



Analysis

The Difference Between Wrongful and Fraudulent Trading

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Biography

Nick Hood is the Senior Business Adviser at the Opus Business Advisory Group (<https://www.opusllp.com>), the largest independent advisory, restructuring and insolvency firm in the UK.

Nick was a licensed Insolvency Practitioner, working in the business rescue market for 25 years. He is a committed internationalist, having created the largest global network of independent business rescue firms and having also worked overseas in Canada, Milan and Bahrain.

In his earlier career and after qualifying as a Chartered Accountant in 1970, Nick held senior executive positions in major companies in the construction, engineering and media sectors, as well as working for a boutique investment bank.

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Abstract

The directors of failed companies can be accused of a range of offences, mainly based on contravening their fiduciary duties. The two most common issues are over Wrongful Trading and Fraudulent Trading. They are often confused, but the consequences can be very different. Directors need to understand them and take the appropriate steps to mitigate any potential liability. In this article, the author looks at what these offences are, and analyzes the differences between each of them.

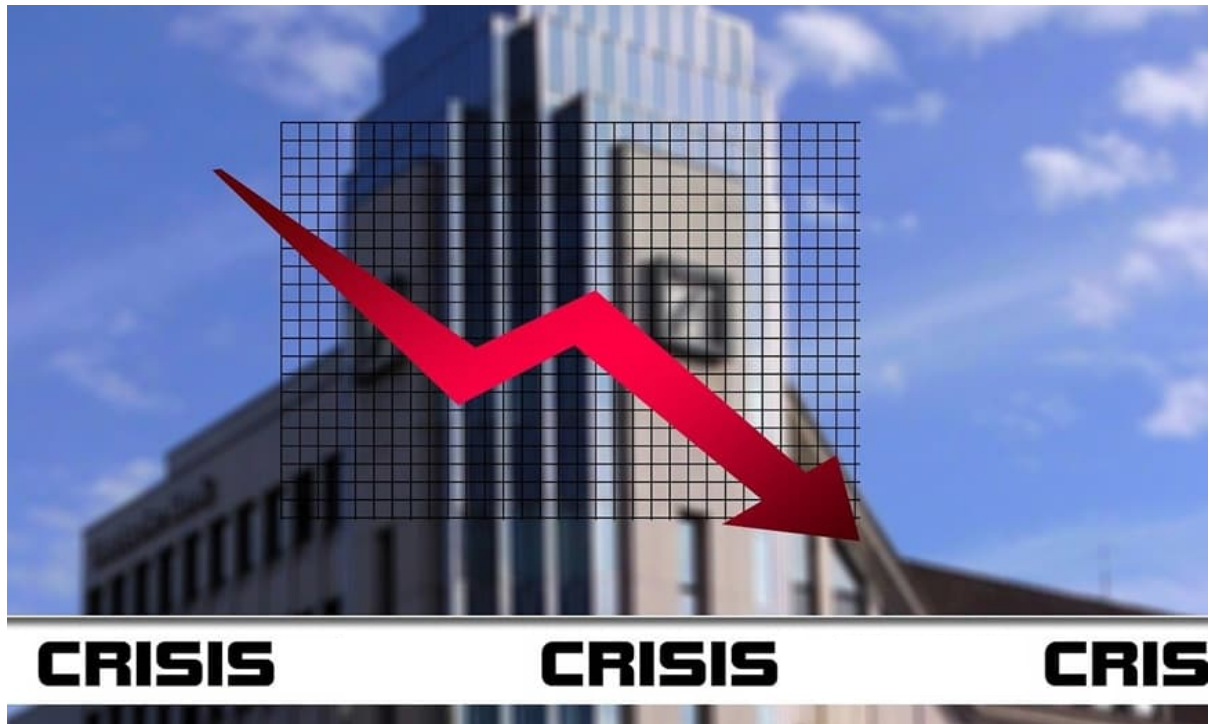
Introduction

Many (but by no means all) UK company directors have heard of at least some of the various offences they can be accused of committing in connection with breaching their fiduciary duties to their company and its stakeholders, especially creditors. The two most common offences are Wrongful Trading, and Fraudulent Trading. Unfortunately, being aware of their existence rarely extends to any meaningful understanding of how the offences can be committed, how they can best be avoided and what consequences there are for those who are found guilty.



Analysis

Both offences are governed by the Insolvency Act 1986¹. Knowing the nuances of insolvency law is vital for company directors, not only for legal compliance but also for upholding professional integrity and safeguarding personal and corporate reputations. The two offences may sound much the same, but they are distinct legal concepts with different liability thresholds, defences and consequences for directors.



Wrongful Trading²

This offence is set out in Section 214 of the Insolvency Act 1986. It's a purely civil action aimed at directors who allow a company to continue trading and incurring additional losses when they knew, or ought to have known, that there was no reasonable prospect of avoiding insolvent liquidation and who fail to take every step possible to minimize potential loss to creditors.

What is the standard of proof?

This is based on the "reasonable person" test: what a reasonably diligent person, having the general knowledge, skill, and experience that may reasonably be expected of someone carrying out the same functions, would have concluded and done in the same circumstances.

What are the consequences for directors?

If found guilty, directors can be ordered by the Court to make contribute personally to the company's assets and are also at risk of Disqualification³ from acting as a director for up to 15 years. However, Wrongful Trading is not a criminal offence; it's a purely civil liability.



Examples of Wrongful Trading

- Directors continuing to accept new orders or incur debts when insolvency is imminent, hoping the situation will improve, despite no realistic basis for such optimism.
- Failing to properly monitor the company's financial position and to seek professional advice at the first sign of significant trouble.
- Not taking steps such as reducing expenses, ceasing trading, or entering into negotiations with creditors when it becomes clear that the company cannot pay its debts as they are demanded.

Proving Wrongful Trading

- There is no need to prove dishonesty or intent to defraud, only that the director's actions fell below the standard of care required by the Insolvency Act 1986.
- Wrongful trading claims can only be brought against directors, including de facto and 'shadow directors'⁴.
- The Court will consider all the circumstances, including whether the director took "every step" to minimize creditor losses, as required by Section 214.





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Fraudulent Trading

This offence is governed by Section 213 of the Insolvency Act 1986. The intention is to penalize those who deliberately set out to defraud creditors.

What is the standard of proof?

The legal standard of proof is high. There must be evidence of actual dishonesty or intent to deceive. This is a criminal as well as a civil offence and actions can be brought not just against directors, but against anyone who was knowingly party to the fraudulent conduct.

Consequences for directors and others

There are a number of unpleasant consequences for those found guilty. They may be ordered to contribute to the company's assets for the benefit of creditors. Criminal prosecution can also result in fines or imprisonment, as well as disqualification from acting as a director for up to 15 years.

Examples of Fraudulent Trading

- Where directors continue to incur credit when they know their company is unable to pay existing debts and have no realistic plan to settle the company's liabilities, with the intention of deceiving creditors.
- Producing and submitting false financial statements or records deliberately to mislead stakeholders and in particular to obtain finance.
- Setting up "phoenix companies" to avoid debts or to facilitate the transferring of assets out of the failing business prior to insolvency for personal benefit or to prevent creditors from recovering their debts.



Proving Fraudulent Trading

- Direct evidence of dishonesty is required; negligence or poor business judgment, without intent to deceive, isn't sufficient proof.
- Both company officers and third parties (not limited to directors) can be found liable if they were "knowingly party" to the conduct. The recent Bilta UK decision⁵ confirms this.
- The standard of proof is higher than for Wrongful Trading. The Court will require a clear demonstration of intent to defraud.

What are the key differences between Fraudulent and Wrongful Trading?

Both offences relate to the conduct of business prior to insolvency, but there are several important differences.

- **What intent has to be proved?**
Fraudulent Trading requires actual dishonesty and intent to defraud, whereas Wrongful Trading is based on negligence or failure to act diligently, regardless of intent.
- **Who can be found liable?**
Fraudulent Trading can apply to any person involved in the fraud (including non-directors), while Wrongful Trading applies only to directors.



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- **What is the required burden of proof?**
The threshold for proving Fraudulent Trading is considerably higher, due to its criminal element. Wrongful Trading is a civil matter and is judged on the balance of probabilities.
- **What are the consequences for guilty parties?**
Fraudulent Trading can lead to both civil and criminal penalties, including imprisonment. Wrongful Trading results only in civil liability.
- **What is the purpose of the Fraudulent Trading offence?**
Fraudulent Trading is intended to punish deliberate wrongdoing, while Wrongful Trading is about holding directors accountable for failing to take the appropriate action to protect creditors once insolvency has become unavoidable.



How should directors act?

Directors must be vigilant, especially when their Company shows signs of significant financial distress. The difference between fraud and a simple error in judgment can hinge on record-keeping, timely advice and transparency. Basic requirements include:

- **Maintaining proper books and records** – Detailed, up-to-date financial records can evidence directors' efforts to act responsibly. They also demonstrate that informed decision-making has taken place.



- **Monitoring financials** – Regularly review trading and financial health. Watch for warning signs such as mounting debt, declining revenues and persistent cash flow issues.
- **Taking professional advice early** – Prompt consultation with insolvency practitioners or legal professionals can make the difference between demonstrating due diligence and falling foul of the law.
- **Acting decisively** – If insolvency appears unavoidable, directors must consider taking steps to protect creditors' interests, such as entering Administration⁶ (or proposing a Company Voluntary Arrangement⁷(CVA).
- **Demonstrating transparency** – Keep shareholders, creditors and other stakeholders informed. Transparency may help mitigate losses and demonstrate good faith.

Conclusion

While both Fraudulent and Wrongful Trading can have severe consequences for individuals involved in a company nearing insolvency, understanding the differences between the offences is crucial for directors.

Directors must act prudently, seek advice early and document their decision-making. By promoting a culture of vigilance and responsibility, they can reduce the risk of liability.

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