

The Fraud Landscape

Insolvency and the fight against fraud



Living with the threat of fraud

The impact of fraud is wide-ranging and extremely harmful. It deprives businesses and individuals of their money and causes numerous other negative effects, including a drain on public funds, an increased risk of some businesses failing and the associated reputational, psychological and emotional damage to victims.

Fraud is often a hidden crime, ranging from cyber and identity fraud through to white collar crimes like 'insider fraud' and fraudulent activity committed by organised crime groups. Fraudsters are also very inventive in their methods, using a multitude of methods to target victims. These factors combined mean that the fight against fraud for both the private and the public sector is extremely difficult.

The scale of fraudulent activity in the UK is staggering. According to latest estimates, the UK economy has lost £52 billion through fraud in the last year alone¹. It is an issue which affects both the private and the public sector, who are estimated to have lost £21.2 billion and £20.6 billion respectively, as well as individuals (£9.1 billion) and the not-for-profit sector (£147 million).

Unfortunately, these losses are set against a backdrop where public resources for tackling fraud are stretched to their limits. By way of example, the Serious Fraud Office's budget for 2014/15 is expected to be over £20m lower than its 2008 level². With a limited budget, the UK's fraud enforcement agencies are only able to address a fraction of the fraudulent activity that goes on in the UK every year.

In 2012/2013, the Serious Fraud Office convicted 22 defendants and recovered just under £43 million from defendants, entities and other persons associated with criminal or unlawful conduct³. In the same financial year, 198 defendants were successfully prosecuted by the Department for Business, Innovation and Skills⁴. Of these defendants, 11 were ordered to pay compensation to their victims, ranging from £250 to £33,514. A further 15 defendants were ordered to pay £1,439,264 due to confiscation proceedings, resulting in £1,176,387 being paid over to satisfy the orders.

Use of insolvency in tackling fraud

In light of cutbacks to Government resources to fight fraud, R3 believes that the insolvency profession can play a vital role in tackling fraud and ensuring that the UK remains a safe place to do business. Insolvency Practitioners (IPs) have significant expertise and wide ranging powers to investigate fraudulent activities and are highly qualified and regulated professionals, who operate under a comprehensive framework of statutory duties.

Under the Insolvency Act 1986 and supporting legislation, IPs have extensive powers to investigate and, under civil litigation, to prosecute those involved in or assisting in fraud. IPs' powers include the ability to interview under compulsion; search and seizure of property associated with fraud; obtain freezing orders against assets of those involved; overturn transfers to third parties; passport orders (where the individual is ordered to surrender their passport to prevent them leaving the country); order for the delivery up of records; hold private and public examinations before the court and recover assets for the benefit of victims, all of which can prove invaluable in detecting, investigating and disrupting fraudulent activity and in making recoveries for victims. IPs also benefit from extensive international recognition powers to enable them to pursue fraudsters and their assets internationally.

¹ Annual Fraud Indicator 2013 – National Fraud Authority

² Serious Fraud Office Annual Report and Accounts 2012-13

³ Ibid

⁴ <https://www.gov.uk/government/case-studies/bis-criminal-prosecutions> (statistics published 13 November 2013)

Any investigations by IPs are carried out under civil litigation, which requires a lower burden of proof than criminal law, and in appropriate cases, IPs' investigations can contribute to the work of law enforcement and other Government departments by improving the evidence available to obtain criminal prosecutions or a disqualification order against a fraudster.

In a survey of R3 members conducted in March 2012, 24% reported being approached by a creditor to use insolvency to combat fraud in the preceding 12 months. Of these members, 71% have been approached more than once, with over 20% having been approached five times or more.

Making use of the powers available to IPs under insolvency legislation is therefore a highly effective method to increase the amount and type of fraud that can be tackled, including the ability to focus on wider targets, such as the corporate entities through which the fraud is perpetrated and those individuals either directly or indirectly involved in the fraudulent activities. As a result, the recoveries for victims can be increased and the benefits for fraudsters reduced. In light of Government spending cuts, it is likely that there are a large number of cases involving fraudulent activity which would not otherwise be taken forward by Government or law enforcement for reasons of resource or due to the fact that, as yet, those cases are evidentially or otherwise unsuitable for criminal prosecution.

Whilst R3 recognises the expertise in various Government departments and law enforcement agencies to tackle fraud, **R3 believes that IPs can provide the much-needed extra capacity and additional processes required to boost the fight back against fraudulent activities and can tackle cases that are otherwise unlikely to be progressed.**

Improving the armoury to tackle fraud

In addition to increasing the use of insolvency powers to combat fraud, R3 believes that there are other legislative and procedural measures which should be put in place to increase the tools available to disrupt fraud and to recover funds for victims. The remainder of this paper includes proposals which will:

- act as a deterrent to fraud;
- improve pre-emptive measures to prevent fraud;
- strengthen the measures in place to combat and disrupt fraudulent activities; and
- increase the recoveries available for victims.



1. Reform of Companies House

At present, Companies House is a relatively passive registry and does not require directors to provide formal proof of their identities before registering their company and status. However, it is often the case that corporate entities can be used as vehicles to mask fraudulent activity and it is easy for fraudsters to create multiple registrations by using slightly different dates of birth, or slightly different spellings of names, or inconsistently using middle names.

Whilst it has been argued that requiring directors to provide identification stifles trade, R3 believes that this argument is specious in view of the fact that directors already need to provide such proof of identity if, for example, they wish to open a bank account. R3 believes that it would be a significant deterrent to fraud and would make a significant difference when investigating fraud if directors were required to provide identity documents when registering with Companies House.

R3 also suggests that a fee should apply to every Form 288 (the Companies House form for the notification of appointment of, termination or change to the directors of a company) when submitted. All or part of this fee could then be used to fund Companies House to check and verify directors' identity documents or go into a fund to tackle fraudulent cases.

There is also a risk that those directors who have been disqualified may continue to operate behind the scenes as shadow directors or 'advisors' to a company. IPs frequently see disqualified directors contributing to successive business failures or fraudulent activity or breaching the terms of their disqualification by acting as shadow directors and 'advisors'. Whilst R3 recognises that directors should not be discouraged from 'trying again' in the spirit of the UK's entrepreneurial culture, it is important that safeguards are put in place to protect against directors who are repeatedly acting improperly. R3 therefore believes that companies should be required to state on their annual return to Companies House or a 'central registry' the names of all directors 'howsoever described' rather than just the appointed directors.

The annual return form and Form 288 should also contain a 'health warning' of what may happen to directors who break the terms of their disqualification order and other directors who are complicit in allowing disqualified directors to be involved with the management of a company. Given that the annual return must be submitted every year and Form 288 must be submitted each time there is an appointment of a new director to the company, adding a 'health warning' to these documents would provide an opportunity to continuously educate directors on the responsibilities and risks involved in running a company.

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R3 believes that companies should be required to state on their annual return to Companies House the names of all directors 'howsoever described' rather than just the appointed directors.

R3 proposes that the annual return form and Form 288 to Companies House should contain a 'health warning' of what may happen to directors who break the terms of their disqualification order and other directors who are complicit in allowing disqualified directors to be involved with the management of a company.

2. Use of bankruptcy as a method of redress for victims

a) Public interest petitions against individuals

The Secretary of State can currently petition to wind up a company in the public interest under section 124A of the Insolvency Act 1986. The presentation of the petition can take place in various situations, including where the company has been used for an unlawful purpose, such as a vehicle to conceal fraudulent activity.

However, whilst such petitions can be presented against companies, it is regrettable that there is currently no provision for individuals to be made bankrupt in the public interest. R3 believes that such a provision would strengthen the tools available to tackle fraud and increase the opportunities for recovering funds for victims of fraud from the individuals responsible.

In appropriate cases, making an individual bankrupt on public interest grounds would ensure that the individual's assets could be removed and realised for the benefit of creditors or victims of any fraud and would hamper the individual's ability to obtain credit and trade on their own account in future, thereby hindering the opportunity for them to start up new businesses to the detriment of the public.

The bankruptcy order would also prevent that individual from acting as a director, would warn the world of his or her previous behaviour and could give rise to a Bankruptcy Restrictions Order (BRO), where the restrictions of bankruptcy that the individual is subject to can be extended for between 2 and 15 years, once again hampering their ability to set up new enterprises to the public detriment in future. BROs can already apply to bankrupt individuals whose financial behaviour leading up to their bankruptcy is judged to be reckless or culpable. It would therefore be consistent to extend the applicability of this existing insolvency tool to those individuals who have engaged in criminal activities in order to protect the public from future harm.

Public interest petitions against individuals would therefore ensure that those fraudulent enterprises which are not incorporated as companies could be shut down via the bankruptcy of the trader, reducing the threat of fraud to the public and other businesses and acting as a deterrent to other individuals who are inclined to act against the public interest.

The cost of this measure could also be 'self-funding', as although there is a cost associated with issuing the bankruptcy petition against the individual, this petition cost would be recovered as a first charge on the bankruptcy estate when assets are recovered and sold.

R3 also suggests that directors of companies wound up in the public interest should face automatic individual public interest petitions for bankruptcy and/or directors' disqualification, acting as a further hindrance to repeat offenders setting up new businesses against the public interest and as a deterrent to those inclined to do so in future. The bankruptcy or disqualification could be dealt with at the same hearing as the public interest petition against the company, thereby saving any costs associated with a separate bankruptcy or disqualification hearing.

R3 believes that the Secretary of State should be able to issue petitions to make individuals bankrupt in the public interest in order to provide a further method via which returns can be made to creditors and victims of fraud, unincorporated entities trading to the detriment of the public can be shut down and to reduce the ability of dishonest traders to set up new businesses in future.

R3 believes that directors of companies wound up in the public interest should face automatic individual public interest petitions for their bankruptcy and/or disqualification from acting as a director.

b) Criminal bankruptcy

As originally enacted, criminal bankruptcy enabled a court to make a criminal bankruptcy order against a defendant where loss or damage was suffered by another person/persons as a result of the offence committed by the defendant and the amount of the loss or damage exceeded £15,000. Through the imposition of a criminal bankruptcy order, the defendant could be forced into bankruptcy for the purposes of realising all of his/her applicable assets in order to cover the loss or damage caused by their criminal activities. This power was then abolished by section 101 of the Criminal Justice Act 1988.

In the absence of a clear rationale for abolishing criminal bankruptcy orders in the past, R3 believes that the power to make a criminal bankruptcy order should be reintroduced in order to act as a further tool to tackle the activities of fraudulent individuals. The reintroduction and use of the power to make such orders would involve little or no extra cost, as the order could be made at the criminal hearing and would therefore not require its own separate hearing.

Whilst under the previous legislation, the Official Receiver – a Government official – would act as Trustee of the bankrupt individual's estate, R3 believes that under a reintroduced criminal bankruptcy regime, it would be more effective for IPs to act as Trustees of all criminal bankruptcy cases in order to take advantage of IPs' experience of investigating the affairs and assets of bankrupt individuals and of using their powers to realise those assets for the benefit of creditors and victims. Any such reintroduced regime would therefore involve no extra burden for Official Receivers or Government associated with dealing with such cases.

Although the imposition of a criminal bankruptcy order may prevent Government from retrieving funds through a confiscation order, it is likely that Government would not actually lose money, as any realisations made under the criminal bankruptcy would be required to be paid into the Insolvency Service Account and therefore subject to a levy by the Insolvency Service.

It is also likely that, as IPs would be involved in the process of realising assets under a criminal bankruptcy by acting as Trustee of the bankrupt's estate, the level of returns on asset realisations would increase given that the IP's powers under a bankruptcy order have distinct advantages over criminal orders. These elevated powers under bankruptcy include overseas recognition to enable recovery of overseas assets, such as the stereotypical 'Spanish villa'.

In addition, the bankruptcy order would enable the IP to realise **all** of the individual's assets, in contrast to a confiscation or criminal order which only covers the proceeds of crime. Government would therefore still benefit from the funds available from the realisations made under criminal bankruptcies, albeit a different part of Government to that which currently benefits from the proceeds of confiscation and criminal orders.

R3 believes that Government should take steps to reintroduce the courts' power to impose criminal bankruptcy orders on defendants as a further means to tackle fraud, disrupt fraudulent activities and increase recoveries for victims.



c) Presumption of bankruptcy in criminal cases

R3 believes that there is merit in introducing a presumption that a defendant will be made bankrupt in criminal cases where there is a loss to victims or the defendant is ordered to pay a defined compensatory payment to victims above a specified minimum amount. In practice, this would see a defendant being given 28 days following a guilty verdict within which to either pay the loss/compensatory payment to the victim, or prove their solvency to make the payment in due course, or else they will be made bankrupt.

As previously mentioned, making a defendant bankrupt has distinct advantages in terms of asset recoveries for victims and the deterrent effect for others involved in criminal activity than the current system of compensation and confiscation orders under criminal law.

Firstly, all of the individual's assets will fall within the bankruptcy, meaning that an IP acting as Trustee of the bankrupt's estate can seek to realise all of the bankrupt's assets for the benefit of repayments to victims. This contrasts with Proceeds of Crime Act (POCA) orders where only the criminal assets or proceeds of crime can be targeted under the order.

There is no privilege or right to silence in bankruptcy, meaning that the individual is required by law to answer all of the IP's enquiries in the course of their investigation. There is also international recognition of the IP's powers under a bankruptcy order, which is particularly useful when an IP is seeking to realise assets abroad. Confiscation and other orders under POCA can also take a long time to enforce, leading to increased costs. Insolvency, by contrast, can be far quicker and involve greater returns to victims as all of the individual's assets can be targeted, as well as acting as a deterrent to future fraudulent or criminal behaviour by others.

R3 believes that there is merit in introducing a presumption that a defendant will be made bankrupt in criminal cases where there is a loss to victims or the court orders the defendant to pay a defined compensatory amount above a specified amount, thereby ensuring there is a more effective method in place to recover assets for the benefit of victims.



3. Improving financial redress for creditors

When a director of a company acts improperly or fraudulently, creditors are often left with nothing after the company enters insolvency. In such circumstances, it is important that creditors should be allowed to recover both their losses and the cost of recovering those losses from the delinquent director(s).

IPs undertake litigation on behalf of creditors against company directors or third parties whose actions have caused serious harm to a business. This can include taking money out of a business for personal use, concealing assets and committing fraud, which in some cases can contribute directly to the failure of the business.

An IP's overarching legal duty is to maximise returns to creditors. In cases where directors have acted improperly, this may involve undertaking litigation to return money rightfully owed to creditors, including the business community and HMRC. The current system of litigation enforces claims of approximately £300m a year, of which between £50m and £70m relates to money owed to HMRC and the rest to business. The powers of litigation available to IPs are an important deterrent to improper or fraudulent conduct by company directors and others involved in the commercial world. Without the use of litigation, errant directors would get away with dishonest practice and businesses and Government would be unable to recover considerable amounts of money from those responsible.

In an insolvency situation, a company by definition has little or no money and as a consequence, there are no funds to pay the legal costs involved in litigation. The creditors' only realistic hope of recouping money owed to them is therefore for the IP to engage solicitors on a Conditional Fee Arrangement (CFA) (a 'no win, no fee' case). In addition to this, IPs may be personally liable for costs incurred as a consequence of litigation so must be adequately protected with After the Event insurance (ATE).

As the system currently exists, CFA success fees and ATE insurance premiums are recoverable from the defendant if a court, on the merits of the case, considers them to be liable. This is particularly invaluable in instances where the assets of the company may have been wholly depleted by the directors and therefore the costs of success fees and ATE might significantly reduce the value of any recoveries made.

In view of the considerable personal costs which may be borne by an IP if a litigation case is unsuccessful, IPs do not pursue frivolous or unmeritorious claims and will only commence litigation on legal advice and if satisfied that it is economically justifiable for creditors.

However, in 2012 the Legal Aid, Sentencing and Punishment of Offenders (LASPO) Act came into force which curbs the use of CFAs and ATE by introducing measures which mean that CFA success fees and ATE premiums are no longer recoverable from the losing party in litigation. Whilst the Government granted a temporary exemption from the LASPO Act for insolvency cases until 2015 due to the significant sums of money which go to HMRC and the business community, R3 calls for a permanent exemption for insolvency from the LASPO Act in order to protect a tool which not only increases the returns available to Government, taxpayers and creditors, including HMRC and the business community, but also acts as a deterrent to fraud and dishonest behaviour by company directors.

Without a permanent carve-out for insolvency cases, there is a real risk that IPs will be discouraged from undertaking litigation in insolvency cases and as a consequence, errant or fraudulent directors will be able to get away with sharp practice and Government, smaller businesses and consumers will lose significant amounts of money which would ordinarily be recoverable via the litigation process.

R3 calls for a permanent exemption for insolvency cases from the Legal Aid, Sentencing and Punishment of Offenders Act 2012 to ensure that important work in recovering money for creditors and in ensuring that delinquent directors are required to pay for their improper or fraudulent conduct can continue.

R3's recommendations

R3 believes that IPs can provide the much-needed extra capacity and additional processes required to assist Government and law enforcement agencies in the fight back against fraudulent activities and can tackle cases that are otherwise unlikely to be progressed.

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About R3:

R3, the insolvency trade body, represents over 97% of insolvency practitioners. R3's full members are all regulated by their recognised professional bodies, they can be licensed insolvency practitioners, solicitors, chartered accountants or certified accountants. They have extensive experience of helping businesses and individuals in financial distress. www.r3.org.uk