Jetivia v Bilta

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Supreme Court decision in *Jetivia SA and another (Appellants) v Bilta (UK) Limited and others (Respondents) [2015]* - a more in depth look at the implications, not just for Insolvency practitioners but also auditors.

Bilta was compulsorily wound up on an HMRC petition, owing £38 million in unpaid VAT. Its liquidators brought a claim against its former directors and a Swiss company, Jetivia, for their dishonest involvement in a fraudulent scheme which caused Bilta to enter transactions constituting VAT fraud. The liquidators relied on section 213 of the Insolvency Act 1986 in bringing their claim for damages.

Jetivia argued that the directors' illegal actions should be "attributed" to Bilta, (in reliance upon the Supreme Court's decision in Stone & Rolls - see below), a sole shareholder company set up by that shareholder to carry out a fraud. If upheld, the effect of this would have been that the company's liquidators would be prevented from bringing a claim against its fraudulent directors because the company, which of course has no independent personality itself, was complicit in the fraud. As for the claim under s213 IA 1986, the Appellants argued that it does not have extra-territorial effect.

Held

The Supreme Court rejected Jetivia's application to strike out the claim and held that ex turpi causa ("the illegality defence") could not be used to defeat the intended statutory purpose of s172 (3) Companies Act 2006, which makes directors liable to the company for breaches of fiduciary duty and which purpose included the protection of creditors of insolvent companies. It also rejected Jetivia's argument that Section 213 did not have extra-territorial effect; it would seriously damage the efficient winding up of a British company if the legislation (which permits a UK court to order a party which participated in the fraudulent scheme to contribute to the insolvent company's assets) did not extend to overseas parties that have been involved in the company's business.

The decision therefore provides helpful clarification of the law for insolvency practitioners looking to bring claims against directors and others for fraud practiced against the company.

Where does that leave auditors who are themselves the victims of fraudulent deception by the directors and who did not spot the fraud when signing off on the audit report? The Supreme Court in Bilta suggested that its decision in Stone & Rolls should not be referred to in future cases involving the application of the illegality defence. However, to understand where the law on the illegality defence stands now in relation to claims against auditors it helps to look at both cases.

Moore Stephens v Stone & Rolls (In Liquidation)

The 2009 decision, in favour of the auditors, was the result of an adroitly constructed legal analysis of the ex turpi causa authorities by Jonathan Sumption QC, then acting for Moore Stephens (now Lord Sumption).

The fraud involved Stone & Rolls Limited ("the Company") persuading a Czech Bank, to pay over $90m to the Company based on false letters of credit, $80m of which was then forwarded to an Austrian company which was connected with Mr Stojevic who was the sole directing mind and will of the Company. The frauds gave rise to claims against both the Company and Mr Stojevic in deceit and the Czech Bank was awarded substantial damages against both. The Company could not pay and went into liquidation.

The Company's liquidators claimed against its auditor, Moore Stephens, for failing to detect Mr Stojevic's dishonest behaviour seeking damages of just under US$174m.

Moore Stephens applied to have the Company's claim struck out arguing the illegality defence applied and the Company should not as a matter of public policy be allowed to recover losses incurred by its own fraud.

It was common ground that if the Company was the victim of the fraud, the defence did not apply. Mr Sumption argued successfully that the company was villain not victim as the fraud was carried out by the Company against third party banks. Also, it was not a situation where the Company was being held vicariously liable for its employees' actions; rather, as the Company was controlled by the principal architect of the fraud, Mr Stojevic, it was a case of the Company being imputed with knowledge of Mr Stojevic and itself perpetrating and being directly liable for its frauds.

It was argued that the illegality defence could not apply as against the auditors because the fraud was the very thing which the auditors had been paid to protect the Company against. Mr Sumption argued, again successfully, that the very thing argument could not apply because that argument went to causation arguments (eg was discovery of the fraud within the scope of the auditors' duties) not whether the ex turpi causa defence applied and where, as here, ex turpi causa did apply because the Company was villain not victim, there was no court discretion, it was a complete defence.

Lord Mance's dissenting judgment

Lord Mance undertook a detailed examination of the duties of auditors and the respects in which those duties went beyond reporting to, or for the benefit of, the shareholders. Quoting from the Companies Act and UK Auditing Standards Lord Mance noted that (i) if resigning, an explanation to creditors should be considered (s394(1)) and (ii) where there was suspected fraud, a report to a proper authority in the public interest may be appropriate (SAS 110.10). His supporting reasoning is too detailed for this article, but his conclusion was that these duties, both contractual and statutory, imposed a duty on the auditors to report fraud and this was the case whether or not the company was a 'one-man' company with no innocent directors or shareholders to report to. In such circumstances, he concluded that the ex turpi causa principle had no application.

Lord Mance considered that the fact that the Company was insolvent at the time of the different audits was critical. The fraudulent scheme rendered the Company increasingly insolvent to the detriment of its existing and future creditors. The auditors had a duty towards the Company to report the fraud of Mr Stojevic (if detected) to the regulators or other proper authorities in the company's interests.

Comment

The Stone & Rolls decision has helped the cause of auditors but, it seems, to a limited degree. At most, Stone & Rolls can now be treated as only a reliable precedent for the following narrow legal proposition: where the company was set up for the purpose of the fraud in question, and there are no innocent directors or shareholders, the illegality defence bars a claim by a company against its auditors for negligently failing to uncover and prevent fraud.

Save for that limited proposition, Lord Neuberger's conclusion in Bilta was that the Stone & Rolls judgment should be put on one side and marked "not to be looked at again" when considering ex turpi causa arguments.

It remains likely in our view that Lord Mance's dissenting judgment in Stone & Rolls will be referred to in future cases to support an argument that provided the claimant company in liquidation was originally set up for genuine trading purposes, and was in or near insolvency at the time of the audit sign off, the illegality defence should not be available to auditors (even where there are no innocent directors or shareholders). For reasons identified by Lord Mance, a case can be made on behalf of creditors that their (not just the shareholders') interests should be taken into consideration, and we shall see it argued in future cases that a defence of ex turpi causa should not be made available to auditors when there are other defences (such as reduction of liability based on a defence of contributory negligence) available to them.

The question of whether it is right for auditor firms to face claims for huge losses which are wholly disproportionate to the professional fees they charge for auditing, and when they themselves are the victim of fraudulent deception, lies at the heart of the decision in Stone & Rolls and the answer to that question depends upon through whose eyes one looks at the issue. It may be that the next case which proceeds to the Supreme Court on this issue will, as was the case in Stone & Rolls, be funded by third party funders who consequently share in any recovery, in which case it is not just the interests of creditors at stake and the courts may allow this to influence them. On balance, we think the auditors will have the better of the argument where there are no innocent shareholders to report to, but this particular chapter on auditor liability is far from closed.