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Turning the World Upside Down: Fraud and Auditors' Negligence
Moore Stephens (a firm) v Stone & Rolls Limited (in liquidation) [2009] UKHL 39

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Introduction

Civil litigators will be aware of the *ex turpi causa* principle that the courts will not enforce a contract expressly or impliedly forbidden by statute or which has been made with the intention of committing an illegal act. The principle also provides that the courts will not assist a claimant to recover a benefit from his own illegal conduct. *Stone & Rolls* raised the issue of whether a company could rely on the fraud of its sole directing mind and will in an action against its auditors for professional negligence. The firm argued that the *ex turpi causa* principle provided a complete defence because the fraud could be attributed to the company and the company had to rely on the fraud in order to establish its claim against the firm; the alleged breach of duty was a failure to detect and stop a massive fraud committed by the company. The complexity of the issues was reflected in the division in the House of Lords (Lords Phillips, Walker and Brown v Lords Scott and Mance) although the firm's argument was upheld by the majority.

Background

S, a Croatian national, was a shadow director, the sole directing mind and will, and owner of Stone & Rolls Limited ("the Company"). He was also a fraudster who used the Company, in concert with an Austrian company, to defraud banks, in particular a Czech bank. Letters of credit were issued by the banks at the request of the Austrian company in relation to the non-existent sales of agricultural products by the Company to the Austrian company; the letters of credit were honoured by the banks when presented by the Company but the banks were not paid by the Austrian company. Funds paid to the Company in this way were immediately transferred to other persons so the Company never held those sums in any real sense. The fraud was discovered, and the Company and S were successfully sued for deceit by the banks. Even though the banks had been negligent, they obtained a judgment for \$94.5m which led to the Company's liquidation. Moore Stephens ("MS") were the Company's auditors when the fraud took place; S had replaced the Company's sole practitioner auditor with MS as part of his strategy to make the Company appear respectable in the eyes of European banks. MS were, in turn, duped by S who gave a fictitious account of the business that the Company had been doing and of the business whose accounts MS would be auditing. The Company's liquidators sued in the Company's name to recover damages for its creditors, principally the Czech bank. They claimed that MS, when carrying out their audit, were negligent in not detecting S's dishonesty and the pattern of fraud involving numerous fraudulent and irregular payments out by the Company to entities controlled by S; as but for this negligence, the fraudulent scheme would have come to an end.

MS applied to strike out the claim, accepting that it owed the Company a duty to exercise reasonable skill and care in carrying out their duties as auditors and, for the purposes of the application (akin to treating averments *pro veritate* at debate), accepting that they were in breach of that duty. However, MS argued that the claim was irrelevant because it was founded on the Company's fraud and defeated by the defence "ex turpi causa non oritur actio".

The Law

The ex turpi causa maxim is a matter of policy rather than discretion. The basis of the policy was set out by Lord Mansfield in *Holman v Johnson* (1775) 1 Cowp 341, 343:

"No court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act. If, from the plaintiff's own stating or otherwise, the cause of action appears to arise ex turpi causa, or the transgression of a positive law of this country, there the court says he has no right to be assisted. It is upon that ground the court goes; not for the sake of the defendant, but because they will not lend their aid to such a plaintiff."

As a defence in a case where a claimant seeks to recover a benefit from his own wrongdoing, it only applies where the claimant was personally at fault, so his responsibility for the wrongdoing was primary rather than vicarious.

In *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 A.C. 500 Lord Hoffmann, at [511], said that it was:

"A question of construction in each case as to whether the particular rule requires that the knowledge that an act has been done, or the state of mind with which it was done, should be attributed to the company."

A company's primary rules of attribution are found in its constitution (memorandum, articles) and are supplemented by the principles of agency (known as the general rules of attribution).

Decisions at first instance and in the Court of Appeal

The strike out application was refused by Langley J. ([2007] EWHC 1826 (Comm)). He first decided that the Company was the perpetrator, rather than the victim, of the fraud since it had not lost anything to which it was properly entitled, and that that the fraud of S could be attributed to the Company since the role of S was as clear an example of the "directing mind and will" as was perhaps likely to exist (at [5]). He concluded at [65] that he did not think the "conscience of the ordinary citizen" would find anything so repugnant in the Company pursuing its claim that would justify ruling it impermissible by application of the ex turpi maxim, adding that he was comforted in his conclusion by the fact that contributory negligence would apply to preclude any recovery that would benefit S. He noted at [7] that the Czech bank had no claim against MS since the latter owed the former no duty of care.

The Court of Appeal ([2008] 3 W.L.R. 1146) allowed the appeal and struck out the claim. Rimer L.J., with whom Keene and Mummery L.J.J. agreed, held that as S's fraud was attributed to the Company, the making of the claim by the Company against MS required the Company to rely on its own fraud and, therefore, ran head into the ex turpi causa principle. He further held that there was no basis for the Company's argument that ex turpi causa was not a defence when the prevention of

the fraud was “the very thing” that MS had been engaged to do since it was trumped by the policy behind *ex turpi causa* to defeat claims which relied on the claimant’s illegality.

Mummery L.J. at [114] held that to suggest that the corporate creature used by S as the vehicle for the fraud was the victim “turns the world upside down” and at [117] said:

“No duty of care is owed by the firm to the fraudster company, which was party to, and not itself a victim of, the fraud, to take reasonable care to detect its fraud.”

The House of Lords

Lord Phillips, with whom Lords Walker and Brown agreed, said that his initial reaction was that, as a matter of common sense, the claim by the Company could not succeed for three reasons: first, the Company could not be the victim of the fraud when it had suffered no loss due to the fact that it had started with nothing and had not legitimately acquired anything; secondly, as MS had itself been duped by the Company it did not seem just that the Company should be able to bring a claim in respect of the very conduct that it had set about inducing; and thirdly, since it would not be considered fair, just and reasonable for MS to owe a duty of care to the banks in respect of unlimited losses that they might sustain as a result of the fraud of the Company, then it would also not seem fair just and reasonable that they should achieve the same result through a claim brought by the Company’s liquidators for their benefit. Applying legal principles rather than common sense, he concluded at [18] that the *ex turpi* defence applied to those for whose benefit the claim was brought, i.e. the banks, fell outside the scope of any duty owed by MS (the duty was not owed to creditors) while the sole person for whose benefit such a duty was owed, namely S who owned and ran the Company, was responsible for the fraud.

Although MS had accepted for the purposes of the application that its breach of duty had caused loss, Lord Phillips said at [85] that to recover damages the Company would have to establish that the scope of the duty undertaken by MS extended to taking reasonable care to ensure that the Company was not used as a vehicle for fraud and that this duty was owed for the benefit of those that the company might defraud, which he could see no prospect of the Company establishing.

Lord Scott said that he had found the case very difficult but disagreed with the majority view because of the difference between a cause of action in negligence brought by a solvent company and a similar cause of action brought by an insolvent company; although in the former case any damages recovered would benefit the shareholders, as the Company was insolvent the damages would benefit the creditors so the public policy behind *ex turpi* was not engaged. He said, at [122], that the wielding of a rule of public policy in circumstances where public policy was not engaged constituted “in my respectful opinion, bad jurisprudence.” Both he and Lord Mance would have allowed the appeal.

Conclusion

The circumstances of *Stone & Rolls* were extraordinary and the application of *ex turpi* unusual. However, the decision has usefully reviewed the scope of the duty of care owed by auditors to its client company and of attribution to a company of acts of its agents. The clear lesson on the scope of the duty is that extreme care has to be taken in assessing and pleading the scope of any duty, while attribution always depends on the particular facts of the relationship between the company and its agent.