Dr Stephen Copp and Alison Cronin, 'The Failure of Criminal Law to Control the Use of Off Balance Sheet Finance During the Banking Crisis' (2015) 36 The Company Lawyer, Issue 4, 99, reproduced with permission of Thomson Reuters (Professional) UK Ltd.

This extract is taken from the author's original manuscript and has not been edited. The definitive, published, version of record is available here:

http://login.westlaw.co.uk/maf/wluk/app/document?&srguid=i0ad8289e0000014eca3cbb3f026cd4c4&docguid=I83C7BE20C70F11E48380F725F1B325FB&hitguid=I83C7BE20C70F11E48380F725F1B325FB&rank=1&spos=1&epos=1&td=25&crumb-action=append&context=6&resolvein=true

THE FAILURE OF CRIMINAL LAW TO CONTROL THE USE OF OFF BALANCE SHEET FINANCE DURING THE BANKING CRISIS

Dr Stephen Copp & Alison Cronin[1]

30th May 2014

Introduction

A fundamental flaw at the heart of the corporate structure is the scope for fraud based on the provision of misinformation to investors, actual or potential. The scope for fraud arises because the separation of ownership and control in the company facilitates asymmetric information[2] in two key circumstances: when a company seeks to raise capital from outside investors and when a company provides information to its owners for stewardship purposes.[3] Corporate misinformation, such as the use of off balance sheet finance (OBSF), can distort the allocation of investment funding so that money gets attracted into less well performing enterprises (which may be highly geared and more risky, enhancing the risk of multiple failures). Insofar as it creates a market for lemons it risks damaging confidence in the stock markets themselves since the essence of a market for lemons is that bad drives out good from the market, since sellers of the good have less incentive to sell than sellers of the bad.[4] The neo-classical model of perfect competition assumes that there will be perfect information. However, it can be difficult to define property rights and establish markets in information.[5]

---

[1] Dr Stephen Copp, Associate Professor in Law and Alison Cronin, Lecturer, the Business School, Bournemouth University. An earlier version of this article was presented as "Off-balance Sheet Finance and the 2008 Financial Crisis: The Case for Deterrence Evaluated" at the Banking & Finance Stream of the Socio-Legal Studies Association Annual Conference (Robert Gordon University, 2014). The law is as stated at 31st May 2014, except as otherwise stated.

[2] See generally C. Veljanovski, *Economic Principles of Law* (Cambridge: Cambridge University Press, 2007), pp. 40 – 41; the problem of asymmetric information arises where one transactor knows more than the other and as a result transactions take place influenced by fraud or deceit or because of judgment problems on the part of buyers who cannot assess quality without information, the "market for lemons" scenario, see B.R. Cheffins *Company Law, Theory, Structure and Operation* (Oxford: Oxford University Press, 1997), pp. 129 – 130. The market for lemons is used to refer to a market for both good and bad cars where only the sellers know which cars are inferior.

[3] See Cheffins (n 2) pp. 129 – 131 for an application of this problem mainly to the public offering of shares.

[4] Ibid.

[5] R. Cooter and T. Ulen, *Law & Economics* (Reading MA: Addison-Wesley, 2000), p. 126.

Information is costly to produce and cheap to transmit. Producers have difficulty in selling information for more than a fraction of its value, "nonappropriability", one person's use of an idea does not diminish its availability for others to use, it is "non-rivalrous", and excluding some people from it can be expensive, it is "non-excludable".[6] Cooter and Ulen conclude, therefore, that state intervention may be needed either in terms of state supply of information, public subsidies for the private provision of information, or the creation and protection of property rights in information.[7]

Early companies' legislation, in particular, the *Joint Stock Companies Acts 1844 to 1856*, was a response to such problems[8] and involved various experiments involving different and innovative legislative techniques that were emerging at the time, for example, registration, information provision, mandatory/ default rules.[9] Criminal sanctions nonetheless were also introduced to support the framework and were subject to piecemeal reform over the years[10] – but surprisingly a generic rule against fraud was not introduced until the *Fraud Act 2006*. Despite the persistence of high profile financial scandals involving companies, the number of successful prosecutions involving the provision of misinformation by companies has remained low, whilst simultaneously the volume and complexity of regulation designed to combat information asymmetry has mushroomed, leading to substantial and undesirable transaction costs[11] that undermine one of the original purposes of the company, namely facilitating market entry,[12] potentially leading to social costs, for example, the loss of innovation. Such regulation can be seen to be highly path dependent in economic terms, implying that radical surgery may be required to resolve the problem.

The current volume and complexity of the regulatory edifice aimed at addressing corporate misinformation is breathtaking. The institutional architecture now includes, at an international level, the International Accounting Standards Board (IASB), the International Auditing and Assurance Standards Board (IAASB), the European Union Internal Market and Services Directorate-General, the European Financial Reporting Advisory Group (EFRAG), and at the UK level, the Department of Business, Innovation & Skills (DBis), the Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA), the Financial Reporting Council (FRC), Companies' House and numerous professional associations of accountants.[13] In relation to financial disclosure, at an EU level the regulatory framework includes the Fourth,[14] Seventh,[15] Eighth[16] and Eleventh[17] Company Law Directives, the

[6] Ibid.
[7] Ibid.
[8] See, in particular, the First Report of the Select Committee on Joint Stock Companies (1844 B.P.P., Vol. VII) (Gladstone Committee Report), see for example paras. 7.8 – 16.
[9] See for example the development of the concept of registration through the Registration Act 1786, the Registering of British Vessels Act 1825, the Savings Banks Act 1817, Friendly Societies Act 1829 and the Building Societies Act 1836, see R. Harris, *Industrialising English Law: Entrepreneurship and Business Organisation 1720 – 1844* (Cambridge: Cambridge University Press, 2000), pp. 274 – 277.
[10] See below.
[11] See below.
[12] See S.F. Copp, "Limited Liability and Freedom" in S.F. Copp (ed.), *The Legal Foundations of Free Markets* (London: Institute of Economic Affairs, 2008), esp. pp. 171 – 172, 179 – 180 and 181 – 183.
[13] See generally http://www.iosco.org/; http://www.ifrs.org/Pages/default.aspx; http://www.ifac.org/auditing-assurance; http://ec.europa.eu/dgs/internal_market/index_en.htm; http://ec.europa.eu/internal_market/securities/esc/index_en.htm; http://www.esma.europa.eu/; http://www.efrag.org/Front/Home.aspx; https://www.gov.uk/government/organisations/department-for-business-innovation-skills; http://www.fca.org.uk/; http://www.bankofengland.co.uk/PRA/Pages/default.aspx; http://www.frc.org.uk/; http://www.companieshouse.gov.uk/. [accessed January 28, 2015].
[14] Directive 78/660/EEC [1978] OJ L222/11.

Accounts Modernisation Directive[18] and various amending Directives,[19] various Regulations governing the adoption of International Accounting Standards.[20] At UK level, there are Parts 15, 16, 35 and 42 Companies Act 2006,[21] supplemented by numerous Statutory Instruments,[22] over 30 Financial Reporting Standards and 11 Statements of Standard Accounting Practice[23] and numerous auditing standards.[24]

Attempting to ascertain the cost of this institutional architecture and regulatory framework would be a massive task. It is only necessary to consider the nonetheless substantial research that was conducted for the Government in relation to the administrative burdens of regulation - the work in relation to the Department of Trade and Industry, the Administrative Burdens Measurement Exercise (ABME), involved a 452 page report supported by a 79 page technical summary.[25] Generally, the ABME found that the regulation of accounting and company law accounted for 51 per cent a staggering £6680 million, of the total estimated administrative cost on business, of which the Companies Act 1985 accounted for 98 per cent. The explanation offered was the existence of nearly 2 million companies in the UK to which information requirements applied.[26] The obligation for small companies to prepare accounts was the second most costly information obligation, with an estimated administrative cost of £1139 million.[27] But it was also noted that 50 per cent of the total costs had their origin in international obligations where there was no discretion, and 5 per cent from international obligations where there was some discretion.[28] The preparation of company accounts for each financial year in accordance with international accounting standards (IAS) or the Companies Act 1985 resulted in an administrative burden of a very modest £57 million.[29] What can be seen from this is that the total cost of a framework, the main original purpose of which was to reduce fraud, is so difficult to ascertain that there is realistically no way of estimating whether it is beneficial or whether it exceeds the cost of the fraud itself or results in an optimal level of fraud in economic terms.[30] Since most of the cost of such a framework may well be imposed on non-fraudulent parties, this must entail significant economic waste. Furthermore,

---

[15] Directive 83/349/EEC [1983] OJ L193/1.
[16] Directive 84/253/EEC [1984] OJ L126/20.
[17] Directive 89/666/EEC [1989] OJ L395/36.
[18] Directive 2003/51/EC [2003] OJ L221/13.
[19] Directive 2006/46/EC [2006] OJ L224/1; Directive 2009/49/EC [2009] OJ L164/42.
[20] See, in particular, Regulation 1606/2002/EC and Regulation 297/2008/EC. The current terminology is "International Financial Reporting Standards" (IFRS) which are issued by the former International Accounting Standards Board (IASB); IFRS now include International Accounting Standards (IAS) issued by the former International Accounting Standards Committee (IASC).
[21] Companies Act 2006 Part 15 (accounts and reports), Part 16 (audit), Part 35 (the Registrar of Companies); Part 42 (statutory auditors), as well as various relevant Schedules.
[22] See, in particular, the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 SI 2008/409 as amended and the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 SI 2008/410 as amended.
[23] See http://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Standards-in-Issue.aspx. [Accessed January 28, 2015].
[24] See further http://www.frc.org.uk/Our-Work/Codes-Standards/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Auditing-standards.aspx. [Accessed January 28, 2015].
[25] DTI, June 2006.
[26] ABME Report, p. 17.
[27] Ibid p. 61.
[28] Ibid pp. 84 – 85.
[29] See Administrative Burdens of Regulation – Department of Trade and Industry" (HM Government, December 2012), p. 8.
[30] For discussion of the concept of the optimal level of fraud see, for example, M.R. Darby and E. Karni, "Free Competition and the Optimal Amount of Fraud" (1973) 16 Journal of Law & Economics 67 and A.M. Polinsky and S. Shavell, "The Optimal Use of Fines and Imprisonment" (1984) 24 Journal of Public Economics 89.

there is fair evidence not only that the system has been historically path dependent in the UK but that its internationalisation makes such path dependence more difficult to ever break free of, something that is likely to entail further economic waste.

This article observes that in economic theory there are grounds for supposing that a general anti-fraud rule would be more efficient than regulation. An evaluation of such complex institutional architecture and regulatory framework(s) is patently impossible in conventional terms; however, a case study evaluation of the role played by OBSF in the 2008 financial crisis, arguably the most serious in history, will demonstrate its failure to address what might have been expected to have been one of the most basic aims of the system, a large scale financial crisis contributed to by large scale corporate misinformation. It examines how the regulatory regime which largely comprised specific offences with limited deterrent value failed to adequately deter the manipulation of corporate information. Regrettably the criminalisation of generic behaviour in the *Fraud Act 2006* did not come into force until January 15, 2007 and was therefore too late to have a significant impact, even though it was potentially highly suited to this role. Given that OBSF evolves in response to regulation and its form at any moment in time tends to be unknown until revealed by scandal, this article has not attempted any evaluation of the current state of play with regard to OBSF and the adequacy of the current regulatory regime to combat it. Overall, this article argues that improving the effectiveness of anti-fraud legislation could provide scope for significant cuts in the volume and complexity of company law, with substantial potential savings in corporate transaction costs.

The contribution of off balance sheet finance to the 2008 financial crisis - a case study in the failure of the mandatory disclosure regime

The problems created by the use of OBSF have been recognised in the UK since the 1980s,[31] though the practice can arguably be traced back to at least the 1920s in other forms.[32] OBSF gained international prominence with the US Enron scandal which broke in 2001.[33] Despite measures designed to combat such schemes, it will be shown how OBSF emerged once more as a significant feature in the financial crisis of 2007 onwards in both the UK and the US. Defining off balance sheet finance is a difficult task, first because successful schemes are unlikely to draw attention for reasons of commercial confidentiality, and secondly because each such scheme represents a response to a particular set of legal requirements, whether from regulation or from market mechanisms, such as ratio requirements imposed by ratings agencies or requirements set out in articles of association. The central problem of off balance sheet finance is, therefore, one of interpretation, redolent of Portia's judgment in Shakespeare's *Merchant of Venice*:

> "This bond doth give thee here no jot of blood;
> The words expressly are, a pound of flesh:
> Take thee thy bond, take thou thy pound of flesh;

[31] See, for example, M. Dickson, "Rescue from a Financial Minefield, Events which brought Burnett and Hallamshire group to edge of collapse", Financial Times 24th January 1986 and "Retailing giant Burton Group has raised £100 million off-balance sheet finance with the creation of a 50% property holding associate", Accountancy Age 16th October 1986.

[32] "Off-balance sheet finance – why all the fuss", Accountancy 26th June 1987, referring to a 1925 letter of Sir Arthur Whinney to the Times objecting to the consolidation of subsidiary companies into one balance sheet. Such schemes may not be limited to business enterprises, seemingly cathedrals may have indulged in it too, see A. Jack, "Thou Shalt Not Cook the Books", Financial Times 17th December 1993.

[33] A. Hill and S. Fidler "Enron ties itself up in knots, then falls over" Financial Times, 29th January 2002.

But, in the cutting of it, if thou dost shed
One drop of ... blood, thy lands and goods
Are by the laws of Venice, confiscate ... ."

Ernst & Young put it nicely, saying "The term implies that certain things belong on the balance sheet and that those which escape the net are deviations from this norm".[34] There are, however, a wide variety of schemes that can constitute OBSF, including the use of consignment stock, factoring, sale and repurchase, deferred consideration and the use of special purpose vehicles (SPVs) which carry with them different levels of risk.[35] This article will focus on the use of SPVs as these have been most associated with the use of OBSF in the UK banking crisis.[36]

The Greene Committee 1926 first raised the issue of what form the accounts of holding companies should take.[37] It noted that there had been complaints from shareholders in holding companies that their accounts were unintelligible without fuller details of subsidiary and associated companies, and that some wanted a compulsory consolidated balance sheet for the whole group of companies.[38] This was rejected on the basis that the matter should be left to shareholders to make such requirements, and that many holding companies had done so already: "we consider that undue interference by the legislature in the internal affairs of companies is to be avoided, even if some risk of hardship in individual cases is involved."[39] Even at this early stage it was observed that there was a "considerable divergence of views ... among both commercial men and accountants".[40] It was felt, however, that shareholders and others were entitled to know whether proposed dividends were justified by group results and therefore it was necessary to include a definition of "holding company" and "subsidiary company" for this purpose.[41] Two alternative tests were adopted, therefore, based on "control": first, where the holding company held more than 50 per cent of voting power or the issued share capital in the subsidiary company, or, secondly, where the holding company had the power to appoint or nominate the majority of directors of the subsidiary.[42].These were incorporated in the Companies Act 1929.[43]

The Cohen Committee 1945 recommended both the thorough revision of the definition of holding and subsidiary company and the introduction of a requirement for a consolidated balance sheet and profit and loss account.[44] Its reasons for concluding that the existing definitions were unsatisfactory were that: (1) it failed to include sub-subsidiary companies; (2) it included as subsidiaries companies which "may be neither under the holding company's *de facto* control for management purposes as branches of the business of the holding company group nor subject to its legal power of control as regards matters as the appointment

[34] UK GAAP p. 1233.
[35] I. Griffiths, *New Creative Accounting* (London: Macmillan, 1995), pp. 129 – 146.
[36] Whilst, SPEs were prominent in the US account of the financial crisis
[37] *Greene Committee Report* (2006), para. 71 .
[38] Ibid p. 33, para. 71.
[39] Ibid p. 34, para. 71.
[40] Ibid p. 33, para. 71.
[41] It was observed that there was nothing in law to prevent a holding company using a dividend from profit-making subsidiaries to pay a dividend on its own shares without taking account of losses suffered by other subsidiaries, ibid see p. 34, para. 71.
[42]Ibid p. 36 – 37, para VII. Where there was no actual control the directors could certify that "the holding company is not lawfully entitled or is otherwise unable to obtain the information" needed.
[43] Companies Act 1929, ss. 125 – 127.
[44] *Report of the Committee on Company Law Amendment* (Cohen Report 1945) pp. 69 - 76, paras 115 – 122.

of a majority of their directors".[45] In the Committee's view, the decisive test should be the question of control, following evidence from the US and Canada, with the only exception being where a company owned more than half the equity share capital in another since it was felt that "such a concentrated holding may well give practical control of the business although the holding company does not necessarily possess a majority of the voting power".[46] Their recommendations were to form the basis of the long-standing provisions of the Companies Act 1948. Broadly, a company was regarded as the holding company of a subsidiary company where (1) it was a member of it and controlled the composition of its board of directors; (2) it held more than half in nominal value of its equity share capital; or (3) the subsidiary company was a sub-subsidiary company.[47] In addition, there were a range of much tighter supporting provisions, for example, defining when the composition of a company's board was deemed to be controlled by another, the significance of how a company's shares were held, and defining the expressions "company" and "equity share capital".[48] These provisions were re-enacted in substantially the same terms in the Companies Act 1985,[49] surviving in force until major changes to the entire framework were introduced as from November 1, 1990.[50] They were, however, easily manipulated, for example, by exploiting the definition of "equity share capital" and the use of weighted voting rights at board meetings.[51]

It can be seen, therefore, that the rationale for recognising groups of companies for accounting purposes was controversial and overrode private provision for this being developed by shareholders. It was based on the perceived need for shareholders to know whether proposed dividends were justified by group results, and required the enactment of ever-more complex definitional provisions to support it. Ironically, these definitions provided the scope for off balance sheet finance because of their rigidity and exclusion of subjective judgment. Simultaneously, they increased expectations of what the balance sheet of a holding company meant.

The increasingly high profile of OBSF schemes in the early 1980s provided much of the impetus for reform. Notable among these were what was described in the Financial Times as "the full horror story behind the collapse of Burnett and Hallamshire",[52] and the scale of use of a "diamond" arrangement by the Burton Group, involving the sale of £100 million of properties to Hall and Sons, a company which was outside of its group for certain tax purposes but inside it for others.[53] The method used by the Burton Group is illuminating. Shares in Hall and Sons were owned equally between a 100 per cent subsidiary and a 50 per cent associate company of the Burton Group, with the Burton Group taking a minority of seats on the board to reflect its 50 per cent direct voting control through the 100 per cent subsidiary.[54] However, the Burton Group had the option to reacquire the properties at cost whenever it chose through an arrangement with a bank that had provided £70 million non-

[45] Ibid p. 70, para. 118.
[46] Ibid.
[47] Companies Act 1948, s. 154(1).
[48] Companies Act 1948, ss. 154(2) to (5).
[49] Companies Act 1985, s736; the updating consisted mainly of clearer language and the addition of a definition of "wholly-owned subsidiary".
[50] Subject to transitional provisions, see Companies Act 1989, s. 144(1).
[51] Tolley's *Company Law*, Section H "Holding and Subsidiary Companies" (Issue 4, March 1991), para. H5007.
[52] Dickson (n 31).
[53] Accountancy Age April 16th, 1987, "Substance over form is a mighty fine sounding principle – accountancy's version of motherhood and apple pie".
[54] Ibid.

recourse funding to Hall and Sons.[55] Ironically, it has been suggested that the DTI's role in the prosecutions in the *Argyll Foods* case inhibited the proper accounting treatment of certain off-balance sheet schemes because of its statement after the magistrates' finding against the defendants, preferring law over substance.[56] In this case, the audit report for Argyll Foods Ltd included a note expressing the opinion that the consolidation of Morgan Edwards Ltd and Subsidiaries, which at the relevant date was not legally a subsidiary (but was the subject of merger negotiations between companies managed and effectively controlled by the same people), did not comply with ss. 150 and 154 Companies Act 1948 (Group accounts and definition of subsidiary) and with SSAP 14 (effective date of acquisition of subsidiary).[57] However, the note proceeded to state that the accounts were not rendered "misleading" because of the non-compliance and gave a true and fair view.[58] Several directors were issued with summonses alleging that the accounts did not show a true and fair view but not with breaching the specific provisions of the companies' legislation referred to.[59] The case was tried in the magistrates' court, involved a galaxy of impressive witnesses, including the head of the Government Accounting Service (a former ICAEW president), and resulted in the relevant directors being conditionally discharged.[60]

The accountancy profession took some initiative in seeking to address OBSF itself, with the ICAEW issuing TR603 in December 1985 as interim guidance only, but with the support of the DTI.[61] "Off balance sheet finance" was defined as "The funding or refinancing of a company's operations in such a way that, under legal requirements and existing accounting conventions, some or all of the finance may not be shown on its balance sheet".[62] The importance of non-subsidiary dependent companies was emphasised by their use in Appendix A as an illustration of off balance sheet finance. The Technical Release distinguished between accounting and disclosure based approaches, where accounting solutions were recorded in the financial statements themselves as opposed to the making of additional disclosures.[63] It noted that the principle was recognised in the legal requirement for accounts to show a true and fair view that there were circumstances where no amount of additional disclosure could take the place of appropriate accounting.[64] Furthermore, where inappropriate accounting could mislead, accounting, rather than disclosure, solutions should be adopted, though such accounting solutions should "usually" comply with the specific requirements of the law rather than rely on the true and fair override.[65] The provisional advice was that the accounting treatment of transactions should be based on economic substance rather than legal form, and any difference disclosed in the notes to the accounts, but that where – rarely – this would not comply with the law and the transaction was material, a true and fair view should be provided by presenting separate pro-forma accounts based on economic substance.[66] A

[55] Ibid.
[56] A legally unreported Magistrates' Court trial which was reported by R.K. Ashton, "The Argyll Foods Case, A Legal Analysis", (1986) 17(65) Accounting and Business Research, pp. 3-12 for the benefit of future researchers in this area.
[57] Ibid pp. 3 and 11.
[58] Ibid.
[59] Ibid, p. 3.
[60] Ibid., p. 7.
[61] TR603 (December 1985); see Accountancy February 1986. It was expressly noted (para. 2) that the DTI rejected any suggestion that the approach being taken by the ICAEW was inconsistent with the DTI's statement in relation to the Argyll Foods case. See further para. 14 for a further discussion of the DTI's statement.
[62] Para. 5(i).
[63] Para. 8.
[64] Para. 9
[65] Paras 9 and 10.
[66] Para. 17.

series of exposure drafts followed,[67] leading to the issue of FRS 5 in April 1994, which remains in force.[68] Meanwhile the property slump of the late 1980s and the recession of the early 1990s highlighted the role played by OBSF in a number of companies that found themselves in difficulties, with off balance sheet subsidiaries unable to repay their debts and parent companies finding that they could not avoid responsibility for loans assumed to be non-recourse.[69]

The ability of the accountancy profession to address the problem of controlled non-subsidiaries was limited, given the DTI accepted the lawyers' viewpoint that their consolidation in accounts would be illegal.[70] The EC Seventh Directive on Consolidated Accounts provided a golden opportunity to address the problem, and it seems that an ASC working party suggested to the DTI that it could use its implementation in legislation to require consolidation.[71] The DTI accepted that the use of controlled non-subsidiaries as a means of off balance sheet finance could not be solved by the use of the true and fair override, and recognised that the EC definition would introduce a "measure of judgment" into what was considered to be a subsidiary or not, something that would be an appropriate area for accounting standards even if ultimately a matter for the courts to determine.[72] The approach taken to implementation in the Companies Act 1989 was innovative, and represented a sea-change from earlier approaches. The general tests of "holding company" and "subsidiary company", which by now were used for a wide range of legal purposes, often unrelated to company law, were separated from the new tests of "parent undertaking" and "subsidiary undertaking", which would be used mainly for legal purposes related to accounting.[73] A power to amend the definitions of "holding company", "subsidiary" and "wholly owned subsidiary" by statutory instrument was also included.[74] The general tests were tightened up as part of the exercise to give better effect to the underlying concept of control and presumably to avoid the manipulation of what constituted equity share capital and the use of weighted voting rights on the board. Accordingly, the test based on holding more than half in nominal value of another company's equity share capital was replaced with holding "a majority of the voting rights" in that other company.[75] Furthermore, the test based on membership and controlling the composition of another company's board of directors was replaced with a test based on membership and "the right to appoint or remove a majority of

[67] ED 42 (March 1988); ED 49 (May 1990) and FRED 4 (March 1993). ED42 notably defined a "controlled non-subsidiary" as "a company, trust or other vehicle which, though not fulfilling the Companies Act definition of a subsidiary, is directly or indirectly controlled by, and a source of benefits or risks for, the reporting enterprise that are in substance no different from those that would arise were the vehicle a subsidiary", see Accountancy (April 1988).

[68] As amended by "'Reporting the Substance of Transactions': Revenue Recognition" (November 2003), "'Reporting the Substance of Transactions': Private Finance Initiative and Similar Contracts" (September 1998), "'Reporting the Substance of Transactions': Insurance Broking Transactions and Financial Reinsurance" (1994) and FRS 25 and FRS 26. Discussed further below.

[69] Financial Times, December, 11 1992 "Property – Creative collapse".

[70] C.K.M. Pong, "Jurisdictional contests between accountants and lawyers: the case of off-balance sheet finance 1985 – 1990" (1990) 4(1) Accounting History 7, 22.

[71] Ibid.

[72] Ibid.

[73] Companies Act 1985, s. 736 and s. 736A (as substituted by Companies Act 1989, s. 144(1)) (definitions of holding company, subsidiary and wholly owned subsidiary and supplemental provisions) and Companies Act 1985, ss. 258 to 260 (as substituted by Companies Act 1989, s. 22) (definitions of parent and subsidiary undertakings, undertaking and related expressions and participating interests).

[74] Companies Act 1985, s. 736B (as inserted by Companies Act 1989, s. 144(3)).

[75] Companies Act 1985, s. 736(1)(a) (as substituted by Companies Act 1989, s. 144(1)). See also Companies Act 1985, s. 736A (2) (as substituted) which further defined voting rights to extend to "rights conferred on shareholders ... to vote at general meetings of the company on all, or substantially all, matters".

its board of directors".[76] An additional test based on membership and control of a majority of voting rights pursuant to an agreement with other members was introduced following the EC Seventh Directive.[77] For accounting purposes, three additional approaches were adopted. The first was to extend the tests based on membership of another company, for example, so that an undertaking would be deemed to be a member of an undertaking where a subsidiary undertaking was a member of an another undertaking.[78] The second was where a parent undertaking had the right to exercise a "dominant influence" over another undertaking through its memorandum or articles of association or a control contract.[79] The third was where a parent undertaking had a "participating interest" in another undertaking and "actually" exercised a dominant influence over it, or it and the subsidiary undertaking were "managed on a unified basis";[80] a holding of 20 per cent or more of the shares in an undertaking was deemed to be a participating interest unless the contrary was shown,[81] but the meaning of "dominant influence" was left undefined.

Despite the apparent comprehensiveness of the new definitions introduced by the Companies Act 1989, flaws became rapidly apparent.[82] The general test might be avoided, it was suggested, by two parties, for example, establishing a company for a specific purpose to which it could be bound by a commercial contract to one party, deadlocked at general meeting and board level but with the desired percentage of the economic interest in the company held by that one party.[83] Similarly, it was suggested that off balance sheet vehicles might be constructed for accounting purposes by using "orphan" vehicles and "joint venture" vehicles; in the first no shareholding interest would be taken, in the second control might be deadlocked.[84] Pimm reviewed a range of possible schemes that could remain off balance sheet.[85] He distinguished two possible approaches: the "entity" approach under which consolidated accounts should include all assets controlled by the parent, and the "ownership" approach where such accounts only included those assets from which the parent's shareholders benefited and questioned whether the Government was right to opt for control as the "only" criterion for defining subsidiary undertakings, because if so such schemes as he identified were perfectly proper.[86] In his view, if there was surprise that some schemes remained off balance sheet, it was probably because a different concept of the group was envisaged; if the Government had chosen the wrong criterion further work would be needed by it or the ASB[87].

[76] Companies Act 1985, s. 736(1)(b) (as substituted by Companies Act 1989, s. 144(1)). On the face of it, this seems little different to the previous test, however, its meaning is supplemented by Companies Act 1985, s. 736A (as substituted) which states that the right means "the right to appoint or remove directors holding a majority of the voting rights at meetings of the board on all, or substantially all, matters" with further explanation of the meaning of a power of appointment or removal.
[77] Companies Act 1985, s. 736(1)(c) (as substituted by Companies Act 1989, s. 144(1)).
[78] Companies Act 1985, s. 258(3) (as inserted by Companies Act 1989, s. 21(1)).
[79] Companies Act 1985, s. 258(2)(c) (as inserted by Companies Act 1989, s. 21(1)).
[80] Companies Act 1985, s. 258(4) (as inserted by Companies Act 1989, s. 21(1)). [See 82 below]
[81] Companies Act 1985, s. 260(2) (as inserted by Companies Act 1989, s. 22).
[82] See, for example, the amendment to Companies Act 1985, s. 258(4) by Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regs 2004, SI 2004/2947 reg 12(1)..
[83] Tolley's (n 51) para H5015.
[84] Ibid, para. H5021.
[85] D. Pimm, "Off balance sheet vehicles survive redefinition" Accountancy (June 1990), pp.88 – 91. The structures he identified were: (1) the use of unequal voting rights; (2) the "diamond" structure; (3) management contracts; (4) the use of charitable trusts, and (4) the use of share options and conversion rights.
[86] Ibid., pp. 88 and 91.
[87] Ibid.

FRS 5, "Reporting the Substance of Transactions", was introduced in 1994.[88] Its basic aim was to "determine the substance of a transaction ... whether any resulting assets or liabilities should be included in the balance sheet, and what disclosures are appropriate".[89] So, when any particular transaction falls to be analysed, the question was "to identify whether it has given rise to new assets or liabilities for the entity and whether it has increased or decreased the entity's existing assets or liabilities".[90] The term "quasi-subsidiary" was coined for a vehicle controlled by a company preparing accounts that did not meet the legal definition of a subsidiary but where the commercial effect of placing assets and liabilities in it was no different from a subsidiary.[91] In these circumstances, FRS 5 required the assets, liabilities etc. and any quasi-subsidiary to be included in the consolidated financial statements of the controlling group as if it were a subsidiary and also for the disclosure in summary form of the quasi-subsidiaries' financial statements. [92]

The next round of changes was unleashed by the Enron scandal, notorious for the role played by OBSF, this time originating in flaws in US regulation, which allowed entities to be treated as off balance sheet where at least 3 per cent of the capital was owned by company outsiders.[93] The regulatory consequences, including the controversial and far-reaching Sarbanes-Oxley Act 2002, relate therefore to US law and fall outside the scope of this article. Nonetheless, the Enron scandal led to much soul-searching outside the US because of Enron's global reach, and did result in some significant changes. In the UK, it contributed to the Companies Act 2004, which, for example, strengthened the regulatory regime in relation to the enforcement and monitoring of accounting and audit standards by the creation of the Professional Oversight Board for Accountancy (POBA).[94] In the EC a Regulation was adopted requiring listed companies to prepare their consolidated accounts in accordance with International Accounting Standards (IAS), now known as International Financial Reporting Standards (IFRS).[95] This seemingly technical move was in fact revolutionary for UK law and practice, in terms of the extent of UK control over how off balance sheet finance is regulated.[96] The EC Regulation required companies with securities traded on a regulated market to use IAS for their consolidated accounts but allowed Member States to permit or require their use by other companies as well.[97] This choice was reflected in UK legislation, but with a "ratchet" provision so that once IAS accounts have been prepared by a company,

[88] It was effective for financial statements relating to accounting periods ending on or after September 22, 1994, with earlier adoption encouraged but not required, see FRS 5 "Reporting the Substance of Transactions (1994), para. 39.
[89] FRS 5, p. 4.
[90] Ibid., p. 5.
[91] FRS 5, p. 7.
[92] However, controversially, where a quasi-subsidiary was used to finance a specific item subject to specific non-recourse finance arrangements, controversially a "linked presentation" is required showing on the face of the balance sheet the finance deducted from the gross amount of the item financed. This was only required where the item was financed in a way that the maximum loss that could be suffered as limited to a fixed monetary amount. See FRS 5, pp. 6 – 7.
[93] A. Hill and S. Fidler "Enron ties itself up in knots, then falls over" Financial Times, January 29, 2002.
[94] See http://www.frc.org.uk/About-the-FRC/FRC-structure/Former-FRC-structure/Professional-Oversight-Board.aspx. [Accessed January 28, 2015].
[95] Regulation (EC) No. 1606/2002 on the application of international accounting standards (July 19, 2002), effective from January 1, 2005.
[96] See P.L. Davies and S. Worthington, *Gower & Davies Principles of Modern Company Law* (London: Sweet & Maxwell, 2012) pp. 770 – 771 for a brief consideration of the governance implications of this, such as the creation of a Monitoring Board, and the filtering process put in place, to give the European Commission some very limited residual influence.
[97] Reg. 1606/2002 art. 5.

all subsequent accounts must be as well, subject to specific exceptions.[98] Henceforth, however, UK company law continued to police compliance of accounts with the relevant regulatory requirements[99] but with progressively little influence over their content.

The immediate effects of the introduction of IAS were, however, relatively modest. The consolidation of financial statements had been addressed by IAS 3 since as long ago as 1976. There was an interactive relationship between the development of the relevant IASs and EC Directives, with IAS 3 being referred to in discussions on the Seventh Directive and its successor in 1990, IAS 27, reflecting further improvements that had been made in developing the Seventh Directive.[100] Significantly, it followed the Seventh Directive's notion of control, with the core definition of a "subsidiary" being an entity that was controlled by the parent. Control was seen as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities, and was generally presumed to exist where the parent owned directly or indirectly more than half of the voting power of an entity.[101] But control could also exist where the parent owned half or less of the voting power of an entity, for example, where the parent had power to appoint or remove the majority of the members of the board of directors or equivalent. SIC 12 specifically addressed special purpose entities, providing that when the substance of the relationship indicated that the parent entity controlled the other, for example, where it pre-determined the special purpose entity's activities, then the special purpose entity should be consolidated.[102] IAS 27 was subsequently reissued in 2008,[103] the year of the financial crash.

The Company Law Review Steering Group in its consultation document *Developing the Framework* identified the "problems with the current structure and legal framework" for accounting and reporting; perhaps surprisingly, off balance sheet finance, which goes to the heart of the reliability of the framework, was not identified.[104] The only suggestion that the information might be defective concerned the backward looking nature of financial reporting and its reliance on financial indicators, as opposed for example to more qualitative factors.[105] However, the subsequent consultation document, *Completing the Structure*, was more pertinent. It questioned which of the rules governing consolidated accounts should be in statute as opposed to delegated rules, including the question of whether a company had subsidiary undertakings and was therefore a parent company.[106] It also rejected subjecting all accounting standards rules to criminal sanctions, arguing that this would tend towards "the legalistic approach that everyone wishes to avoid"; however, it did support the creation of a new criminal offence of publishing accounts calculated to deceive or mislead because this would apply specifically to the preparation and publication of annual accounts with dishonest

[98] Companies Act 2006 ss. 395(1) and 395 (3) – 5).
[99] Companies Act 2006 s. 414 (4), criminalises non-compliance with the Act and where applicable Art. 4 of the Regulation.
[100] D. Cairns, *Applying International Accounting Standards* (Tolley, 2002), p. 236. Further guidance on IAS 27 was provided by SIC 12 and SIC33.
[101] The exception being where in exceptional circumstances it can be clearly demonstrated that such ownership does not constitute control.
[102] Cairns, (n 100) p. 241. See now IFRS 10 "Consolidated Financial Statements", IFRS 11 "Joint Arrangements" and IFRS 12 "Disclosure of Interests In Other Entities". These were effective from January 1, 2013 and therefore fall outside the scope of this article.
[103]And further amended with effect from January 1, 2009 and July 1, 2010.
[104] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy, Developing the Framework* (Department of Trade and Industry, March 2000), pp. 157 – 158.
[105] Ibid., p. 158
[106] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy, Completing the Framework* (Department of Trade and Industry, November 2000), pp. 130 – 1.

intent.[107] The White Paper "Modernising Company Law" did not make much of OBSF; however, given the relevant section commenced by observing that from January 1, 2005 all listed British companies would follow IAS and that the EC Commission would be updating the Directives on company and group accounts, this was perhaps unsurprising.[108]

The only material change relevant to the problem of off balance sheet finance to be set out in the Companies Act 2006 was in fact to be derived from EC law.[109] Section 410A[110] now requires disclosure in the annual accounts where a company is or has been party to "arrangements not reflected in its balance sheet" and "the risks or benefits arising from those arrangements are material", specifically of the nature and business purpose of the arrangements and the financial impact of the arrangements on the company.[111] The disclosure required is limited to the extent that is necessary to enable the financial position of the company to be assessed.[112] Small companies do not have to comply, and there is a minor exemption for medium-sized companies.[113] The provision stirred up some small controversy within the accounting profession, and the FRC's ASB issued a statement[114] that its Urgent Issues Task Force had been addressing the legal definition of off balance sheet finance arrangements. The DBERR's guidance was noted which took the view that:[115]

"... Such off balance-sheet arrangements may be associated with the creation or use of one or more Special Purpose Entities (SPEs) and offshore activities designed to address, inter alia, economic, legal, tax or accounting objectives ..."

It observed that neither the Directive nor the Companies Act provided one, and that it could not issue an abstract without a definition in place.

A very great number of reasons have been advanced for the 2008 financial crisis and it is impossible to say which made a greater or lesser or a sine qua non contribution. Nonetheless, some influential voices have argued that off balance sheet finance played a material role.

The ACCA Policy Paper "Climbing out of the Credit Crunch" questioned whether accounting standards had "inadvertently made the credit crunch worse by turning a crisis of liquidity into one of solvency" but mainly focused on the implications of mark to market accounting.[116] Cryptically, it noted that:

---

[107] Ibid., pp. 128 – 9.
[108] White Paper "Modernising Company Law" (July 2002), Cm 5553-I, p. 33.
[109] Directive 2006/46/EC amending Directives 78/660/EC, 83/349/EEC, 86/635/EEC and 91/674/EEC. The definitions of "subsidiary", "holding company" and "wholly owned subsidiary" set out in Companies Act 1985 ss. 736 and 736A (as amended) were substantially re-enacted in Companies Act 2006 s. 1159 and Sch. 6; the definitions of "parent undertaking" and "subsidiary undertaking" set out in ss. 258 – 259 and Sch. 10A Companies Act 1985 (as amended) were substantially re-enacted in ss. 1161 – 1162 and Sch. 7 Companies Act 2006 ss. 1161 – 1162 and Sch. 7.
[110] Inserted by the Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008, SI 2008/393, reg. 8 as from April 6, 2008, see specifically recitals (8) and (9) and Article 1 (6).
[111] Companies Act 2006 s. 410A(1) and (2).
[112] Companies Act 2006 s. 410A(3).
[113] Companies Act 2006 s. 410A(1) and (4).
[114] ASB PN328.
[115] DBERR "Guidance for UK companies on Accounting and Reporting: Requirements under the Companies Act 2006 and the application of the IAS regulation", (June 2008).
[116] ACCA Policy Paper "Climbing out of the Credit Crunch" (September 2008), p. 5.

"The credit crunch is not another Enron as far as the accountancy profession is concerned – though in the extensive use of off-balance sheet vehicles there is a superficial resemblance – but preparers and auditors of accounts in the affected organisations legitimately face questions."[117]

The ACCA Discussion Paper "Corporate Governance and the Credit Crunch" noted that:

"Inconsistencies in capital regulations encouraged banks to use off-balance sheet arrangements for holding assets, in order to lower regulatory capital. The credit crunch exposed the fact that off-balance sheet vehicles were still liabilities of the institutions, because of reputational risk or liquidity recourse agreements."[118]

It went on to ask whether "the present close linkage between accounting numbers and regulatory capital requirements [should] be broken".[119]

Tomasic interestingly observed the extensive use of off balance sheet entities, but criticised instead the structured investment vehicles (SIVs) because they "failed to adequately isolate a company from the liabilities that had been placed in these entities".[120] Specifically, he criticised the use of a SPV, Granite, by Northern Rock because (1) it formed part of the flawed "originate and distribute" business model, where originators of loans did not have incentives to assess and monitor credit risks and investors in the SPV were less able to; (2) such entities resulted in ambiguity and confusion regarding the risks associated with the offbalance sheet vehicle.[121]

The Turner Review identified two forms of off balance sheet vehicles as contributing to increased system vulnerability, "structured investment vehicles" (SIVs) and "conduits", [122] seen as examples of "shadow banking"[123] and later described as "one of the crucial factors in the origins of the crisis".[124] Such shadow banks were "performing bank-like functions, but ... were not regulated as banks".[125] SIVs were singled out as a clear case of regulatory arbitrage,[126] though it was acknowledged that many of the problems arose from inadequate regulation in major centres such as London and New York and that the role of offshore financial centres was "not central".[127] These were not included in standard measures of gross or risk adjusted leverage, despite being highly leveraged, and their classification as off-balance sheet turned out to be inaccurate because many banks were in effect forced to take these back on balance sheet because of liquidity provision commitments and reputational concerns.[128] The Turner Review also criticised such vehicles as a form of "shadow banking" because they were performing "large-scale maturity transformation between short-term

[117] Ibid.
[118] ACCA Discussion Paper "Corporate Governance and the Credit Crunch" (November 2008), p. 12.
[119] Ibid.
[120] R. Tomasic, "Corporate rescue, governance and risk-taking in Northern Rock: Part 1" (2008) 29(10) The Company Lawyer 297 at 303.
[121] Ibid. at 331.
[122] FSA, "A regulatory response to the global banking crisis" (Financial Services Authority, March 2009), p.20 (Turner Review).
[123] Ibid., p. 21, the others listed after it being investment banks and mutual funds that had extended their activities into bank-like maturity transformation, discussed below.
[124] Ibid., p. 70.
[125] Ibid.
[126] Ibid., p. 71.
[127] Ibid., p. 74.
[128] Ibid.

promises to note-holders and much longer term instruments held on the asset side".[129] This rather opaque terminology is explained as referring to the usual banking practice of holding longer term assets than liabilities, a crucial function but carrying the risk that if everyone wanted their money back on the contractual date, no bank could repay them all.[130] A more specific problem arising from the use of SIVs was that senior notes were given high credit ratings on the basis that the SIV would be wound up before the holders were at risk, but led to a systemic problem because there were attempted simultaneous asset sales by multiple SIVs leading to a rapid disappearance of liquidity.[131]

The Turner Review concluded:[132]

"The essential principle which needs therefore to be agreed and implemented internationally is that regulation should focus on economic substance not legal form. Off-balance sheet vehicles which create substantive economic risk ... must be treated as if on-balance sheet for regulatory purposes."

The HM Treasury White Paper "Reforming Financial Markets" observed:

"[R]egulators and central banks, and many other authorities and commentators underestimated the risks that were building up in the financial system. They did not appreciate the true extent of system-wide risks or the full implications of activities outside the regulatory boundary, in particular the build-up by banks of large exposures to off-balance sheet financing vehicles, and the lack of transparency that accompanied them."[133]

The *Future of Banking Commission Report*[134] also thought that accounting standards needed to be reviewed; one of many examples given was international inconsistency between UK banks applying IFRS and US banks applying US GAAP in the rules surrounding off balance sheet vehicles and Repo transactions. In its view: "The accounting standards should not allow assets and liabilities to move off the balance sheet without trace. Such off-balance sheet transactions result in banks carrying more leverage than investors, clients, trading counterparties and central banks realise."[135]

Concerns about the role of off balance sheet finance loomed large in the US as well, with the Valukas Report and the collapse of Lehman Brothers, albeit of a different nature to the manipulation of group company relationships that this article focuses on. Lehman had used "Repo 105" transactions to temporarily remove $49.102 billion and $50.383 billion from its balance sheets at the first and second 2008 quarter year ends, succeeding by doing so in reducing its net leverage by 1.9 per cent and 1.8 per cent respectively.[136] Repo 105 was in essence "a trick allowing Lehman to sell packages of mortgages, Treasury bonds, Eurobonds, even Canadian government instruments, on a temporary basis at the end of an accounting

[129] Ibid., p. 21.
[130] Ibid. But the Review later notes that these vehicles had "liabilities far shorter in tenor than the maturity of assets", p. 70.
[131] Ibid., p. 22.
[132] Ibid., p. 72. Its recommendations included the bullet-point under "Institutional and geographical coverage" "Economic substance, not legal form".
[133] HM Treasury White Paper "Reforming Financial Markets" (HM Treasury, Cm 7667, July 2009), p. 4.
[134] *The Future of Banking Commission Report* (2010) pp. 70 and 73.
[135] Ibid.
[136] *Valukas Report* (March 2011), pp. 18 – 20.

quarter, with an obligation to buy them back a few weeks later".[137] Subsequently, there have been suggestions that the massaging of Lehman's balance sheet was not unusual. One technique that emerged from an internal review at Freddie Mac found that it had entered into a series of deals with Credit Suisse that allowed the investment banks trading desk to 'park' some $8 billion in mortgage-backed securities on the mortgage firm's balance sheet.[138] Another technique used elsewhere was for a bank to borrow money at the beginning of a quarter, invest it in short-term bonds that mature before the end of the quarter, then pay back its debts, so that the bank appeared to generate more profit off what appeared to be fewer assets.[139] The US Financial Crisis Inquiry Commission observed how the growth of a shadow banking system that rivalled the size of the traditional banking system had been allowed to grow, with key components including the use of off balance sheet entities being "hidden from view", without the protections constructed to prevent financial meltdowns.[140] Within the EU too, the De Larosiere Report highlighted the role played in the crisis by off balance sheet special purpose vehicles in generating a dramatic expansion of leverage within the financial system.[141]

The overall conclusion is that the role of OBSF in the 2008 financial crisis and the severe impact on the Western world for generations to come show not only the failure of technical regulatory approaches to OBSF but a fundamental need for deterrence, something that the criminal law is ideally placed to achieve.

The economic case for a strong anti-fraud rule over mandatory disclosure

This need for deterrence is supported by economic analysis. Becker, in a ground-breaking study, has argued that criminal sanctions have a price-like character, can be characterised in market terms and that optimal policies to combat illegal behaviour are part of an optimal allocation of resources. [142] Generally, he argues that fines are a preferable form of sanction because: (1) probation and institutionalisation use up social resources whereas fines are a transfer payment; (2) determination of the optimal number of offences and severity of punishments is somewhat simplified by the use of fines; (3) fines compensate victims in a way that other punishments do not.[143] Nonetheless, he acknowledges that use of fines can be criticised on the basis of non-efficiency grounds, such as: (1) offences should not be capable of purchase as other commodities, which he rebuts on the basis that this simply substitutes a different unit of measurement; (2) punishment should not depend on the economic position of an offender, which he rebuts on the basis that, if the goal is to minimise social loss, then fines should depend on the harm done.[144] Becker does, however, accept that in the case of certain crimes no money can compensate for the harm inflicted and fines cannot be relied upon where the harm exceeds the resources of an offender.[145] This would appear to be the case

[137] A. Clark, "Lehman Brothers: repo 105 and other accounting tricks" The Guardian, March 12, 2010.
[138] D. Wilchins and M. Goldstein, "Lehman balance sheet massaging may not be unusual" Guardian, March 13, 2010.
[139] Ibid.
[140] *US Financial Crisis Inquiry Commission Report* (January 2011), p. xx.
[141] *The High-Level Group on Financial Supervision in the EU Report* (the "De Larosiere Report") (February 2009), pp. 7 – 8.
[142] G.S. Becker, "Crime and Punishment – An Economic Approach" in *The Economic Approach to Human Behaviour* (Chicago & London: The University of Chicago Press, 1976 reprinted from (1968) 76 Journal of Political Economy 169), p. 39 and especially at 49 and 77.
[143] Ibid., pp. 63 – 64.
[144] Ibid., pp. 64 – 65.
[145] Ibid., p. 66.

with the damage that can result from OBSF, for example, and suggests that both criminalisation and a realistic prospect of imprisonment as a consequence would be the appropriate approach to deterrence.

Easterbrook and Fischel have explored the benefits of an anti-fraud rule: an anti-fraud rule could be cheaper than alternative certification methods or individual verification, notwithstanding problems of enforcement costs;[146] however, such an anti-fraud measure could provoke the response by a company of remaining silent.[147] Voluntary disclosure should take place in any event as companies offering disclosure would save investors' search costs and therefore place themselves at a comparative advantage.[148] Cheffins, in considering the appropriateness of mandatory requirements for small companies, questioned whether there was evidence of market failure justifying regulation, for example, systematic lapses of judgment among those running such businesses, but concluded that such evidence was meagre.[149] Easterbrook and Fischel observe that: first, a mandatory disclosure obligation avoids the excessive production of redundant information, that is, it avoids duplication by a number of parties; secondly, it avoids the third-party effect of requiring companies to produce information which may be beneficial to unconnected parties who cannot be forced to pay for it; and thirdly, it enables standardisation of disclosure which no individual company would have the incentive to achieve.[150] Coffee disagreed sharply with their analysis, preferring instead "a simpler theory" of society, through mandatory disclosure, subsidising the production of information otherwise under-produced; avoiding the waste that might arise otherwise through investors seeking trading gains; avoiding agency problems; and providing information needed by investors to optimise their portfolio.[151] Easterbrook and Fischel may appear rather optimistic about the scope for the costs of fraud enforcement being less than alternative certification – though perhaps in aggregate this is correct. In conclusion, it would appear that the case for mandatory disclosure is not fully made out: the strongest arguments in favour of it would appear to be agency theory combined with standardisation, since management voluntarism might work well when a company is prospering but be subject to opportunism otherwise, and an absence of standardisation might render even strong anti-fraud measures ineffective.

Mandatory disclosure does not necessarily suggest that mandatory auditing should follow. It has already been seen that Easterbrook and Fischel explored how an anti-fraud rule might be an alternative to mandatory disclosure and potentially preferable to alternative certification devices such as the audit. However, if the true rationale for mandatory audit is agency theory, then a mandatory audit would seem to be implied as well: Jensen and Meckling, for example, regarded audit costs as a typical "bonding" cost incurred as a consequence of the agency relationship.[152] Bromwich draws attention to a number of conceptual problems with

[146] F.H. Easterbrook and D.R. Fischel, "Mandatory Disclosure and the Protection of Investors" (1984) 70 Virginia Law Review 669 at 677-679, eg. Where prosecutions were concentrated on verifiable statements of fact rather than predictions.
[147] Ibid., at 677 and 680.
[148] Ibid., at 684-685.
[149] Cheffins, (n 2) p. 520.
[150] Easterbrook and Fischel, "Mandatory Disclosure and the Protection of Investors" (1984) 70 Virginia Law Review at 681-687.
[151] J.C. Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System" (1984) 70 Virginia Law Review 717, at 720-723, 737-747. See also I. MacNeil, "Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory" (2001) 1 Journal of Corporate Law Studies 107 at 126, who argues that mandatory disclosure is necessary for the development of a securities' market.
[152] Jensen and Meckling, op. cit., p. 9.

mandatory auditing, including the extent to which the principal controls the optimal information system and auditing requirements, the means by which the auditor might be motivated to be efficient in the same way as the manager and the possibility of collusion between the auditor and manager.[153] Whilst collusion might be dealt with by an anti-fraud rule which is already assumed, the possibility of an auditor agency problem is more difficult and the solution probably lies in reputation: a poor auditor will be more associated with companies which fail and the market will value more highly a company audited by an auditor with a strong reputation.

The failure of criminal sanctions in the banking crisis

There have been serious concerns expressed regarding the failure of the criminal law to provide effective sanctions against the forms of conduct that emerged in the banking crisis, and, in particular, at the seeming dearth of prosecutions in the UK.[154] What can be seen to have emerged by the time of the banking crisis, was a criminal law landscape comprising a number of general criminal provisions which might potentially have applied to accounts manipulation: for example, under the Theft Acts and a raft of highly 'particularized' criminal and regulatory provisions relating to the offences contained in the Companies Act 2006 and the Financial Services and Markets Act 2000. Significant overlaps in the wording of these offences mean that potentially the same conduct might in principle be prosecuted under a range of different provisions, subject to different conditions as to the intent required and the range of potential victims required to be shown. The position is further complicated by the fact that the banking crisis straddled a period of intense law reform of both criminal law and company law, so that potential offences might be committed under both old and new law. A range of approaches to analysis was therefore possible. This section will commence by analysing the requirement for dishonesty, which is a requirement for some – but not all – of the relevant offences, before analysing four categories of offence that OBSF potentially gives rise to: accounts related offences, share market related offences, offences in relation to the winding up of a company and general offences involving deception or fraud.

Dishonesty

The broad reach of the criminal law of fraud might come as a surprise to directors and company/ commercial practitioners more used to the regulatory and civil law regimes. Indeed, it may be suggested that important and widely publicised developments in the civil law have served as a distraction, focusing attention away from the criminal law. The early run of civil cases that consider liability for misleading statements[155] culminate in one of the most infamous cases to grace the law books today, *Caparo v Dickman*.[156] Of note, the arguments rehearsed in the Court of Appeal were premised in the law of negligence. However, the original action was commenced in 1985 and claimed against the directors of the

[153] Bromwich, op. cit., pp. 348 – 351.
[154] See, for example, A. Tyrie MP, Chairman of the Parliamentary Commission on Banking Standards (January 2013, cited in J. Fisher "The global financial crisis: the case for a stronger criminal response" Law and Financial Markets Review (May 2013), *Law and Financial Markets Review* 159; and J. Taylor, "Why have no bankers gone to jail?" History & Policy (October 2013).
[155] See for example *London and General Bank (No 2)* [1895] 2 Ch 673, CA and *Newton v BSA* [1906] 2 Ch. 378.
[156] *Caparo Industries v. Dickman* [1989] QB 653 and House of Lords judgment at [1990] 2 AC 605.

company, Fidelity Plc, on the ground of fraudulent misrepresentation in contract law[157] and against the auditors for negligent mis-statement of the company's financial standing. The directors did not appeal and therefore the focus of this landmark case was solely the auditor's negligence point. Whilst culpability in criminal law is not limited by Lord Atkinson's "neighbour principle", the civil law of negligence clearly is. As such, the essence of the auditor's appeal was that while he was found to owe investors a duty of care as individuals, potential investors were a indeterminate class such that the relationship between them and the auditors was not so close and proximate as to give rise to a duty of care. As an authority well known to lawyers and students alike, it is not clear to what extent this case may have blinded thinking generally in relation to liability for misleading accounts. Furthermore, in considering the negligence point, Bingham LJ found that the provisions contained in the Companies Act 1985 showed:

"[A] plain parliamentary intention that shareholders in a public company shall receive independant and reliable information on the financial standing of the company (and thus of their investment) ...to enable the members to make an informed judgment whether, and if so how, they should exercise the powers of control enjoyed by them as members. The commercial man's answer would more probably be: to enable each shareholder to make an informed judgment whether he should retain or reduce or increase his holding of shares in the company."[158]

This is a far cry from the prevailing view of the time, that the purpose of corporate accounting and the standard implied by the expression "true and fair view"[159] is "to enable the members of the company *and third parties* to obtain all the information contained in the company's financial statements, at a uniform standard of integrity, without having to undertake further enquiries."[160]

Caparo[161] also marked a departure from the approach taken in earlier cases where on similar facts a different action had been brought. For example, in *Re London and General Bank (No. 2)*[162] it was alleged that the balance sheets did not show the true position in that the dividends were paid out of capital and not out of profits. Section 7(6) of the then applicable Companies Act 1879 required the auditor to "state whether, in his or their opinion, the balance-sheet referred to in the report is a full and fair balance-sheet properly drawn up, so as to exhibit a true and correct view of the state of the company's affairs". The directors and auditors were found jointly and severally liable to pay the official liquidator the amounts of dividends paid out of the capital and, here too, one of the auditors appealed. Lindley LJ in this case stated

[157] In *Derry v. Peek* (1889) 14 App Cas 337, the House of Lords held that a person could be liable for fraudulent mis-statements in relation to representations made in a company prospectus and the Directors' Liability Act 1890 extended liability to instances of negligent mis-statement too. Where a person is induced to acquire shares as a result of false mis-statements, the contract can be rescinded whether the mis-statement was made fraudulently, negligently or innocently. This may be actionable under s. 67 Companies Act 1985 which was replaced by s. 166 Financial Services Act 1986 or the Misrepresentation Act 1967. In addition, a fraudulent mis-statement could give rise to an action for deceit at common law or fraudulent or negligence mis-statment at common law. See S. Griffin, 'Damages for mis-statements in company prospectuses', (1991) 12(11) Co Law 209-212.

[158] *Caparo Industries v Dickman* [1989] QB 653 per Bingham LJ at p684. See too the judgments of the Lords of Appeal in Ordinary at [1990] 2 AC 605, for example Lord Jauncey of Tullichettle at 661-2, Lord Bridge of Harwich at 626 and Lord Oliver of Aylmerton at 654.

[159] This expression formed the standard since 1947.

[160] See E. Grace and K.P.E. Lasok, "The True and Fair View", (1989) 10(1) Co Law 13-19 at 17.

[161] *Caparo Industries v Dickman* [1989] QB 653 and House of Lords judgment at [1990] 2 AC 605.

[162] *Re London & General Bank (No. 2)* CA [1895] 2 Ch 673.

that while the balance sheet and profit and loss account were true and correct, they were nevertheless entirely misleading and misrepresented the real position of the company. *Caparo*[163] also approved *Al Saudi Banque [1990]*,[164] in which the fact that it was highly probable that the company would need to borrow money did not make the auditor liable to potential lenders. That being said, s. 507(1) Companies Act 2006 creates a criminal offence of knowingly or recklessly causing an auditor's report to include any matter that is misleading, false or deceptive in a material particular.

If the raison d'etre of most off balance sheet financing is the concealment of relevant information,[165] it is lamentable that the law has not been utilised to greater effect, particularly given the government's failure to implement its promise to outlaw such activity as far back as 1988.[166] However, the approach taken in the early criminal cases in which convictions were imposed for manipulation of company accounts is now bolstered by more recent case law which demonstrates that the criminal law will intervene even where there has been no wrong at civil law.[167] The 2001 case of *R v Hinks*[168] was ground-breaking in that the defendant's conviction for theft was upheld[169] notwithstanding the court's acceptance that she had received an otherwise indefeasible gift.[170] Criminal culpability, it is argued, should not be constrained by civil concepts;[171] the criminal law has a different role and purpose, not least to delimit acceptable behaviour and punish the wrongdoer,[172] and its efficacy lies in the flexibility achieved via judicial redefinition in the case law.[173] Concerned that a narrow definition of appropriation would place beyond the reach of the criminal law dishonest persons who should be found guilty, Lord Steyn observed:

---

[163] *Caparo Industries v Dickman* [1990] 2 AC 605 per L. Bridge at p. 623 and L. Jauncey at p. 662.
[164] *Al Saudi Banque v Clark Pixey* [1990] Ch 313.
[165] Grace and Lasok, (n 160).
[166] See The Times August 17, 1988 p.20, 21.
[167] The acceptability of this inconsistency between civil and criminal law is controversial, see for example A.T.H. Smith, "Constructive Trusts in the Law of Theft" [1977] Crim Law R 395; J.C. Smith, "Theft" (1998) Crim Law R 904 and "Theft", [2001] Crim Law R 162 and "Civil Law Concepts in the Criminal Law" [1972B] Cambridge Law Journal; W. Holland, *The Law of Theft and Related Offences* (Carswell Pubs, 1998); S. Gardner, "Property and Theft", (1998) Crim Law R 35; S. Shute and J. Horder, "Thieving and Deceiving: What is the Difference?" [1993] 56 Modern Law Review 548; G. Williams, "Theft and Voidable Title" [1981] Crim Law Rev 548.
[168] *R. v. Hinks* [2001] 2 AC 241, [2000] 4 All ER 833, [2000] 3 WLR 1590, [2001] 1 Cr App Rep 252, 165 JP 21, 144 SJ LB 265.
[169] The certified question put to the House of Lords was whether the acquisition of an indefeasible title is capable of amounting to an appropriation of property belonging to another for the purposes of s. 1(1) Theft Act 1968. The majority answered in the affirmative.
[170] Earlier controversial cases were those of *Lawrence* [1972] AC 626 H. L. and *Gomez* [1993] AC 442 H.L. in both of which it was held that an "appropriation" for the purposes of the theft offence (at Theft Act 1968, s1) could amount to an instance whereby property passed with the owner's consent. Both cases involved criminal activity, albeit they would have been more properly charged as a s15 obtaining by deception, and both involved contractual transactions that were tainted by an established vitiating factor such that they were both voidable at civil law. In Hinks, the Court of Appeal considered an undue influence argument in relation to the gift but this line of argument did not feature in the subsequent appeal to the House of Lords.
[171] In its 2002 *Report on Fraud* (Law Com No. 276, 2002), the Law Commission noted that it had informally proposed that a defendant should not be dishonest if he has a legal right to do what he is doing, however, there had been strong opposition from the CPS, the SFO and the Law Society who were concerned at the complexity that would be added to the criminal law by importing civil law concepts.
[172] See for example, W Holland, *The Law of Theft and Related Offences* (Carswell Pubs 1998); W. Freidman, *Law in a Changing Society* (2nd ed., Penguin Books 1972); G. William & B. A. Hepple, *Foundations of the Law of Tort* (2nd ed. Butterworths, 1984)
[173] Notably, the civil law achieves this through the dual system of the superior body of equitable rules which mitigate the harshness of the common law, a feature which is absent from the criminal law.

"While in some contexts of the law of theft a judge cannot avoid explaining civil law concepts to a jury ... the decisions of the House of Lords eliminate the need for such explanations in respect of appropriation. That is a great advantage in an overly complex corner of the law".[174]

One consequence of *Hinks*[175] is that dishonesty becomes determinative of criminality, absent any otherwise unlawful behaviour, where that behaviour conforms to the offence definition. The effect of this controversial decision was not lost on the Law Commission who recognised that *"(a)ctivities which would otherwise be legitimate can therefore become fraudulent if a jury is prepared to characterise them as dishonest*".[176] Thus, for example, the dealer who dishonestly buys an antique at a gross undervalue is protected in civil law by the rule of caveat vendor, but this would not in itself be a defence to the fraud offence.[177] The application of this approach to the problem of OBSF and the criminal law of fraud is not inconceivable, notwithstanding compliance with the letter of both the civil law and accounting rules.

In line with theft, and the *Hinks*[178] authority, conviction for fraud may turn on finding of dishonesty.[179] Dishonesty is a simple question of fact for a jury and only in cases of doubt is the *Ghosh*[180] direction given. *Ghosh* defines dishonesty by reference to a two-stage test:[181] first, the jury must consider "*whether according to the ordinary standards of reasonable and honest people what was done was dishonest*". If answered in the affirmative, the jury must then go on to consider *"whether the defendant himself must have realised that what he was doing was [by the standards of reasonable and honest people] dishonest."* If satisfied on both limbs, the jury will find the defendant dishonest. Case law in this area is illuminative. In *Buzalek [1991]*,[182] for example, the defendant's case was that he was not dishonest but had told 'white lies' for the greater good and with the well-intentioned objective of keeping two companies afloat. The court rejected this defence, finding that he had lied in order to get banks to extend credit when they would not have done so had they known the truth. In contrast a similarly altruistic defence was also ultimately unsuccessful in the 2007 case of *Gohill*,[183] where there was arguably both a civil and criminal wrong. In this case the defendants, who were convicted of theft and false accounting, made no charge for hiring equipment to certain customers, accepting instead a small personal tip; the defendants had acted to promote the business and in the interests of customer care, such that the business would benefit in the long run. The defence submitted, unsuccessfully, that there had been no dishonesty.

Whether juries would convict in instances of misleading accounting practices remains to be seen and, ultimately, guilt would be determined on a case-by-case basis by reference to criminal law principles. Plainly, legal and accounting compliance may be a factor perceived

[174] *Hinks* (n 168) 4 All ER 833 at 843.
[175] *Hinks* (n 168).
[176] Law Commission, *Report on Fraud* (No. 276, 2002), at para 3.8, p 14.
[177] This is the example provided in by the Law Commission in its *Report on Fraud* (2002), at para 7.64, p 74.
[178] *Hinks* (n168).
[179] See Fraud Act 2006, s. 2(1)(a) s. 3(a) and s. 4(1)(b).
[180] *Ghosh* [1982] QB 1053.
[181] Ibid., p. 1064D-E
[182] *Buzalek* [1991] Crim Law R 130
[183] *DPP v. Gohill* [2007] EWHC 239.

as relevant by a jury,[184] as may the defendant's belief that he had a legal right to act he did,[185] but it need not be determinative of the issue. A very difficult - and notoriously circular- question is whether and how accounts can be regarded as misleading or dishonest if they are prepared in compliance with the relevant law and accounting standards. The conflict arises from the requirement that accounts should comply with the law and show a true and fair view or, in relation to companies' financial years which begin on or after January 1st, 2005, whether they comply with IAS, where appropriate.[186] There has been a substantial debate as to the overriding nature of the requirement to show a true and fair view[187] and more recently as to what extent IFRS actually require a true and fair view to be shown.[188] This debate is relevant to this article because, as defence counsel argued in the *Argyll Foods* case, "true and fair means not misleading" but also that "there was room for more than one true and fair view".[189] Yet the magistrates there nonetheless concluded that the accounts did not show a true and fair view and therefore did not comply with the law. We argue in this article that the rationale for the invocation of the criminal law is deterrence of dishonest behaviour. If the motivation for utilising OBSF might be perceived in effect to be to *choose* one true and fair view over another, for example to allow a company to raise capital from investors that some investors might otherwise not be prepared to subscribe for, or to circumvent a borrowing limit in the articles of association imposed by shareholders for their protection, then this might appear dishonest. We are not, of course, arguing that the use of OBSF was in such circumstances *per se* dishonest – that could only be determined on the basis of evidence of relevant motive.

Indeed, the decision as regards criminality in *Hinks*[190] appears entirely consistent with a substance over form regulatory approach. That being said, the use of the general criminal law to address the publication of misleading accounts through the employment of off balance sheet finance would mark a radical departure from the contemporary response. The fact that the distortion of information in this context is not treated as criminal may well result in the perception that is not in fact criminal in any circumstance. However, perception is important, given the subjective element of dishonesty and the circularity of the test such that conduct is

[184] See Law Commission Report, *Report on Fraud* (No. 276, 2002), at para 7.65 at p 74.
[185] Ibid.
[186] The relevant provisions during the period preceding the banking crisis would have been Companies Act 1985 ss. 226 – 227 as amended by Companies Act 1989 ss. 4(1) and 5(1) as from April 1, 1990 and as substituted by new ss. 226, 226A, 226B, 227, 227A – 227C by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regs 2004, SI 2004/2947, reg. 2 as from November 12, 2004. With effect from April 6, 2008, the current provisions are set out in Companies Act 2006 ss. 393, 396 and 397.
[187] L. Hoffman QC and MH Arden "Legal Opinion Obtained by Accounting Standards Committee of True and Fair View, With Particular Reference to the Role of Accounting Standards" (September 13, 1983); L. Hoffman and M.H. Arden "The Accounting Standards Committee Supplementary Joint Opinion" (March 20, 1984); M.H. Arden "Accounting Standards Board The True and Fair Requirement Opinion" (April 21, 1993); Lasok (n. 160).
[188] See Financial Reporting Council "The True and Fair Requirement Revisited, Opinion of Martin Moore QC" (FRC; 2008); Financial Reporting Council "True and Fair" (FRC; July 2011). P.L. Davies and S. Worthington in *Principles of Modern Company Law* (London: Sweet & Maxwell, 2012) p. 765 observe that the position is "probably the same" with IAS accounts based on the requirement in IAS 1 that the accounts present fairly but add robustly in fn. 85 that if this is not the case there is a "flat contradiction" between s. 393 and companies' obligations under the IAS Regulation.
[189] Ashton (n 56). This may also give rise to some interesting questions of EU law, see Financial Reporting Council "The True and Fair Requirement Revisited, Opinion of Martin Moore QC", op. cit., pp. 27 – 29, where Martin Moore concluded that EC jurisprudence should not be seen as in effect creating a hierarchy of "true and fair views" but simply that what might have been a true and fair view in one situation might not necessarily be so in another. Such questions fall outside the scope of this article.
[190] *Hinks* (n168).

only dishonest if reasonable and honest people consider it dishonest. Considerations of this nature may have acted as some restraint on pursuing a novel prosecution of this nature, particularly in the absence of direct precedent and since a prosecution can only be brought following a decision that there is sufficient evidence to provide a realistic prospect of conviction.

Historically, there has been a demonstrable reluctance to criminalise corporate wrongdoing, evidenced in the approach taken in the regulation of business activity generally.[191] Although this may cloud our current notion of corporate crime, there is very recent evidence of an increased tendency to control corporate behaviour through the mechanism of the criminal law.[192] The criminal law is thus a reflection of the prevailing morality of the time[193] and, conversely, it can be used specifically to delimit acceptable behaviour[194] where there is a pressing social need to change people's attitude to some kinds of conduct.[195] The recently enacted Bribery Act 2010, which sets out liability for corruption offences, is designed to "reinforce ethical conduct in the commercial world and society generally".[196] The bribery offence is constructed on the premise that the main harm caused by corruption is that inflicted on economic markets.[197] In this respect, clear parallels can be drawn with the impact of

[191] This reluctance can be dated to our earliest attempts to deal with corporate fraud, see the early company legislation e.g. Joint Stock Companies Act 1844 and see too D. Hay, "Property, Authority and the Criminal Law" in D. Hay and P. Linebaugh et al (eds), *Albion's Fatal Tree* (Allen Lane 1975); W.R. Cornish and G. Clark, *Law and Society in England 1750-1950* (Sweet and Maxwell 1989); M. Foucault, *Discipline and Punish: The Birth of A Prison* (Harmondsworth Penguin 1977); K.J.M. Smith, *Lawyers, Legislators and Theorists: Developments in English Criminal Jurisprudence 1800-1957* (Clarendon Press, 1998); A. Norrie, *Crime, Reason and History: A Critical Introduction to Criminal Law* (2nd ed.) (Cambridge: Cambridge University Press, 2001).

[192] Law Commission, "Criminal Liability in Regulatory Contexts" (Consultation Paper No. 195, 2010), para. 7.16 at p. 136 identifying that a large quantity of new criminal legislation has been targeted at business activity. See too the same consultation paper at para 3.83 at p. 46 in which the Consumer Protection Act 1987 is discussed, noting that, "A key function of the Act was to provide better remedies for consumers in civil law. However, P. Cartwright in *Consumer Protection and the Criminal Law* (Cambridge: Cambridge University Press, 2001) p. 63 argues that "the criminal law has tended to be the primary means by which the state has sought to protect consumers from unsafe products". See also, for example, the Bribery Act 2010 which takes a zero tolerance approach to corporate corruption; The Secretary of State for Justice, then Jack Straw, when addressing the 5th European Forum on Anti-corruption in June 2009, "A strong legal architecture is necessary in tackling corruption..Ultimately our aim must be to bring about behavioural change within businesses themselves, creating corporate cultures in which no form of corruption is tolerated."

[193] Rather, the criminal law can only be understood by reference to historical contingencies in the political, social and economic context. For recent proponents of this view see for example R. Dagger, "Republicanism and the Foundations of Criminal Law"' in R.A. Duff and S. Green (ed.), *Philosophical Foundations of Criminal Law* (Oxford: Oxford University Press, 2011); R.A. Duff, L. Farmer et al, *The Boundaries of the Criminal Law* (Oxford: Oxford University Press, 2010).

[194] There is a line of argument that suggests that crime was simply an instrument of governance and used to shape conduct, J. Simon, "Governing Through Crime" in L.M. Friedman and G. Fisher (eds) *The Crime Conundrum: Essays on Criminal Justice* (Boulder, Colorado: Westview Press, 1997) 174; W. Friedman, *Law In A Changing Society* (2nd ed,, Penguin Books, 1972). Certainly, the expressive function of the criminal law is not controversial, it is accepted as a means not only of articulating condemnation but also of providing authoritative statements about moral and social values', L. Zedner, *Criminal Justice* (Oxford: Oxford University Press, 2004).

[195] Law Commission, "Criminal Liability in Regulatory Contexts" (Consultation Paper No 195 2010), para 4.16 at p. 70. Modern examples would include the contemporary view of 'drink driving'; marital rape, *R. v R* [1992] 1 AC 599, [1991] 3 WLR 767, HL; corruption per Bribery Act 2010.

[196] Ministry of Justice, *Impact Assessment of the Bill on Reform of the Law of Bribery* (2009).

[197] Law Commission, Reforming Bribery" (Consultation Paper 185, 2007), Appendix D at D5 and citing P. Alldridge, "The Law Relating to Free Lunches", (2002) 23 Company Lawyer 264, 267.

OBSF on the market economy.[198] Notwithstanding the analogy that can be made, the Bribery Act takes a radical, zero-tolerance approach to the problem, using a robust general criminal law to deter corporate wrongdoing.[199] This tendency can also be identified in the Proceeds of Crime Act 2002 as regards the money laundering offences.[200] In principle, therefore, and to prevent the same harm, there would appear to be little objection to extending the same approach to OBSF.

Accounts related offences

The approach of successive companies' legislation to misleading accounts by the time of the banking crisis had become excessively light touch. False statements in "any return, report, certificate, balance sheet, or other document required by or for the purposes of this Act" had been made a misdemeanour as early as s. 28 CA 1900, which coincided with the introduction of a requirement for companies generally to produce an annual audited balance sheet.[201] The maximum penalty was punishment on indictment by two years' imprisonment with or without hard labour.[202] However, the Companies (Consolidation) Act 1908 commenced the practice of limiting the false statements offence to specified provisions of the Act listed in a Schedule. Nonetheless, this extended to the requirement for a balance sheet contained in the annual summary.[203] This offence was re-enacted in the Companies Act 1929 with a proviso that:

"[I]f the last ... balance sheet did not comply with the requirements of the law as in force at the date of the audit with respect to the form of balance sheets there shall be made such additions to and corrections in the said copy as would have been required to make it comply ... ."[204]

The Companies Act 1948 retained the false statements offence[205] and introduced a specific offence where a director failed to take all reasonable steps to secure compliance with requirement for the balance sheet and profit and loss account to show a true and fair view and comply with the specific requirements of the Act as to content and form, the maximum sentence on summary conviction for which was imprisonment for 6 months or a £200 fine.[206]

---

[198] See the National Fraud Strategic Authority's National Fraud Strategy 2009-2010, "A New Approach to Combating Fraud" and the Attorney General's Foreword, Rt Hon Baroness Scotland QC, "Economic confidence is essential for investment, spending and ultimately prosperity in our communities. However, ... the continued presence of fraud within our economy cannot help in rebuilding this much needed trust ... (to) strengthen our communities and economy".

[199] See too Bribery Act s. 7 which imposes criminal liability on the organisation on the basis of a failure to prevent bribery.

[200] For example at Proceeds of Crime Act 2002 s. 330.

[201] Companies Act 1900 Ss. 21 – 23. The Joint Stock Companies Act 1844 had required directors of the unlimited liability corporations registered under the Act to ensure that a "full and fair" balance sheet was made up and filed, together with an auditors' report, with the Registrar of Companies, s. 43 but this had been repealed by the Joint Stock Companies Act 1856.

[202] CA 1900, s. 28.

[203] CCA 1908 s. 26 refers to "the statement, in the form of a balance sheet, audited by the company's auditors, and containing a summary of its share capital, its liabilities, and its assets, giving such particulars as will disclose the general nature of those liabilities and assets, and how the values of the fixed assets have been arrived at, but the balance sheet need not include a statement of profit and loss."

[204] Companies Act 1929 s. 362 and Sch. 11, referring to Companies Act 1929 s. 108.

[205] CA 1948 Sch. 6 set out the requirements for the annual return which, in accordance with s. 127(1) included certified copies of the accounts except, broadly, where the company was an exempt private company.

[206] Companies Act 1948 S. 149(6), with the proviso that there should be no imprisonment unless the offence was wilful.

It seems likely that this formed the basis of the *Argyll Foods Ltd* prosecution discussed by Ashton, where it was concluded by the magistrates that the 1979 accounts did not show a true and fair view and so contravened the Companies Act 1948, a case regarded as setting an important precedent.[207] The directors in question were conditionally discharged and no other formal penalties were imposed.[208] A significant amendment was introduced by the Companies Act 1981 stating explicitly that the requirement to give a true and fair view overrode the new Sch. 8 (containing detailed accounting disclosure requirements) and other requirements of the Act as to the matters to be included in a company's accounts or notes,[209] in contrast to the Companies Act 1948 statement that Sch. 8 was "without prejudice to" the true and fair view and any other requirements of the Act.[210] The Companies Act 1985 abandoned the general false statements offence altogether in favour of specific offences set out in the Act, with all criminal offences under the Act being listed in Sch. 24, 22 pages in total. Significantly, it created offences of laying or filing "defective accounts", being in the case of individual accounts those that did "not comply with the requirements of this Act as to the matters to be included in, or in a note to, those accounts", and in the case of group accounts those that failed to comply with specific, but very broadly drafted, provisions of the Act.[211] However, the maximum penalty for this was on indictment a fine and on summary prosecution the statutory maximum – no imprisonment.[212] Further changes were made by the Companies Act 1989, applicable from April 1st, 1990, which located the offence within the provision relating to the approval and signing of accounts, making it an offence to knowingly or recklessly approve accounts, defined by reference to both individual and group accounts, which did not comply with the Act.[213] This was amended as from November 12th, 2004, to additionally apply to accounts that did not comply with Art. 4 of the IAS Regulation, where applicable.[214] This was re-enacted as s. 414 Companies Act 2006, with effect from April 6th, 2008, the penalty remaining non-imprisonable. Significantly, however, s. 1112 Companies Act 2006 created a new "General false statement offence", with effect from October 1st, 2009, which provides that it is an offence to file a document or make a statement that is "misleading, false or deceptive", for which the maximum penalty on indictment is two years' imprisonment, a fine or both. While this was developed in the context of general filing requirements, the wording would appear sufficiently general to cover accounts. In a sense this is odd because it overlaps significantly with s. 5 Perjury Act 1911, that makes it a misdemeanour punishable by up to two years' imprisonment and a fine on indictment to "knowingly and wilfully make a statement false in a material particular" where the statement is made in various settings including "an ... account, balance sheet ... report, return, or other document" which he is "authorised or required to make ..." by any public statute.[215]

---

[207] Ashton (n 56) pp. 3, 7 and 11.
[208] Ibid., p. 7.
[209] Companies Act 1948 s. 149 as inserted by s. 1 Companies Act 1981 s. 1 .
[210] Companies Act 1948 S. 149(3).
[211] Companies Act 1985 Ss. 229(5) to (7) and 230; s. 229(6) permitted group accounts, for example, to be prepared in non-consolidated form and s. 230, for example, specifically required group accounts to give a true and fair view.
[212] CA 1985 Sch. 24.
[213] Companies Act 1989 s. 233(5).
[214] Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regs 2004/2947 Reg. 3, Sch. 1, paras. 1, 10, applicable to companies' financial years which began on or after January 1, 2005.
[215] See the comments of the then Lord Chancellor and Viscount Colville of Culross as to its significance on the enactment of s. 17 Theft Act 1968, Hansard HL, March 12, 1968, including by the latter that "it is hardly the place that .. one would expect to look, in a sensible, modern, revised criminal law, for something to do with false accounting."

There is an alternative – and more serious - offence in s. 17 Theft Act 1968, which deals specifically with false accounting. Curiously, its origins can be traced back to early company law. The Joint Stock Companies Act 1844 introduced by Gladstone in the wake of serious corporate scandals included in s. 31 a single general criminal offence to address acts of fraud or wilful omission by directors or officers, including falsification or fraudulent erasure of "Books of Account ... or any Document". This was repealed by the Companies Act 1856 and replaced with a provision applicable in insolvency only.[216] The flurry of publicity from the successful *Royal British Bank* prosecution for the long-standing common law offence of conspiracy to defraud, however, led the then Attorney General, Sir Richard Bethell, to ask leave to bring in the Fraudulent Trustees Act 1857. The general criminal law to the present day was to emerge from a group of provisions in ss. 5 to 8 of this Act, which applied to directors, members and public officers of corporate bodies and public companies.[217] In particular, s. 6 made keeping fraudulent accounts a misdemeanour, and s. 7 the wilful destruction of books, which extended to making or concurring in a false entry or material omission in books and accounts. This group of provisions went on to be consolidated in ss. 81 to 84 Larceny Act 1861, where ss. 82 and 83 were subsequently consolidated with the Falsification of Accounts Act 1875, which applied to employees,[218] into s. 17 Theft Act 1968. The substantive offence under s. 17 is not limited to any category of person or organisational form. It includes the falsification of any account, record or document and can be committed simply by producing or using them knowing that they are or may be misleading, false or deceptive "in furnishing information for any purpose". In contrast to the Companies Act offences dealing with defective accounts, however, dishonesty is required.[219] It is also necessary to show that the act has taken place "with a view to gain for himself or another or with intent to cause loss". It is noteworthy that this is not restricted by the categories of potential victims, in contrast to s. 19 Theft Act, discussed below, which criminalises making false statements by company directors to members or creditors of the company with intent to deceive.[220] Further, s. 17(2) establishes that the omission of material particulars can have the effect of falsifying the accounts and, favouring the substance over form approach, they may be misleading for the purpose of s. 17(1)(b)[221] even if there are no outright lies. A defendant under s. 17 is liable on conviction on indictment to imprisonment for up to 7 years.[222]

What conclusions can be drawn as to the adequacy of accounts related criminal offences to address OBSF? From a prosecutor's perspective the Companies Acts offences relating to defective accounts would appear the more attractive to prosecute: the lesser standard of recklessness, as opposed to dishonesty, is required and, whilst the sanction may be non-

[216] CA 1856 s. 79.
[217] Fraudulent Trustees Act 1957 ss. 5 to 8.
[218] Dishonest clerks often escaped on indictments for embezzlement because it was hard to prove an appropriation, hence the Falsification of Accounts Act 1875 was enacted making it a misdemeanour, punishable with 7 years' penal servitude for a clerk or servant wilfully, and with intent to defraud, to alter, or make false entry in, or omit a material particular from any account of his master.
[219] The Court of Appeal in *Ghosh* [1982] QB 1053 set out principles for deciding whether an accused is dishonest. The first limb asks whether the conduct is dishonest by the ordinary standards of reasonable and honest people; if so, the second limb considers whether the defendant himself realise that his actions were dishonest by those standards.
[220] The false accounting offence at s. 17 does, however, require proof of dishonesty and s. 19 applies only to existing members and creditors.
[221] Theft Act 1968 s. 17(1)(b) makes it an offence for a person to dishonestly, with a view to gain for himself or another or with intent to cause loss to another, to furnish "information for any purpose produces or makes use of any account , or any such record or document as aforesaid, which to his knowledge is or may be misleading, false or deceptive in a material particular". See too *Neil* [2008] EWCA Crim 478 and *Kylsant* [1932] 1 KB 442.
[222] Theft Act 1968 s. 17(1).

imprisonable, the *Argyll Foods Ltd* case demonstrated, by the galaxy of witnesses that were called, the seriousness with which such a prosecution is treated by a substantial company, even where the trial took place in a magistrates' court. The disadvantages, however, are weighty: the need to show that the accounts did not comply with the Act (including since 2004, the IAS Regulation), is likely to bog any prosecution down with complex and difficult questions of accounting law and practice debated by respectable experts on both sides. Any prosecution under the Theft Act would not necessarily avoid these issues. For example, a key requirement of accounts under the Companies Acts is that they show a true and fair view. Ironically, the more recently enacted s. 1112 Companies Act 2006 begins to appear more attractive, the sanction being 2 years' imprisonment, with proof of recklessness and that the document is misleading replacing the Theft Act requirements to demonstrate dishonesty and motive. The offence under the Perjury Act 1911 would be of little assistance since it only applies where the statement is in fact false.

Share market related offences

The approach of financial services law towards various offences originally designed to deal with fraudulently inducing a person to become a shareholder charted a similar path to the false statements offences in company law, with originally weighty criminal offences downgraded to a light touch civil offence regime. The current regime is now set out in Part 7 Financial Services Act 2012 and covers misleading statements (s. 89), impressions (s. 90) and statements in relation to benchmarks (s. 91), the latter a response to the recent LIBOR scandal.[223] It originated with s. 12(1) Prevention of Fraud (Investments) Act 1939, which appears to have been modelled on s. 84 Larceny Act 1861, discussed below. Section 12(1) applied where "any person" made "statements, promises and forecasts" that were "deceptive, induces, or attempts to induce" "another person" to "enter or offer to enter" an agreement relating to securities.[224] This was later re-enacted in s. 13 Prevention of Fraud (Investments) Act 1958. There was a division of judicial opinion as to whether it would suffice that a defendant had been seriously and inexcusably negligent in failing to ensure a statement, etc. was not false or unfounded,[225] which was resolved by s. 22(1)(a) Protection of Depositors Act 1963, making it apply whether or not there was dishonesty. The Prevention of Fraud (Investments) Act 1958 was repealed by the Financial Services Act 1986 and replaced by a very different regime, governing the conduct of investment business generally.[226] Nevertheless, s. 47(1) Financial Services Act 1986 recreated an offence along similar lines, the key difference relating to the need to show that a person had broadly been induced to enter into an "investment agreement" as defined. Section 47(2) added a new offence where a person's course of conduct created a false or misleading impression as to the market, price or value of investments. Section 397 Financial Services and Markets Act 2000 replaced the Financial Services Act 1986 provisions. These have now been largely re-stated and extended in ss. 89 and 90 Financial Services Act 2012 with the addition of a new offence in s. 91, as above.

Section 89 criminalises knowingly making a false or misleading statement, the reckless making of such a statement or the dishonest concealment of material facts in connection with

[223] Commenced April 1, 2013.
[224] "Securities" were defined in Prevention of Fraud (Investments) Act s. 26(1) as "shares or debentures, or rights or interests ... in any shares or debentures".
[225] R.R. Pennington, *The Law of the Investment Markets* (Oxford: Blackwell, 1990), p. 41.
[226] FSA 1986 s. 212(3) and Sch 17 Part 1.

the statement where there is the relevant intention.[227] A person can therefore be convicted where he neither misleads nor intends to mislead and, of note, recklessness has been construed in relation to earlier such provisions to import an objective, rather than subjective, assessment of the conduct.[228] This is significant in that the objective approach to fault attribution is infrequently found in offences that are considered "truly criminal" but is a common characteristic in the regulatory context, the latter comprising rules that are not enforced directly in court but are implemented by the regulator[229] subject to appeal to a tribunal. Similarly, the burden of proof for "offences" has been likened to the lower standard applicable in civil proceedings and, therefore, it might be concluded that, although the regulator's powers mimic the substantive criminal law, breach of a Pt. 7 offence may be considered a mere "civil offence", typical of the regulatory regime.[230] The maximum penalty, however, is on conviction on indictment 7 years' imprisonment and a fine, much more serious than the defective accounting offence under company law.[231]

There is again an alternative – and more serious – general criminal offence set out in s. 19 Theft Act 1968. Ironically, as with the comparable false accounting provision, the origins of this can be traced to early company law with s. 65 Joint Stock Companies Act 1844, which penalised false pretences as to the patronage of companies, and s. 31, which, as has been seen, made fraudulent acts or omissions by directors and officers a misdemeanour. These were repealed by the Joint Stock Companies Act 1856. Section 8 Fraudulent Trustees Act 1857, re-enacted in s. 84 Larceny Act 1861, made it a misdemeanour to publish false statements with intent to deceive, defraud or induce a person to become a shareholder, etc. (so victims did not have to be existing shareholders).[232] Of note, it was not under the Companies Act but under s. 84 Larceny Act 1861 that Lord Kylsant was subsequently convicted in 1932,[233] having published a misleading prospectus for the issue of debenture stock. As with the 1858 *Royal British Bank* case, discussed below, the prospectus contained statements which were of themselves entirely true but, taken as a whole, gave a false impression of the position of the company.[234] In essence, the company drew on secret taxation reserves accrued during a previous abnormal "boom" period to pay dividends and provided a 10- year average annual balance; this was misleading in that the information implied that the company was profitable whereas it had in fact made large trading losses for the previous 7 years. Section 19 Theft Act 1968 now makes it an offence for officers of

[227] There must be either an intention or recklessness as to whether making or concealing as above might induce a person to make an investment decision of the type set out in the section.
[228] See I. Smith, "Financial Fraud: what does it take to be a fraudster?" (2011) 10 JIBFL 601; *R. v Russell* [1952] 2 All ER 842; *R. v MacKinnon* [1959] 1 QB 150; L Bingham's judgment in *G* [2004] 1 AC 1034 at [28] the meaning of 'recklessly' and 'reckless' remains open, see *Blackstone's Criminal Practice* edited by Lord Justice Hooper and David Ormerod (OUP, 2011) at B7.24.
[229] The Financial Services Act 2012 has amended s.401 Financial Services and Markets Act 2000 so that the Financial Conduct Authority is now granted the power to prosecute Pt 7 offences in place of the Financial Services Authority.
[230] A. Haynes, "Market abuse, fraud and misleading communications", (2012) 19(3) JoFC 234-254. For an excellent explanation see A. Hudson, *The Law of Finance* (Sweet & Maxwell, 2009) 14-15.
[231] FSMA 2000 s. 397(8).
[232] Fraudulent Trustees Act 1857 s. 8 would appear to overlap with the false pretences offences and s. 14 provided that if an offence appeared to be larceny the person on trial would not be entitled to acquittal of a misdemeanour under this offence (oddly not repeated in Larceny Act 1861 s. 84).
[233] *R v. Kylsant* [1932] 1 KB 442 (the Royal Mail Steam Packet Company case).
[234] Of note, the Court of Appeal judges, Avory, Branson and Humphreys JJ, were not referred to the British Royal Bank authority and decided the point by reference to 3 civil cases, *Gluckstein v Barnes* [1900] AC 240; *Peek v Gurney* (1873) LR 6 HL 377 and *Aaron's Reefs Ltd v Twiss* [1896] AC 273, in which it was fortunate that Lord Halsbury had expressed his view with regard to criminal, as well as civil, liability, at 284.

organisations generally including a body corporate to publish, etc. a misleading, etc. "written statement or account" with intent to deceive "members or creditors". It differs from the earlier legislation as it does not require the document to be used with intent to induce someone to become a shareholder but is limited to existing members (i.e. not prospective members). The maximum sentence on conviction on indictment is 7 years' imprisonment.[235]

Superficially, there would appear to be some incentives for a prosecutor to rely on the share market offences rather than those specifically related to accounts. The combination of a substantial maximum penalty of 7 years' imprisonment, the lower standard of *mens rea* for the FSA 2012 offence and the generality of the requirement to show a false statement as opposed to non-compliance with the Companies Act accounting requirements would all be attractive. However, there is no case law as to whether accounts constitute a statement as required by FSA 2012. Similarly, the *mens rea* essentially requires proof that the defendant intended to, or was reckless as to whether a person entered into or refrained, etc. From entering into, etc. a relevant agreement, which might prove a difficult obstacle. The generality of s. 19 Theft Act might, therefore, be more attractive. It carries a similar maximum penalty and publication of an account is specifically covered, though, oddly, intent to deceive is restricted to existing members or creditors rather than potential shareholders, as had been the case under the Larceny Act. The need to prove intention to deceive in relation to s. 19 may be more difficult to prove than dishonesty at s. 17, in which case the s. 1112 provision still looks the most promising so far.

Offences in relation to winding up

There have long been specific offences relating to the destruction, etc. of company books, etc. in the context of insolvency law that have extended to falsification of books of account. The origins of such legislation can be traced to s. 114 Joint Stock Companies Winding Up Act 1848 (JSCA), which made it an offence to destroy company books, etc. broadly in contemplation of the winding up. This specifically extended to making any false or fraudulent entry in books of account or other documents with intent to defraud creditors or contributories, and was made a misdemeanour, punishable by a maximum of two years' imprisonment. This was carried forward into subsequent companies' legislation in 1856, 1862, 1908, 1929, 1948, 1985 and 1986.[236] Section 271 Companies Act 1929 created a large number of specific insolvency offences, including broadly similar conduct carried out within 12 months of the commencement of a company's winding up. The maximum penalty was also 2 years for this offence, which contained additional and specific defences. This was again carried forward into subsequent companies' legislation in 1948, 1985 and 1986.[237] However, the 1985 legislation increased the criminal penalty for both offences to a maximum of 7 years' imprisonment.[238]

The use of insolvency offences is obviously limited to those situations where the company in question becomes insolvent and is, therefore, likely only to be of limited value as it is a relatively uncommon occurrence for the sort of large listed companies that typically engage in complex OBSF activities. Nonetheless, it cannot be ruled out as the use of OBSF itself

[235] Theft Act 1968, s. 19(1).
[236] JSCA 1856, s. 79; CA 1862, s. 166; Companies (Consolidation) Act 1908 s. 216;CA 1929 s. 272; CA 1948 s. 329, CA 1985 s. 627; and CA 1986 s. 209.
[237] CA 1948 s. 328; CA 1985 s. 624(2); and IA 1986 s. 206.
[238] CA 1985 s. 627(2); and s. 624(6) CA 1985 and CA 1985 Sch. 24 CA 1985. See now Insolvency Act 1986 Sch. 10.

may increase the probability of a company becoming insolvent, and furthermore the powers and responsibilities of a liquidator make it more likely that the liquidator will be able to obtain information about the use of OBSF that may be hidden while the company is a going concern. Section 206 Insolvency Act 1986 makes various forms of conduct within 12 months of winding up a criminal offence, including concealing a debt due from the company, the falsification of books or papers relating to the company's affairs and fraudulent omissions in any document affecting the company's property or affairs; a defence is available to the concealment offence of proving that there was no intention to defraud, and in relation to the falsification offence that there was no intent to conceal the state of affairs of the company or defeat the law. This provision is, however, unlikely to be helpful with OBSF as the 12-month period is likely to be too short, such conduct may well have taken place over a longer period of time. Section 209 Insolvency Act 1986 is more promising as it makes it a criminal offence to falsify the company's books, etc. with intent to defraud or deceive any person. Furthermore, unlike the comparable provision under s. 17 Theft Act 1968, which carries the same maximum penalty, there is no need to show a view to gain or causing loss.

General fraud based offences requiring dishonesty

The centuries-old common law offence of conspiracy to defraud has been preserved by s. 5(2) Criminal Law Act 1977, when common law conspiracy was generally abolished. Early on it was used for false statements, for example, *R. v De Berenger (1814)*[239] where false rumours of Napoleon's death and imminent peace with France were spread to increase the price of government securities. The possibility of the manipulation of accounts being regarded as conspiracy to defraud can be traced back to 1858 and the case of *R v Esdaile & others*, commonly known as the *Royal British Bank* trial.[240] During the trial it was alleged that certain directors of the bank[241] had conspired to defraud by false representations of solvency. Their crime involved including bad debts as an asset on the balance sheets without stating that they had effectively been "written off", declaring and paying a dividend of 6 per cent knowing it should not be paid and fraudulently issuing new shares. "Although the balance sheet truly represented the books, it would be fraudulent ..." because the defendants knew the true state of affairs.[242] The directors were duly convicted of "intending to deceive, defraud and prejudice such of the shareholders of the Royal British Bank as were not aware of the true state of affairs of the bank, and to induce the Queen's subjects to become customers and creditors of the bank, and to purchase and hold shares therein" and "did conspire falsely and fraudulently to publish and represent that the bank ... were in a sound and prosperous condition". The directors were found guilty even though they had intended no direct personal benefit and had hoped to rescue the bank. The maximum sentence available for the common law offence is now 10 years' imprisonment.[243]

Historically, it must be borne in mind that the relevant legal provisions would have been designed in the shadow of the notorious Bubble Act 1720, which made:

---

[239] *R v De Berenger & others [1814-23]* All ER Rep 513; See A Hudson, *Securities Law* (London: Sweet & Maxwell 2008) at 775.
[240] *R v Esdaile* (1858) 175 ER 696.
[241] Stapleton, Esdaile, Valient, Macleod, Kennedy and Cameron.
[242] *R v Esdaile and Others* (1858) 175 ER 696 at 698.
[243] Criminal Justice Act 1987 s. 12(3). The CPS web-site adds "See Attorney General's Guidance of 9/1/2007 attached to Policy Bulletin 15/2007. Prosecutors will need to specify why this charge is being chosen as opposed to any other and will need management approval to charge ...". See https://gov.uk/use-of-the-common-law-offence-of-conspiracy-to -defraud-6 [Accessed February 26, 2015].

"All undertakings ... presuming to act as a corporate body ... raising ... transferrable stock ... transferring ... shares in such stock ..., either by Act of Parliament or any charter from the Crown and acting under any charter ... for raising a capital stock ... not intended ... by such charter ... and all acting ... under any obsolete charter ... for ever be deemed illegal and void".

In this context, the criminal law gave rise to a number of general offences based on the making of false pretences or deception, which might have been expected to be adequate to cover such conduct designed to induce a person into buying or selling shares. The earliest was introduced by s. 1 Obtaining Money by False Pretences Act 1757, which was extended in 1812 to specifically cover obtaining bonds and other securities. This was repealed and re-enacted by s. 53 Larceny Act 1827 which made the offence of obtaining money, et.c a misdemeanour; and also noted that "a Failure of Justice frequently arises from the subtle Distinction between Larceny and Fraud", so s. 53 went on to say that there should be no acquittal if the way in which property was obtained amounted to larceny and there should be no further prosecution for larceny. This offence was further re-enacted in ss. 88, 89 and 90 Larceny Act 1861, with s. 88 also providing that it was not necessary to show intent to defraud any particular person, and finally appeared in s. 32 Larceny Act 1916 in substantially the same terms but without the qualifications above. The Theft Act 1968 later addressed comparable deception offences with s. 15 criminalizing obtaining property by deception, s. 15A the obtaining of a money transfer, s. 16 obtaining pecuniary advantage by deception and s. 20(2) the procuring the execution of a valuable security, now all repealed by the Fraud Act 2006.

A more effective deterrent might have been prosecution for fraudulent trading, not least as this now carries a potential sentence of 10 years' imprisonment.[244] The origins of this can be traced back to s. 275 Companies Act 1929, when the offence applied only when the company was in the course of winding up.[245] This restriction was removed in s. 458 Companies Act 1985. Section 993 Companies Act 2006 now creates 3 separate fraudulent trading offences: carrying on the business with intent to defraud creditors of the company; doing so with the intent to defraud the creditors of any person; and being a party to the carrying on of the business for any fraudulent purpose. While a single transaction is sufficient to commit either of the defrauding creditors offences,[246] the fraudulent purpose offence is aimed at the carrying on of a business with the requisite intention rather than individual transactions.[247] As Davies and Worthington note, there is also no limit on the prior period which may be scrutinised, the liquidation of the company simply being a condition of the claim.[248] Fraudulent purpose is commonly recognised in instances such as using a company as vehicle for a systemic carousel tax fraud,[249] however, it need not be the sole or even the dominant purpose for which the business is conducted.[250] Of note, this offence has been charged in situations where accounts have been manipulated: for example, in *R. v. Bright*[251] where counts of fraudulent trading were added to the indictment containing charges of conspiracy to

[244] Under s. 458 CA 1985 it was a maximum 7 year custodial rising to 10 years for offences committed on or after January 15, 2007: Sch. 24, column 4 regarding s. 458 being amended by s. 10 Fraud Act 2006.
[245] Re-enacted in Companies Act 1948 s. 332.
[246] *Re Gerald Cooper* [1978] Ch 262; *Lockwood* [1986] Crim LR 244.
[247] *Morphitis v. Bernasconi* [2003] Ch552 pp. 42-49 CA.
[248] P.L. Davies and S. Worthington, *Gower & Davies Principles of Modern Company Law* (London: Sweet & Maxwell, 2012), p. 228, n. 12.
[249] E.g. Tax tribunal cases of TC02761: Silicon 8 Ltd, July 5, 2013; TC02667: *CCA Distribution Ltd (in admin)* [2013] UKFTT 253 (TC).
[250] *R v Philippou* (1989) 89 Cr App R 290.
[251] *R v Bright* [2008] All ER (D) 83 (Mar)

defraud where the defendant dishonestly manipulated the accounts of an insurance company by keeping claims data off the computer system and the company's books of account; and *R. V, Smith,*[252] where the defendant was convicted where he had supplied accounts, including misleading lists of debtors, supported by false invoices to maintain the credit of a marketing company which eventually failed with a deficit of £520,000. Davies and Worthington observe that a single charge of fraudulent trading has been regarded as less confusing for a jury than numerous charges of individual fraud.[253]

The Fraud Act 2006 established for the first time a general fraud offence. The Act's potential application to corporate misinformation, and the particular problem of OBSF, is easy to discern. Indeed, in its introduction to the new Act, the Law Commission's 2002 Report particularly highlighted Government's commitment to address major commercial fraud.[254] Quoting Lord Irvine of Lairg L.C., it stated,

"[T]he ability to respond effectively to major fraud is of the highest priority to the government. We recognise that, in recent years, the public has at times felt that those responsible for major crimes of the commercial sphere have managed to avoid justice. Even when fraud is detected, the present procedures are often cumbersome, and difficult to prosecute effectively".

Accordingly, the report went on to recommend that, "...introducing a single crime of fraud would dramatically simplify the law of fraud[255]... a general offence of fraud would be aimed at encompassing fraud in all its forms".[256]

In view of the complexity of the current disclosure rules, regulation and criminal legislation, the proposition remains most attractive. The Fraud Act clearly envisages prosecutions for fraud in the corporate arena.[257] However, contradicting its own 2002 Report,[258] the Law Commission has subsequently proposed that specific regulation by criminal sanction should not be used to deal with fraud when the conduct in question is covered by the 2006 Act.[259]

Heralded for its robust nature and broad-brush drafting, the Fraud Act 2006 avoided the pitfalls associated with highly particularized deception offence definitions, and can be employed in any dishonest context where there has been the making of a false or misleading representation,[260] the failure to disclose information where there is a legal duty to disclose it[261] or the abuse of position.[262] The offence would have been committed in these circumstances where there was an accompanying intention to make a gain for himself or another, or cause a loss, or risk of loss, to another.[263] Given that any investment or lending

[252] *R v Smith* [1997] 2 Cr App R 1 (S)
[253] Davies & Worthington, op. cit., p. 227, n. 9, citing *R. v. Kemp* [1988] QB 645 (CA).
[254] Law Commission, *Report on Fraud* (2002).
[255] Ibid., p. 3, para. 3.
[256] Ibid., para. 4.
[257] In addition to the Interpretation Act 1978 [provisions], s. 12 implicitly provides that company officers may liable for fraud as individuals where they have consented or connived with the fraud of the body corporate.
[258] Law Commission, *Report On Fraud* 2002 (2002).
[259] Law Commission, "Criminal Liability in Regulatory Contexts", (2010), p. 10 at 1.39, Proposal 5. Further, at 1.42 it states that "too many fraud-based offences are being created when the conduct in question is already covered by the Fraud Act 2006".
[260] Fraud Act 2006 s. 2.
[261] Fraud Act 2006 s. 3.
[262] Fraud Act 2006 s. 4.
[263] Fraud Act 2006 ss. 2(1)(b), 3(b) and 4(c); see also s. 5 for the interpretation of "gain" and "loss".

decision carries with it an inherent risk of loss owing to market forces and fluctuation, the determinative criminal elements, in effect, must be proof of dishonesty combined with the performance of the proscribed behaviour. The maximum penalty on indictment is up to 10 years' imprisonment and a fine.[264] Thus, s.2 applies to any person who dishonestly makes a representation of the company's financial position that he knew was, or might have been, untrue or misleading, for example to investors or potential investors, creditors or potential creditors. However, the question as to whether the use of OBSF amounts to a false representation is an interesting one and closely related to the earlier discussion regarding dishonesty and the implications of the *Hinks* decision, namely that legal and accounting compliance is not necessarily a defence to a criminal allegation where dishonesty is found.[265] Section 3 is more narrowly drawn, the potential criminal liability biting in relation to persons who dishonestly fail to disclose information that they are under a legal duty to disclose. At first sight, it might seem that this could be jeopardised in the same way as the false representation offence, namely whether the information complied with what a director was expected to disclose by regulation. However, it is interesting to observe here the developing judicial trend in relation to the interpretation of directors' fiduciary duty of loyalty to the company, which, inter alia, encompasses a duty to disclose their own misconduct to the company and renders their position closely analogous to that of trustee with the further implications that brings. [266] It may appear tempting to rely on s. 4, which relates to the dishonest abuse of a position where the person is expected to safeguard the financial interests of another. The use of OBSF might be perceived as a failure to safeguard the interests of shareholders or potential shareholders as this might avoid any prosecution becoming jeopardised by technical expert questions as to regulatory compliance. However, this would raise an interesting question as to whether directors were expected to protect the interests of the company as an abstract legal entity or instead the individual shareholders or perhaps a group of shareholders.

The use of the Fraud Act 2006 to criminalize in the commercial context has a number of advantages. It carries a potentially robust sentence. As an offence deriving from the general part of criminal law, it is not restricted in terms of categories of potential defendants or victims, and because it is drafted in inchoate mode, unlike the predecessor deception offences, no actual loss or gain or exposure to loss needs to be proved. It is highly serviceable as a prosecution tool, simply drafted and accessible and its inchoate character means that it can be employed prior to the commission of any financial harm. Regrettably, it came into force on January 15th, 2007 and was therefore too late to make much of an impact there insofar as many of the seeds of the crisis had been sown long beforehand.

CONCLUSIONS

The overarching purpose of company law since its inception has been to address the persistent problem of scandal and fraud inherent in the nature of the company. A vast international – and potentially therefore very path dependent – regulatory infrastructure has been evolved in response, the costs of which may well now exceed the benefits. The case study of the contribution of OBSF to the 2008 financial crisis shows that the regulatory system was inadequate and may well remain inadequate whatever reforms are introduced, given the way in which market behaviour has responded to changes in regulation to date.

[264] Fraud Act 2006 s. 1(3)(b).
[265] *Hinks* (n. 168).
[266] *Item Software (UK) Ltd v Fassihi* [2004] B.C.C. 994; *GHLM Trading Ltd. v Maroo & Others* [2012] EWHC 61 (Ch)

Economic theory suggests that a generic anti-fraud rule might well be the way forward. The law in force during the period up to the emergence of the banking crisis has been seen to have been in an extraordinary state of flux, with major reforms to company law, accounting regulation, financial services law and the criminal law taking place, especially towards the end of this period, all of which would have made prosecution of potential offences that might have taken place over years and straddled various regulatory regimes more difficult than otherwise. Numerous distinct criminal offences that might have been available to a prosecutor during the period ending December 31st, 2007 were identified, summarised in Appendix 1. The most robust and serviceable provisions were all in effect generic fraud provisions. Section 2 Fraud Act, concerned with fraud by false representation, was potentially the most suited, but regrettably this would have only been available for conduct on or after January 15th, 2007 and therefore effectively unavailable. Similarly, the new general false statement offence under s. 1112 Companies Act might have been of assistance, particularly where no dishonesty can be shown, was only available on or after October 1st, 2009. Fraudulent trading under s. 458 Companies Act 1985 and/ or s. 993 Companies Act 2006 (on or after October 1st, 2007) might have proved sufficiently generic to be of assistance. Perhaps surprisingly another such provision might have been the common law offence of conspiracy to defraud, which had proven effective in the Victorian era in the *Royal British Bank* trial. In each case the maximum sentence available would have been 10 years' imprisonment. We are not suggesting in this article that the use of OBSF prior to the banking crisis amounted to criminal conduct (there would have been many evidential and legal obstacles to any prosecution), only that the criminal law failed to perform its deterrent role on some socially damaging behaviour.

While some will argue that the use of criminal offences based on fraud is too blunt an instrument and will discourage legitimate business activity, this ignores the part that might be played by markets in regulating themselves, albeit under the shadow of the criminal law, an example of which can be seen in the approach to the implementation of the Bribery Act. In the event that such rigorous prosecution is adopted, there would be much scope to dismantle much of the international and domestic company law regimes which would be unnecessary, their original purpose being satisfied in other ways. Not only would it signify a huge financial reduction in compliance costs, the substance over form approach would make the scrutiny of business activity subject to a common moral compass under the test of dishonesty. Regulation can be as detailed and as particularized as one may desire; however, it will always fail to address fraud because fraud is notoriously difficult to define. What distinguishes fraud as a criminal offence is that it is not an activity in itself; it is simply a way in which an otherwise lawful activity is performed. What distinguishes lawful conduct from fraudulent conduct is not compliance or non-compliance with a legal rule – it is whether the conduct is done with accompanying "dishonesty". It is that characteristic that must surely place certain instances of accounts manipulation firmly within the ambit of the criminal law, and rightly so. The criminal law has a moral basis; it is about stigma and censure following conviction, and it is entirely appropriate that the provision of misleading information by companies should be deterred by it.

APPENDIX

Summary table of relevant criminal offences applicable during the period January 1, 2000 to January 1, 2008

Description	Statutory	Effective	Mens rea	Need to	Max

of offence	authority	date	requirement?	show victims?	sentence
Approving defective accounts	s. 233(5) CA 1985 (as amended s. 7 CA 1989)	Before November 12, 2004	Knowing or reckless as to non-compliance	No	Fine
Approving defective accounts	s. 233(5) CA 1985 (as amended IAS Refs 2004)	November 12, 2004 up to and including April 5, 2008 (see also n. 214 above)	Knowing or reckless as to non-compliance	No	Fine
False accounting	s. 17 Theft Act 1968	Throughout period	Dishonesty & view to gain or cause loss; knowing it may be misleading	No	7 yrs custodial
General false statement offence	s. 5 Perjury Act 1911	Throughout	Knowingly makes false statement	No	2 yrs custodial
Misleading statements and practices offence	s. 47(1) FSA 1986	Before December 1, 2001	Knowing or reckless as to whether misleading	No	2 yrs custodial
Misleading statements and practices offence	s. 397(1) and (2) FSMA 2000	On or after December 1, 2001	Knowing or reckless as to making misleading statement / dishonest concealment and intention to induce	No	7 yrs custodial
False statements by company directors	s. 19 Theft Act 1968	Throughout period	Knowing it may be misleading, intention to deceive	No	7 years custodial
Fraud etc in anticipation of winding up	s. 206 IA 1986	Throughout period	Intention to defraud/conceal/ defeat the law	No	7 years custodial
Destroying / falsifying company books	s. 209 IA 1986	Throughout period	Intention to defraud/deceive	No	7 years custodial
Common law conspiracy to defraud	Preserved by s. 5(2) Criminal Law Act 1977	Throughout period	Dishonesty & intention to defraud	No	10 years custodial

Obtaining property by deception	s. 15 Theft Act 1968	Before January 15, 2007	Dishonesty & intention to permanently deprive	Yes	10 years custodial
Obtaining pecuniary advantage by deception	s. 16 Theft Act 1968	Before January 15, 2007	Dishonesty	Yes	5 years custodial
Fraudulent trading	s. 458 CA 1985	Before October 1, 2007	Intention to defraud/ fraudulent purpose	No	7 years custodial
Fraudulent trading	s. 993 CA 2006	On or after October 1, 2007	Intention to defraud/ fraudulent purpose	No	10 years custodial
Fraud by false representation	s. 2 Fraud Act 2006	On or after January 15, 2007	Dishonesty & intention to make gain or cause loss	No	10 years custodial
Fraud by failure to disclose information	s. 3 Fraud Act 2006	On or after January 15, 2007	Dishonesty & intention to make gain or cause loss	No	10 years custodial
Fraud by abuse of position	s. 4 Fraud Act 2006	On or after January 15, 2007	Dishonesty & intention to make gain or cause loss	No	10 years custodial