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Mayer Brown Client Alert - Moore Stephens (a firm) v Stone & Rolls Ltd (in liquidation) [2009] UK HL 39

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Audit liability and fraudulent corporate vehicles – the House of Lords opines.

In a judgment delivered on 31 July, the House of Lords has upheld the Court of Appeal judgment of 18 June 2008 by which it struck out the claim of Stone & Rolls Ltd against its auditors. The Judgment is important for auditors and will be of interest to companies, their creditors and directors and their insurers in relation to the circumstances in which knowledge of wrongdoing on the part of a company's management may prevent the recovery of money from third parties.

The Facts

The essence of the claim brought by Stone & Rolls Limited (in liquidation) ("**the Company**") against its auditors Moore Stephens ("**the Firm**") was that the Firm had negligently failed in the course of its various audits to detect the fraudulent behaviour of Mr Zvonko Stojevic. Mr Stojevic, the sole directing mind and will of the Company, had used the Company to commit a letter-of-credit fraud against banks. The fraud consisted of the presentation by the Company of false documents to the banks, the receipt of funds by the Company and the payment away of those funds to other parties, leading to a claim in the region of $174 million pursued by the liquidator in the name of the Company.

The Issues and Judgment at First Instance

At first instance before Langley J, the Firm submitted in its defence that the Company was never in any real sense deprived of its money by the fraud but was simply used as a conduit for the passage of funds. In essence, the Company's claim involved it seeking to rely upon and recover a loss caused by its own fraud – as such, on the basis of the maxim *ex turpi causa* (no action will arise out of an illegal or immoral act), the Company could not claim losses suffered as a result of its own criminal conduct, the claim was doomed to failure and should be struck out. The Company, in turn, submitted that Mr Stojevic's dishonesty was not to be attributed to the Company, which was not, therefore, relying upon its own fraudulent conduct in bringing the claim; alternatively, the Firm could be liable because the Company's illegal conduct was the 'very thing' that the Firm was under a duty to prevent.

Whilst finding that Mr Stojevic was the directing mind and will of the Company such that his knowledge and wrongdoing was properly attributable to the Company; and that there was no compelling reason in these circumstances why the Company should not be subject to the *ex turpi causa* principle, Langley held that the principle could not prevent a claim founded on fraud that would not have occurred had the Firm properly complied with their "very duty" as auditors of the company (which included the discovery and reporting of fraud). In such a situation, the conscience of the ordinary citizen would not find the pursuit of the claim so repugnant that it ought to be prevented "by use of the unforgiving and uncompromising operation of the *ex turpi* maxim".

The Judgment of the Court of Appeal

The Court of Appeal reversed this decision and ordered that the Company's claim be struck out.

- Ex Turpi causa

  The Court of Appeal noted that there was no dispute on the facts of this case that the Company's claim relied upon, was based substantially on and was inextricably linked with the fraud that was perpetrated on the banks. In such circumstances, the victims of the fraud were the banks. There was no prospect of establishing at trial that the Company was the victim of the fraud.
- Attribution

  It followed that the next question was whether in these circumstances Mr Stojevic's fraud could properly be attributed to the Company. On this issue, the Court of Appeal held that, where Mr Stojevic "owned the Company and controlled it in its every relevant act", his dishonest intention could properly be attributed to the Company which could be as much a wrongdoer as the

individual involved. In such circumstances, the claim by the Company could be met by the plea of *ex turpi causa* which would afford a complete defence to the claim, subject only to consideration of the Company's second submission that this principle could not provide a complete defence when the detection of dishonesty was "the very thing" that the Firm was retained to do.

- "The Very Thing"

  The Court of Appeal accepted the submissions of Jonathan Sumption QC, on behalf of the Firm, that "the very thing" concept arising before the Court of Appeal in *Reeves v Comr of Police of the Metropolis* [1998] 2 All ER 381 is a concept that is about causation and does not displace the operation of the *ex turpi causa* defence so as to enable the bringing of a claim that relies on the claimant's illegality.

  In the words of Lord Justice Mummery, "it is contrary to all common sense to uphold a claim that would confer direct or indirect benefits on the corporate vehicle, which was used to commit the fraud and was not the victim of it, and the fraudulent driver of the fraudulent vehicle."

The Judgment of the House of Lords

The Law Lords have dismissed the Company's appeal and so its claim against its auditors remains struck out – but only by a majority of 3:2. The judgments are lengthy and complex and vary in their reasons (with two of those upholding the decision of the Court of Appeal doing so on different grounds to the lead judgment in that Court). It is nevertheless possible to draw some themes from the majority judgments:

- The Company's claim for compensation was defeated by the *ex turpi causa* principle because the perpetrator of the fraud was also the sole directing mind and will and beneficial owner of the Company, which could not properly be treated as also being a victim of the fraud and the Court will not assist a Claimant to recover compensation for the consequences of his own illegal conduct.
- The Court of Appeal decision had been described as limiting the application of the *ex turpi causa* principle to 'one-man' companies. The Lords' majority make it clear that it may apply in situations involving more than one director or shareholder, as long as all are complicit in the fraud (including by way of reckless indifference). This may include circumstances in which other directors or shareholders are subservient to a dominant personality; and where there are two or more individual directors and shareholders acting closely in concert.
- It appears that their Lordships were not persuaded that *ex turpi causa* would defeat a claim by a company against its auditors in circumstances in which there were "innocent" directors and shareholders – but that was not the situation in this case.
- Caution should be adopted in seeking to establish general propositions from this case of wider application to different sets of facts. In concluding that it was in his judgment appropriate for summary disposal, Lord Walker noted that it was "...a rare and extreme case...".

The majority (Lords Phillips, Walker and Brown) differed in their reasoning as to why the "blunt instrument" of *ex turpi causa* should not be overridden. Lord Walker and Lord Brown agreed that the principle in *Hampshire Land* (that it would be "unjust to its innocent participators (honest directors who were deceived, and shareholders who were cheated)" to fix a company with its directors' fraudulent intention) did not apply where there were no honest directors or shareholders and "*ex hypothesi* no innocent participator". They also agreed with the submissions made by Jonathan Sumption QC in the Court of Appeal as to why *ex turpi causa* is not trumped by "the very thing" argument.

Lord Phillips, however, giving the lead judgment, preferred to analyse the issue in terms of the scope of an auditor's duty of care – i.e., not whether the fraud should be attributed to the Company but whether *ex turpi causa* should defeat the Company's claim for breach of the auditor's duty, which "in turn depends, or may depend, critically on whether the scope of the auditor's duty extends to protecting those for whose benefit the claim is brought". In this case, the ultimate beneficiary of a successful claim would be those that the company defrauded, the banks. It was clear that Lord Phillips saw no prospect of (or did not wish himself to contemplate) an expansion of the present law so as to extend the duty of care owed by auditors for the benefit of those that a company might defraud. He concluded that all whose interests formed the subject of any duty of care owed by the Firm to the Company in this case, namely the Company's sole will and mind and beneficial owner Mr Stojevic, were party to the illegal conduct that formed the basis of the company's claim and it was on this basis that *ex turpi causa* provided a defence.

The Dissenting Judgments

In contrast to Lord Phillips, the dissenting judgments of Lord Mance and Lord Scott postulate that a duty is owed by auditors (as officers of the company) for the benefit of innocent creditors in the case of a company that is insolvent or threatened with insolvency and that *ex turpi causa* should not defeat a claim brought for their benefit. There is a lack of clarity in the judgments as to whether this would

amount to a departure from or at least an extension to the long established principles laid down by the House of Lords in *Caparo Industries v Dickman* [1990] 2 AC 603. That case established that the duties of an auditor are owed to the company in the interests of its shareholders as a body. No duty is owed directly to individual shareholders (because the shareholders' interests as a whole are protected by the duty owed to the company), and no duty is owed to creditors.

Lord Mance in particular was clearly influenced by policy considerations around some of the high profile frauds discovered in the current financial crisis. He points out that many large financial enterprises are run by one person and states that these are the very companies which auditors should be the most vigilant to protect. Referring, earlier in his Judgment, to auditors as watchdogs if not bloodhounds, he concludes that the decision of the majority of the Law Lords "will weaken the value of an audit and diminish auditors' exposure in relation to precisely those companies most vulnerable to management fraud".

Implications

The decision of the House of Lords and the judgments of the majority are obviously helpful to auditors. Whilst its application is clearly fact sensitive and will depend on the degree to which, in any given case, it is established that those responsible for the perpetrated fraud effectively amount to the "sole directing mind and will of the Company involved", its effect is not limited to so called 'one man' companies, so long as all those involved are complicit in the fraud and there are no "innocent participators". It is important to note that the case does not interfere with the principles of attribution derived from *Hampshire Land* whereby the intention of a dishonest agent who is not the directing mind and will of a company will not generally be attributed to it for the purposes of claims against others or so as to prevent indemnification of the innocent parties.

The claim in this case was one of the first significant claims to use commercial third party funding. It will be interesting to see if the result discourages similar claims or whether the absence of conformity of reasoning on the part of the majority, combined with powerfully expressed dissenting judgments and their emphasis on wider public policy factors, will instead encourage potential claimants and their backers in the current environment still to bring claims.

The decision of the House of Lords in this case will be the subject of a Webinar hosted by Mayer Brown's Accountants Group in conjunction with Brick Court Chambers (the Chambers of Jonathan Sumption QC and Tom Adam QC who acted for the successful auditors) in September. Formal invitations with further details will be sent shortly.

For further information about the matters raised in the case, please contact:

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