The scope and development of the illegality defence – key issues for auditors and directors

Liquidators of companies may have breathed a sigh of relief in April of this year when the UK Supreme Court held that the dishonest directors of a company could not rely upon the “illegality defence” to defeat a claim by the company against them. Patrick Perry considers the impact of this far reaching decision for auditors and company management.

Auditors are appointed by the client company to provide audit reports, which contain their opinion on the truth and fairness of the company’s annual accounts. In performing the audit tasks, auditors have essentially undertaken the duty to act as gatekeeper and watchdog of the company and its shareholders.

During the course of an audit, should an auditor fail to detect unlawful acts that ultimately cause loss to his client company, he can face the risk of being held liable to the client company for breach of his professional duties.

However, what if the unlawful acts were committed by one or several members of the management of the client company, and the company claims against the auditors for loss suffered as a result of the illegal conduct? Are there any limitations on the potential professional accountability of auditors? If the company is effectively itself guilty of dishonest conduct, is it right that it can bring a claim against its auditors?

This article will provide a brief overview on the illegality defence and its application in a corporate context for directors and auditors, in view of the recent UK Supreme Court judgment in the case of Jetivia SA and another v Bita (UK) Ltd and others [2015] UKSC23.

The illegality defence for auditors – Stone & Rolls

The Latin maxim ex turpi causa non oritur actio, also known as the illegality defence, prohibits a party that has engaged in unlawful conduct from seeking compensation from another party for the loss suffered owing to his
own illegal action. Put simply, where a claimant has to rely on his own illegal act to make out a claim, that claim must fail.

In Moore Stephens v Stone & Rolls Limited [2009] 1 AC 1391, the auditors involved, Moore Stephens, successfully relied on the illegality defence to bar a claim from their client company, Stone & Rolls Limited.

In that case, the controlling shareholder of Stone & Rolls, Mr. Stojevic, used Stone & Rolls to deliberately carry out a scheme to defraud banks, and then pay away monies to himself or other of his companies. As a result, the company became heavily insolvent and entered into liquidation. Stone & Rolls brought a claim against Moore Stephens for failing to detect that Stone & Rolls' transactions were fraudulent and bogus and for delay in stopping the continuing fraud.

The House of Lords, by a 3:2 majority, held that Moore Stephens were entitled to rely on the illegality defence to strike out the claim by Stone & Rolls. In summary, the House of Lords was of the view that Mr. Stojevic was the only shareholder, the sole director and controlling mind of the company, and hence Stone & Rolls was vested with the knowledge of the fraudulent scheme. Although Moore Stephens owed a duty of care to their client company and its shareholders, Stone & Rolls was precluded from suing its auditors in order to take advantage of and obtain benefit from its own fraud.

Applicability of the decision in Stone & Rolls

A company, as a persona ficta, is a separate legal entity but in reality, it can only act through individuals. The House of Lords in Stone & Rolls attributed the fraud or dishonesty of the company’s “directing mind and will” to the company. By attributing the unlawful conduct of Mr. Stojevic to the company itself, the fraud was treated as the conduct of the company. The auditors could then rely on the illegality defence to prevent the company from pursuing a claim against them.

Nonetheless, one should not forget the unique facts underlying Stone & Rolls:

1. Stone & Rolls was formed and run for the exclusive purpose of fraud, and was along used as a vehicle of fraud;
2. Stone & Rolls was a one-man company acting through and completely under the control of Mr. Stojevic, who was the sole shareholder and the directing mind and will of the company. Mr. Stojevic was the only human emanation of Stone & Rolls – the company and the fraudster were in effect one and the same person;
3. It was the fraud with which the claim was entirely concerned.

The question that Stone & Rolls left undetermined is whether the illegality defence can still assist auditors in limiting their liability, when there are other non-culpable members in the management and/or ownership of the company who are unconnected with the fraud, or when the company has engaged in otherwise legitimate business apart from the fraud.

Position in Hong Kong – Moulin

As can be seen from Stone & Rolls, when an auditor faces a claim from its client company, in order to establish a basis for the illegality defence, the auditor will have to show that the fraud, which is the foundation of the company’s claim, should be treated as the conduct of the company itself (and not merely as conduct for which the company may be vicariously liable).

In Hong Kong, the rules relating to attribution have been considered and analysed in Moulin Global Eyecare Trading (in Liquidation) v The Commissioner of Inland Revenue (FACV 5/2013).

Moulin was considered and applied in Jetivia. The same judge, Lord Walker, heard both Stone & Rolls and Moulin. The two jurisdictions are therefore closely intertwined on this issue.

The case concerns a company, Moulin Global Eyecare Trading Limited, which ceased trading in 2005 and was wound up in June 2006. Later, the liquidators discovered that the profits of Moulin had been fraudulently inflated through fictitious sales by its then management over a period of 6 tax years. The company paid almost HK$89 million in profits tax, which was assessed pursuant to the Inland Revenue Ordinance (Cap. 112).

In Hong Kong, the rules relating to attribution have been considered and applied in Moulin Global Eyecare Trading (in Liquidation) v The Commissioner of Inland Revenue (FACV 5/2013).

The Commissioner rejected the liquidators’ claim on the grounds that the profits tax returns were submitted by the company with knowledge of the relevant fraud. The liquidators consequently applied for judicial review and the case went to the Court of Final Appeal.

The Court of Final Appeal held that the fraudulent knowledge of the directors should be attributed to the company, such that Moulin in effect knew that the profits had been grossly inflated when the relevant returns were filed.

The reasoning of the Court of Final Appeal was based upon questions of attribution of knowledge and what is known as the fraud exception.

When considering the rules of attribution, the Court repeated the various tests (from Meridian Global Funds Management Asia Limited v Securities Commission [1995] 2 AC
Most importantly, when considering the illegality defence, the Court stressed that the rule of attribution is sensitive to the factual situation in which the questions of attribution arise, and the language and legislative purpose of any relevant statutory provisions. Therefore, context, including the statutory context, should be of fundamental importance.

The fraud exception, also known as the Hampshire Land principle, prevents the knowledge of an agent who is defrauding his principal in the same transaction being attributed to the principal. The underlying rationale of this doctrine is to avoid the injustice and absurdity of directors or other members of the management of a company relying on the obvious awareness of their own wrongdoing as a defence to a claim against them by their own company.

In Moulin, consideration was given to the inter-play between the rules of attribution and the fraud exception.

Lord Walker of Gestingthorpe NPJ, in his leading judgment in Moulin, considered that the crucial distinction depended upon the nature of the proceedings in which the issue of attribution applies:-

1. If the company is being sued by a third party (which may be an official body) because the company is responsible for the dishonest conduct of its directors or employees, the fraud exception does not apply. The knowledge of the dishonest directors may therefore be attributed to the company, and it may be found liable to the third party for that dishonest conduct.

2. However, the fraud exception will apply in situations where the company itself is seeking to make its own dishonest directors accountable for the loss the company has suffered. This is because it would be unjust to permit a fraudulent director to use his own breach of duty to his corporate employer as a defence. In those circumstances, the director cannot say that his dishonest conduct is attributed to the company, such that the “dishonest” company cannot bring a claim against him.

Where do auditors fit within this classification? Unfortunately for auditors, Lord Walker in Moulin felt that where the auditor had undertaken to use reasonable professional skill to uncover fraud, there was no reason for the law to absolve them of their contractual obligations. Internal fraud was the “very thing” from which the auditors had a duty to protect the company. His comments were, however, obiter and therefore non-binding.

Jetivia SA and another v Bilta (UK) Ltd and others

The UK Supreme Court handed down its much anticipated judgment in Jetivia SA and another v Bilta (UK) Ltd and others [2015] UKSC 23 on 22 April 2015. By a unanimous decision, the seven Supreme Court judges dismissed the appeal by Swiss company Jetivia and its chief executive to strike out Bilta (UK) Limited’s claims against them on the basis of the illegality defence.

Bilta was compulsorily wound up by the High Court in November 2009. Following the winding up, the liquidators brought proceedings against Bilta’s two directors (one of whom was also the sole shareholder) together with Jetivia SA, for conspiracy and dishonest assistance.

The claim alleged that the two directors caused Bilta to engage in fraudulent trading, such that Bilta had a claim for damages against the directors. The directors argued that Bilta was a vehicle for the fraudulent scheme, and the illegality defence should bar Bilta, as a party to the illegality, from suing the directors as a means of recovering the company’s loss.

The Supreme Court, consistent with the decision of the Court of Final Appeal in Moulin, found that it would be unjust and absurd to allow the directors to escape liability for their breaches of fiduciary duty by attributing to the company the very misconduct by which the directors had damaged it. In the circumstances of the case, the illegality defence could not be relied on.

Clarification of the rules of attribution

The rules of attribution, as well as the limited scope of the fraud exception, have been clarified by the Supreme Court to the effect that directors cannot avoid the consequences of their own fraud by attributing their conduct to the company and using it as a defence to a claim brought against them by the company or its liquidators :-

“where a company has been the victim of wrong-doing by its directors, or of which its directors had notice, then the wrong-doing, or knowledge, of the directors cannot be attributed to the company as a defence to a claim brought against the directors by the company’s liquidator, in the name of the company and/or on behalf of its creditors”

This was held to be the case even where the directors were the only directors and shareholders of the company, and even though the wrongdoing or knowledge of the directors may be attributed to the company in other types of proceedings.

At the same time, the Court recognised that the position would be different as between the company and a defrauded third party who was not involved in the directors’ breach of duty. In this case, the company should be treated as a “perpetrator of the fraud”. As observed by Lord Sumption :-

“for a person, where natural or corporate, who is culpable of fraud to say to an innocent but negligent outsider that he should have stopped him in his dishonest enterprise is as clear a case for the application of the illegality defence as one could have”
But what about auditors? Well, the Supreme Court was not prepared to shut the door on the defence of ex turpi causa applying to protect an auditor when sued by a company, whose directors may have been involved in fraudulent conduct.

As with all of the judgments on this issue, there was disagreement amongst the Law Lords involved.

Lord Mance regarded it as an open question.

Lord Neuberger clearly struggled with the defence applying to auditors and said: “it is very hard to derive much in the way of reliable principle from the decision of the House of Lords in Stone & Rolls”, before going on to describe it as a case to be “put on one side and marked ‘not to be looked at again’.”

A ray of light can however be found in the judgment of Lord Sumption who held that:

“For a person, whether natural or corporate, who is culpable of fraud to say to an innocent but negligent outsider that he should have stopped him in his dishonest enterprise is as clear a case for the application of the illegality defence as one could have.”

On this basis, Lord Sumption was prepared to find that the illegality defence was correctly applied in Stone v Rolls to protect the auditor.

**Conclusion**

*Jetivia* has confirmed beyond doubt that a dishonest director (unsurprisingly) cannot say that his own fraudulent conduct should be attributed to the company, to prevent a claim being made by the company against him.

Conversely, if an innocent third party is seeking to bring a claim against the company, the dishonest conduct of a director may be attributed to the company, to make it liable.

Auditors, however, fall into that grey area, where they are not to be regarded as wholly innocent third parties, because of the duties they have to the company to identify inaccuracies in their accounts.

The House of Lords in Stone & Rolls opened the doors for the illegality defence to be used by auditors in negligence claims from their client companies. The Hong Kong Court of Final Appeal in Moulin sought to limit the scope of application for this defence. The UK Supreme Court in *Jetivia* has kept the door ajar – and the defence will remain available in certain circumstances. These are likely to be where the company is a “one-man” company: one that is entirely owned and controlled by an individual or where there is no other person concerned in the management or ownership of the company who was not implicated in the wrongdoing. In situations where there are other innocent members in the management of the company, to apply the illegality defence will prove a far greater challenge. The reality is that rules of attribution are highly fact sensitive and ultimately, the answer will depend on the circumstances in which the question of attribution arises. The Court will, in effect, often work backwards from the decision that it wants to reach.

The whole subject is a source of considerable judicial confusion. Lord Walker appeared in both the House of Lords in Stone & Rolls and the Hong Kong Court of Final Appeal in Moulin. As he accepted, his decisions were not consistent.

Typically, five Justices hear a case in the Supreme Court. In Jetivia, there was an enlarged panel of seven. Notwithstanding that, Lord Neuberger suggested that the illegality defence should be considered by a panel of nine Justices as soon as appropriately possible. This illustrates the difficulty and inconsistency with the law in this area.

Auditors may therefore take some comfort from the fact that the Supreme Court decision of *Jetivia* does not preclude them relying upon the illegality defence in certain circumstances. Applying the defence will not be straightforward, but it must be remembered that this is but one of the many potential defences that may be available to an auditor who is sued by their client company for failing to detect fraud by the management.

In the first instance, the primary responsibility for preparing accurate management accounts remains with the directors. As Lord Justice Lopes famously said, an auditor is a “watchdog” and not a “bloodhound”: he is not bound to be a detective, or, to approach his work with suspicion, or with a foregone conclusion that there is something wrong. The fact that the auditor has failed to detect management fraud does not, without establishing negligence, make him liable.

Furthermore, in cases of management fraud, causation arguments may prove to be a major battleground. If there was systemic fraud amongst the management, even had the auditor detected it, it may have had no consequences in terms of the losses that the company has suffered.

There may also be arguments available that deductions should be made for contributory negligence. This is another complex area, with highly inconsistent decisions. However, in Barings Plc v Coopers & Lybrand, the court held that Barings was partially to blame for the losses it suffered arising from the fraudulent conduct of its employee, (the infamous) Nick Leeson, to give rise to substantial reductions in the damages awarded as a result of contributory negligence.

Finally, auditors should consider the potential for contribution claims against third parties, which can include fraudulent directors, or even the company itself. Under English and Hong Kong law, an auditor is precluded from obtaining an indemnity from the company, but the position is not the same in other jurisdictions. Where the audit engagement may be subject to the laws of other territories,
it may be possible to counter-claim for an indemnity, subject to the Articles of the Company, the terms of the Engagement Letter and the local law. Auditors faced with claims by liquidators of insolvent companies, where management fraud has arisen, should therefore consider the scope for application of the illegality defence, and the further arguments outlined above. The only certainty arising from the decisions of Stone & Rolls, Moulin and Jetivia is that this will not be the last word we will hear on this issue. Already, Canada is keen to join the debate, and its Supreme Court will shortly be grappling with these arguments. We will keep you updated accordingly.

Further information
If you would like further information on any issue raised in this update please contact:

Patrick Perry
E: patrick.perry@clydeco.com
Clyde & Co
58th Floor, Central Plaza
18 Harbour Road
Wanchai, Hong Kong
T: +852 2878 8600
F: +852 2522 5907

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