudulent trading

The UK Insolvency Act 1986 had a huge impact on cases where a business is nearing insolvency and how such an organization should continue operating because it can no longer pay its debt. The act stated that wrongful trading by such a business amounts to a civil act, whereas fraudulent trading amounts to a criminal act. At the same time, the business should be well aware of its financial position, and the failure to realize may lead to negligence charges on the part of the directors of the business.

Fraudulent trading emerges when a company can no longer pay its debt and as such the creditors file for legal action against this business with a view of recovering their debt. The business in turn faces closure or liquidation owing to this financial circumstance. The individuals involved in the insolvency process in the UK have an obligation to create a report, detailing the conduct of the directors in the event leading to the liquidation of the business. If the individuals are found to undertake actions to deliberately derail the payment of the liabilities owed to creditors, then legal action can be sought against them for these criminal actions (Garcia-Gallont and Kilpinen, 2015).

Some of the actions of the directors that would be analyzed include the selling of some of the company's assets at prices below their true value. At the same time, actions aimed to create deception that the business was operating, such as the acceptance of credit lines from suppliers or receiving payments from customers with no intent of delivering or paying back, may be viewed in a similar light.

Fraudulent trading is provided for in the UK Insolvent Act 1986 under Section 213. Under this section, the law provides the options available to the court when it is reasonably determined that the directors continued to trade with the intent to defraud another party in the course of winding up the company. The law states that the court upon the liquidator's application may declare any director or person that was knowingly a party to the execution of the business intended to defraud are liable. The liability of such persons is limited to making such contributions to the company as the court may deem proper.

The intent of the directors during the winding process is what brings the difference between wrongful trading and fraudulent trading. Where it is ascertained that the directors continued to carry on with the company business with the intention to defraud other parties, the law under Section 213 applies. The directors involved in such an undertaking may be liable for a number of ways, including imprisonment, the contribution of the company assets in an effort to protect or pay the defrauded creditors or persons.

In practice, this law is not applied often in the UK. This is owing to the heavy burden of proof associated with the fraud. Usually, fraudulent trading occurs when the company is not insolvent, and thus, the law requires heavy proof to make a decision. There are a number of cases that have been decided based on this law. A good example is that of *R* v. *Grantham* [1984] QB 675. In this case, the court determined that the directors' acts had the intent to defraud as the directors were privy to the prospect that the company could face challenges in repaying its debts.

In this case, Grantham was tried for fraudulent trading, and the jury established dishonesty and the intent to defraud the creditors because the director (Grantham) obtained the credit when he was aware that the company had no ability to settle the debt. Grantham's appeal was dismissed, and he was found liable.

Another case is *Re Augustus Barnett and Son Ltd* [1986] BCLC 170, where the auditors of Augustus Barnett and Sons were not certifying the accounts on an ongoing basis unless Rumasa gave his assurance that he would continue supporting the business financially. Rumasa, in a letter of comfort dated June 1, 1982, promised that he would give the company an additional working capital if he had £4m in the company by 1981. In 1983, the company went into voluntary liquidation, and the liquidator applied that Rumasa was a knowing party to fraudulent trading activities whose intent was to defraud the creditors. Rumasa, however, opposed this application, arguing that there was no reasonable cause of action as it was never alleged that the directors of Bernett were dishonest or had any intent to defraud. On analysis, Judge Hoffmann J held that the section on fraudulent trading required finding someone carrying out the business with the intent to defraud. In this case, it was hard to determine this. However, the judge said that there could be an action in the tort of deceit. In *obiter dicta*, Hoffmann J assessed one of the liquidator's reasoning in the said letter of comfort. Based on this promise, it was found that the company was liable and not the director.

In one of the latest cases decided under fraudulent trading, *Jetivia SA* v. *Bilta (UK) Limited* (in liquidation) [2015] UKSC 23, the court made a decision based on the attribution of unlawful acts by the director and the extent of the liability for fraudulent trading acts. In this case, therefore, the court held that where the directors were accused of fraudulent trading acts, their acts could not be linked to the company. This argument left the company liable

instead of the director as the liability of fraudulent trading under Section 213 of the Insolvency Act 1986 had extraterritorial effect. The decision arrived at by a jury of seven judges, in this case, is significant in laying down precedence for deciding other similar cases in future. This case further highlights the difficulties that the court may face in deciding such cases, especially where the so-called "sole actor" exception applies.

Wrongful trading, on the other hand, emerges when a company's directors fail in their obligation to inform the shareholders of the company on whose board they sit that the business can no longer sustain its operations and needs to be declared insolvent. The directors of a company have an obligation to tell shareholders that their business interests in the company are under threat (Parker, 2015). They also have the obligation to inform creditors of the exposure their debt in the business faces. If the directors fail to comply with these actions, they are deemed to have contravened the law. At the same time, the shareholders need to inform the business creditors equally of the danger their interests face and not offer preferential treatment to others while failing to offer the same information to others. The actions of the company's directors should be to inform the creditors in adequate time to allow them to take actions to safeguard their business interests.

Wrongful trading according to the UK law is a type of civil wrong under Section 214 of the Insolvency Act 1986. This act came into existence to protect the creditors from directors who continue to trade "carelessly or recklessly" with no real prospect of saving the business. This section of the law, therefore, requires that those responsible for the mismanagement of the business and consequently causing a loss to the creditors are liable. This concept of wrongful trading was coined to complement fraudulent trading, which per se requires that a heavy burden of evidence should be provided to the court. Wrongful trading is, therefore, less serious and more common than fraudulent trading. Apparently, there have been difficulties in determining the points at which the directors should determine that the company is inevitably becoming insolvent.

Second, the law is not clear on the steps the directors should take to minimize the loss to creditors. Based on this, the courts in the UK have been anxious not to slap heavy fines on the directors based on their actions. The recent reforms to this law were introduced in the year 2015 by the Small Business, Enterprise, and Employment Act of 2015. This new law allows the liquidator to assign the right to bring wrongful trading proceedings. This allows, for instance, a large creditor to buy the right and pursue directors under Section 214 at his risk and for his benefit. In *Grant* v. *Ralls, Re Ralls Builders Ltd* (in liquidation) [2016] EWHC 243, the company was going insolvent, and the directors' bid to have an external investor inject money into the business failed. The company finally went into liquidation, and the liquidator sued the directors under Section 214. Specifically, the liquidator sought the declaration that the directors had the knowledge or ought to have had the knowledge that by the end of July 2010, the company could not avoid insolvent liquidation. In making a decision, the judge first sought to determine whether the directors knew or ought to have known that the company was indeed going insolvent. The judge took the view that the company's only hope for survival depended on the possible investment by an external investor; thus, the directors genuinely believed that the company would get the funding until late September 2010, when it would become apparently clear that no funds were coming.

Further, the judge sought to determine whether the directors did all that was in their power to minimize the loss to creditors from the date it was clear that the external investor funds were not coming forth. The court adopted a narrow reading that provided that the directors who continue trading will be deemed to have done all possible to minimize the creditors' loss only if the trading is done in view to:

- minimize individual creditor's losses; and
- reduce the company losses.

Based on this, the court found that the creditors who traded with the company after August 2010 were unfairly treated, as a significant percentage of the money obtained from this trading was used to pay the current creditors. In other words, the directors of the company had done little to protect the new creditors but did something to protect the former creditors. The court, therefore, did not order the directors to contribute to the company assets, arguing that the continued trading did not cause any loss to the company; instead, it improved the company's position.

This decision and many others explain how Section 214 of the Insolvent Act 1986 is used in the UK to determine the liability of the director. This law in the UAE is contained in the UAE Commercial Law of 2015 under Section 162. The law contained here bears much resemblance and can be applied to a wider number of different cases involving directors' liability as far as company operations are concerned during normal operations and liquidation.

Why directors get charged

The directors of a company refer to the shareholders involved in the formation of the company and who exercise authority over day-to-day management decisions or individuals chosen by shareholders to represent their interests in the business organizations. As such, directors exercise control over the running of the business and can generally influence the direction the business takes and key milestones.

In terms of the removal of the removal of the corporate veil takes place in cases where the business and its owners have no real separation and both entities are intertwined. In other cases, individuals set up a business as an LLC but continue to operate it as a sole proprietorship. This then places the business in a clear path of conflict, which may in turn affect the operations of the business. The directors of the business may in other cases create the LLC without fully meeting all the requirements of the business during the registration. In other cases, they may fail to meet the requirements during the operation of the business, such as the filing of tax returns for the business. A prominent example of these cases emerges when the owner of the business uses the business' bank account to settle personal liabilities or fails to keep records of company minutes as required in the articles of association during the formation of the company. This may lead to the court nullifying the veil created and expose the directors of the business to potential liability or even legal action for some of the moves the business has undertaken.

The most prominent of these cases emerged when the owners of the business engaged in actions which they knew were fraudulent but went on to undertake them. These actions may have been undertaken in a reckless manner or with the intent of swindling investors, suppliers or even customers. If the court finds that the actions amounting to financial fraud were undertaken, it will then lift the veil on the corporation. As such, the veil may be lifted with the view of holding such individuals liable for gross misconduct and as such charge them before the law (Muscat, 2016).

In other cases, the corporate veil may get lifted owing to the realization that some of the business' creditors were hit with certain unjust costs. In some cases, businesses might use the pretext of being corporations to run up the costs of operations. These may include acquiring goods and services from creditors with no intent of paying. As such, the court may opt to lift the corporate veil on such companies with the view of forcing the directors of the business to pay the creditors and correct the unjust actions taken by the directors.

Consequences of lifting the veil

The action of lifting the veil takes place at the court of law, and this action inadvertently means that the shareholders and directors of a business get held accountable for debt that a company has accumulated over a given period it operated. The creditors of the business then have the authority to attach personal assets owned by the directors or shareholders toward the servicing of their debt. They can also auction these assets with the goal of recovering their debt. The court also places a limitation on who gets held responsible for this debt and which individuals can have their assets auctioned. In most cases, the individuals found to have the most responsibility in accumulating the debt or acquiring the debt take the largest blame.

Global cases

Following the global financial crisis, there were calls to have some of the assets of the directors or even members of management auctioned owing to the realization that they had full information on the crisis and failed to take action to inform creditors. The creditors were mostly investors who took the advice of the financial institutions and acquired assets whose credibility was questionable. For instance, there were calls to attach the assets of Lehmann Brothers CEO Dick Fuld for failure to take action against the toxic assets the company had on its balance sheet. The justice department was able to attach some of the assets of Bernie Mardoff for the actions of running a Ponzi scheme.

A popular case is that of Prest v. *Petrodel Resources Ltd* [2013] UKSC 34, where during the divorce proceedings, Mr Prest sought to use the corporate veil to not only conceal some of the assets he owned through his companies but also use the same as a pretext to frustrate alimony payments. Mrs Prest then sued, claiming that Mr Prest and his companies seeking to have some of the matrimonial homes turned over to her. The case reached the supreme court, which ruled that Mrs Prest could not have the corporate veil removed for the purposes of the case but could still have her amicable settlement.

The UAE law on lifting the corporate veil

In the UAE, several years were spent to identify the rules and regulations according to which all companies have to work and organize their activities. Federal Law No. 2 (2015) concerning commercial companies is one of the final improvements (New UAE Commercial Companies Law 1). According to this law, all companies have to improve their governance and amend all articles of association with regard to the new standards that are focused on the development of the UAE in a global market and the promotion of social responsibilities. However, the UAE Commercial Companies Law is not the only document that should be considered. There are also the Penal Code, which establishes the rules and penalties with regard to the political, social and economic issues of the country, and the Commercial Transactions Law, which introduces the provisions to traders and other commercial activists.

The peculiar feature of company laws in the UAE is the attention to the penalties that can be applied to those who violate the law and meet personal demands and interests only. Therefore, not just directors should know about their liabilities and understand the possible scope of their actions. It is more important for everyone involved in a particular business to learn their duties and consider the duties of their directors so that they can clarify what to expect from their directors, when directors make mistakes, wrong decisions or poor judgments and how ordinary employees and shareholders can protect their rights within a company. The UAE is a country of contrasts, with a certain attention to the traditions,

family relations and fair business. All company laws introduced in this country aim at identifying and explaining the worth of cooperation and trust.

Under the UAE jurisdiction, the director is personally liable for fraud when he/she signs a document in the name of the company containing misleading information. The director is held personally liable and is subject to a fine or jail sentence as the judge may deep proper depending on the matter at hand. Andrew noted that the magnitude of liability is a matter of the court to decide, which has a direct impact on the duration and fines imposed by the court. Moreover, the judge must also consider the magnitude of misrepresentation and the intention of the director (Bainbridge, 2012). Moreover, a director can be held liable for giving false information, especially if the director had prior knowledge that the information was false. Giving false information attracts similar charges to that of signing and issuing a document with false information. In addition, directors can be held accountable for disclosing confidential information to their benefit or third parties that attract similar penalties.

Under the Penal Code, a director is personally liable for fraudulent funds, property, and legal right. The Penal Code was introduced to prevent directors who might think of taking advantage of their position to abuse their powers for their benefit. Moreover, the UAE Penal Code explicitly states that when a director acts *ultra vires* by disclosing confidential information of a company, he/she can be held personally liable and charged in court. More specifically, the UAE Penal Code states that directors are criminally liable for drawing a check with prior knowledge that the company does not have enough money to meet that obligation. Under this liability, the judge must consider the knowledge of the director before drawing the check. The director can personally be charged in court or serve a jail term of less than five years.

A director is personally liable for making a public offer in an LLC. Under the UAE Company Law Act, a director cannot be allowed to make a public offer personally because it contravenes the Companies Act, which provides circumstance and procedure under which shares should be issued (Boustany, 2011). Moreover, a director can be held personally liable for misrepresenting a company's value. This occurs when a director having prior knowledge of the value of the company decides to price the shares above or below their real value. UAE Capital Market Security Law expects directors to act in good faith when valuing a company's shares to ensure that the price represents the true value of the business. If a director is found guilty, he/she can be charged in court for a maximum of two years in prison or a maximum of $27,000 in fine, whichever the judge may deem fit.

Under the UAE Bankruptcy Law (Federal Decree Law No. 9 of 2016), a director is personally liable for stealing the properties of a company. This includes a deliberate action of a director during insolvency to enter into fraudulent agreements with creditors and suppliers of a company. This includes the act of false director misrepresentation of information and the company capital position with an intention to defraud the company. When a director receives money that is above what is specified under the Companies Act in the form of bonuses, compensation and false misrepresentation of a company's debt, he/she is personally liable for misrepresentation and fraud. However, under the UAE, the law does not specifically mention the magnitude of liability that can be imposed on directors if they commit such acts.

Under the UAE Anti-Trust Law, the director can be held personally liable if he/she encourages unfair competition in the industry that harms other companies in the same industry. Specifically, if a director approaches an employee of another company (competitor) with an intention of acquiring confidential information is personally liable. The law clearly states that if a director tries to acquire confidential information from a competitor, whether

for his/her personal gain or in the interest of the company, he/she is personally liable and can attract a penalty of two years in prison. Similarly, if a director conspires in the distribution of deceptive good with an aim of deceiving the consumer, he/she can attract the same penalty. In addition, a director is personally liable for damages caused by the publication of distribution of scandalous information about a competition that results in financial losses. Such a director can attract similar penalties. Nonetheless, to succeed in a defamation case, the competitor must be able to prove that the statements made by the director were defamatory, and that the statements were directed to the company, which resulted in financial losses. In this case, the director is sued under the law of contributory negligence for defamation.

Wrongful and fraudulent trading in UAE

The concepts of wrongful trading and fraudulent trading under the English system do not exist per se under the UAE Commercial Company Law; however, they are notionally existent under Articles 84 and 162-1 of the new Commercial Company Law, 2015, and Articles 878-880 of the UAE Commercial Transaction Code, which will be discussed in the following sub-sections. Articles 84 and 162-1 state that the directors and managers are liable to the company, shareholders and third parties for all acts of fraud, misuse of power and violation of the provisions of this law or the articles of association of the company or an error in management (i.e. mismanagement).

The UAE Law considers fraudulent trading quite serious. In the UAE Law, fraudulent trading has both civil and criminal liabilities. As shown above, the UAE Commercial Companies Law contains provisions along with the UAE Penal Code to determine the suitable penalties to be imposed on executive-level staff who commit frauds in the company or simply create companies to defraud their customers. In the UAE Law, any misuse of executive power in the corporate context is considered to be a serious violation. Therefore, the concept of corporate veil is not applicable to the directors in this case or any relevant cases; they (directors) can be subjected to civil and criminal lawsuits by the shareholders of the company that was affected, its creditors or any other party victimized in the case. However, Article 162-2 of the new Company Law provides that if in UAE, a director can provide sufficient evidence of not being supportive or involved in the case of fraudulent trading, then all the previous charges pressed against him/her will be lifted. Fraudulent trading in the UAE law can take two forms: civil liability and criminal liability.

Articles 84 and 162-1 of Commercial Companies Law explain that when and if a director/manager of a company is discovered to have been involved in fraudulent trading activities, he/she will be personally liable, and any kind of protection that prevents him/her from being personally answerable will be lifted. However, it is explained that when directors act within the limits of their authority and powers, they will not be in the danger of facing charges such as those in fraudulent trading. However, in civil liability, directors who are confirmed to be dealing with such people and are found to be guilty with respect to fraudulent trading activities are disqualified from becoming a director in any other company or holding, therefore, a position in an organization of that stature or rank as a punishment for their acts. Civil liabilities on the guilty directors become effective once their criminal liability charges have been passed and they have received the said term punishment or is applicable.

As noted earlier, the UAE Law does not directly address wrongful trading. However, Articles 84 and 162/1 in the Commercial Company Law explain that directors/managers of a company could be held personally liable for their actions if they are found to be negligent or grossly negligent of their actions. Wrongful trading has civil liabilities, and when directors are found to be negligent, they can be prevented from serving as directors at any other

organizations, but in the case that the wrongful trading led to the bankruptcy (which would then be regarded as a wrongful bankruptcy), then this might extend to a criminal liability. In any case, the punishment should not exceed the one-year term for the guilty directors. At the same time, the maximum monetary penalty that may be imposed is AED 10,000. Once the imprisonment term has been passed, the accused and guilty may not be allowed to enter another organization either at the position of a director or any other title of that position or rank as such.

Although the above-mentioned articles do not specify the action that should be taken by a shareholder against the director, the act of mismanagement in itself attracts personal responsibility. However, Article 166 gives any shareholder the right to sue directors for losses incurred because of director's neglect and misjudgment in decision-making (Ibrahim, 2012). For instance, if shareholders do not receive a share of the profit of the company because of management neglect, they can bring a lawsuit against the directors.

Under the jurisdiction of the UAE Civil Code, a director is personally liable for his/her action of resignation when the company is in a crisis, thus resulting in huge financial losses. However, the director cannot be held liable if he has been given a six-month notice of his intention to resign. The company must also be able to prove that the losses resulted from the lack of special skills of the director. Moreover, they must prove that the director acted intentionally that resulted in financial losses.

Under Articles 24, 84 and 162/1 of the Companies Act, companies should not include any provision in the memorandum of association that exempts directors from personal liability as a result of fraud and mismanagement (Hodgins, 2010). Indeed, Articles 24, 84 and 162/1 clearly state that any provision that forgives directors from personal liability for fraud and mismanagement shall be considered rendered void and inapplicable. Both in the USA and UAE, it is a common practice for companies to grant money in defense of a director, although it is treated as a loan that is later paid back. However, this provision has not been applied in the UAE, and there is a doubt that courts will make any sense of this provision in the long run as they do with exception liability.

Under 144 of the UAE Bankruptcy Law (Federal Decree Law No. 9 of 2016), a competent court may obligate the directors and general managers, all or part of them, jointly or not, to pay all or part of the company's debts in cases where they are held responsible for the company's losses, according to the Commercial Companies Law. This provision applies in cases where the company's funds are not sufficient to fulfill at least 20 per cent of its debts.

Further to the aforesaid liabilities provided in the Commercial Companies Law, the Bankruptcy Law implements penalties against directors and general managers. Article 198 of the Law states that directors and general managers shall be sentenced to a period not exceeding five years and shall be fined an amount not exceeding AED 1,000,000, if, after issuing a final resolution to initiate legal proceedings against the company, they commit any of the following:

- hide, damage or alter all or some of the company's records, with the intention of harming the creditors;
- embezzle or hide a part of the company's assets;
- acknowledge unpayable debts and knowingly, in writing, verbally, in the budget or through refraining from submitting papers or explanations in their possession, know the result of such refraining;
- obtain the preventive composition or restructure for the company through deception; and

- announce false information of the subscribed or paid-up capital or distribute fictitious profits or receive bonuses higher than the amount stipulated by law or in the memorandum or articles of association of the company.

Also, Article 68 of the UAE Bankruptcy Law obliges a debtor company to submit a request for the initiation of procedures to the court if it has stopped paying its debts at its maturity for over 30 consecutive working days owing to the instability of its financial position or if it has a negative asset position. If this scenario befalls the company, it is arguable that the company's failure to initiate formal procedures will constitute "mismanagement" on the part of the manager, and will therefore, constitute grounds for creditors to bring claims under Article 162(1) of the Commercial Companies Law.

Directors can also be held liable for breach of other laws mentioned above. In fact, in most cases, a director is liable in criminal law for all breaches of law that involve fraud and mismanagement (Robinson *et al.*, 2010). It is essential for directors to ensure that they have observed due diligence when dealing with company affairs to ensure that they do not breach this law. Most laws that identify liabilities of directors for fraud and mismanagement overlap with criminal law, which exposes directors to high chances of being held liable for the mistake they commit when dealing with the organization.

In summary, even though the above-mentioned articles do not effectively cover all aspects of director's responsibilities and liabilities for fraud and mismanagement, they have raised critical instances where a director can be held personally accountable for acts of fraud and mismanagement. The director can be personally liable under the Penal Code, insolvency law, security law and criminal law. Various stakeholders can bring a lawsuit against a director for personal liabilities. For instance, a shareholder has the right to sue directors for fraud and mismanagement if they incur losses as a result of the director's decisions (Terblanche, 2009). However, for shareholders to be able to sue directors, UAE laws require that a shareholder be elected by other directors during a general meeting. However, if the company does not bring a lawsuit against directors for fraud and mismanagement, any shareholder can sue the directors for personal losses incurred as a result of their decisions. This lawsuit is specifically preferred when a company has failed to sustain a case against a director for fraud and mismanagement. However, only parties that have suffered financial losses as a result of the director's action can raise such a proceeding against the directors.

Is there really a difference between UK and UAE? No

The author studies the contents and provisions of UK Insolvency Act 1986, truly the concepts of wrongful trading and fraudulent trading are not explicitly mentioned in the UAE Law, but the said terms associated with "Lifting of Corporate Veil" are notionally existent under the UAE Federal Law No2/2015, otherwise known as Companies Law (Articles 84 and 162-1), and under the UAE Bankruptcy Law (Federal Decree Law No. 9 of 2016), that which provides legislation governing trading while the company is insolvent.

In cases No. 316/2003 and 69/2007, the managing director and shareholders exploited the principle of separate legal identity of a firm to conceal fraudulent acts and misappropriation of funds to harm their partners and creditors. The Dubai Court of Cassation held them personally liable to the extent of their personal assets to make up for the firm debts to the creditors and shareholders. In another example in 2011, the Dubai Court of First Instance set an example of lifting the veil for a company's shareholders who committed fraudulent trading by trading in foreign currencies and cheating their customers when they did not have a commercial license to carry out those activities in the first place and falsified documents to indicate an excess profit to lure customers. The company shareholders were

held personally liable to compensate the claimants as it bears a great similarity to the common law concept of a tort of deceit.

In the event of bankruptcy (whether fraudulent, negligent or gross negligent bankruptcy), the Criminal Court shall be competent and shall sentence the bankrupt trader or manager of a company, or the member of its board or its liquidator, to a prison term that may not exceed five years in the event of fraudulent bankruptcy. Alternatively, a fine of Dh 20,000 in the event of a gross negligent bankruptcy and no more than two years of prison or a fine of Dh 10,000 in the event of negligent bankruptcy may be issued.

In addition to the above, Federal Law No3 1987 (the Criminal Code) contains provisions related to bankruptcy in Articles 417 to 422. Article 420 provides:

> If a commercial company is bankrupt, its board of directors and managers shall be convicted with the sentencing related to fraudulent bankruptcy if it was proven that they have committed any of the acts provided in Article 417 of this Code or assisted in the company ceasing its payment, whether by declaring wrongful facts about its subscribed capital or its paid-up capital, or by publishing wrongful balance sheets or by distributing fictitious dividends, or by taking to themselves more than they are entitled to in the company articles of association.

Issue which pertains for the penalties of directors or business owners who knowingly trade while their business is insolvent is provided in Articles 301 and 302 of the Companies Law. The articles state that where the losses of an LCC or a joint-stock company (JSC) reach half of its capital, the creditors will act on their decision whether to continue the company operations or resort to dissolving the company.

With regard to the provisions for directors, Article 301 of the Companies Law provides that it is the manager who must convene the shareholders for a general meeting to discuss the insolvency of the company when the losses incurred reach half of the capital. In Article 302, the same provision applies to the issue of JSC losses reaching half of its capital, and then the board of directors must convene the shareholders for general assembly meeting to decide whether they want to continue for the operations of the company or apply for company insolvency. Particularly, Articles 84 and 162 of the Companies Law provide that directors shall be liable to the company, shareholders and third parties for any fraudulent acts for any losses incurred owing to improper use of power or when provisions regarding any applicable law of the memorandum of association of the company are breached.

Under Article 84, directors will be liable:

> [. . .] against the company, the partners and third parties for any fraudulent acts by such manager and shall also be liable for any losses or expenses incurred due to improper use of the power or the contravention of the provisions of any applicable law, the memorandum of association of the company or the contract appointing the manager or for any gross error by the manager.

Article 162 equivalently provides that:

> The Chairman and the Directors shall be jointly liable to indemnify the company, the shareholders and the third parties for the damage that arises from acts of fraud, misuse of power, and violation of the provisions of this Law or the Articles of Association of the company or an error in management. Every provision to the contrary shall be invalid.

From the wording of Article(s) 84 and 162 read together, it is possible to infer a number of duties in which breach may result in personal liability for the director. For example, where a director breaches:

- a duty to act honestly;
- a duty not to abuse their powers;

- a duty to act in accordance with the articles of association and the law generally; and
- a duty to act in the best interests of the company and its shareholders.

Clearly, the board of directors will have to answer the creditors for any gross error they committed, such as gross negligence of their responsibility, to maintain the good financial standing of the company. Articles 301 and 302 further imply that if the directors continue to trade while the company has lost half of its capital and yet do not convene the assembly, it is apparently a breach of the Companies Law. This means that directors will be subject to joint liability to the company, the shareholders and the third party. Moreover, it can also be contended that directors who knowingly trade when they have an idea that the company is winding up commit fraudulent acts and gross errors.

In relation to the extent to which "mismanagement" and "gross error" may result in personal liability for the director, there is little by way of commentary or case law to clearly define where potential personal liability may flow in the event a director neglecting or mismanaging tasks required under the Companies Law or the company's articles of association. Nevertheless, the general wording and potentially far-reaching effects of such provisions mean that a director's personal liability for mismanagement or neglect is a relevant consideration where allegations are made of a breach of duty.

It should be noted that under Article 162 of the Companies Law, directors are jointly responsible to the company, the shareholders and third parties for any wrongful acts resulting from a unanimous decision of the board. If, however, a director records his objection to a wrongful decision taken by his fellow directors in the minutes of a meeting, he will not share responsibility for that decision. The absence of a director from a meeting in which a wrongful decision was taken does not relieve him from liability unless he was not aware of the decision; he was aware of the decision but was unable to object to it; or he objected to the decision once he was made aware of it. Table I best summarizes the principle of lifting the veil of incorporation under the UK Law, and it is possible to infer that there is not much difference between the UK and the UAE (Skudra, 2013).

Conclusion

The corporate veil has been one of the most important concepts in company law as it allows for the establishment of the company person while shielding the owners and directors from potential liability. However, the limited liability aspect can in some cases be abolished, especially in cases involving fraudulent actions against either the shareholders of the company or the creditors of the business. In this, a business has the obligation to ensure it does not continue trading if it has a huge debt obligation as this may be tantamount to wrongful or fraudulent trading. Wrongful trading emerges when a business does not inform shareholders or creditors in good time that their business has a huge obligation and that insolvency offers the best course of action. Fraudulent trading, on the other hand, emerges when a company continues to operate as though it was in good financial health and as such receives lines of credit or even takes customer resources as though there were plans to supply goods and services. Overall, company laws in the UK and the UAE have evolved to take into account the expanding international trade. This has helped the courts to deal with cases involving cross-border mergers.

Table I.
Trading law variances between UK and UAE

Option:	Fraudulent trading (civil)	Wrongful trading	Fraudulent trading (criminal)
Legal basis:	*s* 213 of the Insolvency Act 1986	*s* 214 of the Insolvency Act 1986	*s* 993 of the Companies Act 2006
Elements	(Based on McPherson's Law of Company Liquidation, [16.018]–taken from *Morris* v. *Bank of India* [2004] 2 BCLC 236, 243)	(See P. Totty, G. Moss and N. Segal [Eds]), *Totty, Moss & Segal: Insolvency* (Looseleaf, Sweet & Maxwell, [B1-32])	(Based on J Richardson QC [Eds]), Archibold: Criminal Pleading, Evidence and Practice *2013* (59th edn, Sweet & Maxwell 2013), [30-118]-[30-122])
	1. The company was in liquidation	1. that the relevant company had gone into insolvent liquidation	
	2. Such business has been carried on with the intent to defraud creditors or for any other fraudulent purpose	2. that at some point before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation	1. the business has been carried on with the intent to defraud creditors or for any other fraudulent purpose
	3. The defendant participated in the carrying of business	3. that at the time the person reached his/her conclusion or ought to have reached his/her conclusion about the company's fate (and for convenience that time is called "the relevant time") that person was a director of the company	2. the defendant participated in the carrying of business
	4. The defendant did so knowingly	But the foregoing is subject to a caveat contained in s.214(3), which provides a statutory defense, in that no declaration will be made if the court is satisfied that the (ex) director took every step he ought to have taken to minimize creditors' potential loss	3. the defendant did so knowingly
Remedy(ies)	Liability to make such contributions (if any) to the company's assets as the court thinks proper	Liability to make such contributions (if any) to the company's assets as the court thinks appropriate	Ten years' imprisonment and/or a fine, compensation orders made and post-conviction proceedings under Proceeds of Crime Act 2002 legislation to recover creditors' monies/assets
	(if the defendant is a director, disqualification will almost inevitably follow if it has not been done already)	(disqualification will almost inevitably follow if it has not been done already – and wrongful trading actions can be pursued against directors only)	
	NB – It is also worth noting that options 1 and 2 are specifically not mutually exclusive by virtue of s 214(8)		

Notes

1. *Ibid.*
2. See Liptrap, *supra* note 7.

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