HOUSE OF LORDS SESSION 2008–09
[2009] UKHL 39
on appeal from:[2008] EWCA Civ 644

OPINIONS
OF THE LORDS OF APPEAL
FOR JUDGMENT IN THE CAUSE

Moore Stephens (a firm) (Respondents) *v* Stone Rolls Limited (in liquidation (Appellants)

Appellate Committee

Lord Phillips of Worth Matravers
Lord Scott of Foscote
Lord Walker of Gestingthorpe
Lord Brown of Eaton-under-Heywood
Lord Mance

Counsel

Appellant:	*Respondent*:
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Mark Simpson QC	Jonathan Sumption QC
David Murray	Tom Adam QC
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LORD PHILLIPS OF WORTH MATRAVERS

My Lords,

Introduction

1. Mr Stojevic is a fraudster. He used the appellant company, ("S&R") as a vehicle for defrauding banks. The fraud was discovered and both S&R and Mr Stojevic were successfully sued for deceit by the principal victim, Komercni Bank SA ("the Bank"). The respondent, Moore Stephens, were S&R's auditors. Moore Stephens accept that they owed S&R a duty to exercise reasonable skill and care in carrying out their duties as auditors. For purposes of the present argument they also accept that they were in breach of that duty and that, but for their breach, the fraud that Mr Stojevic was perpetrating through S&R would have ended earlier. In this action S&R seek to recover losses caused to them in consequence of the extension of the period of their fraudulent activity that they submit was caused by Moore Stephens' breach of duty. Moore Stephens contend that this claim cannot succeed because it is founded on S&R's fraud and is met by the defence commonly described by the Latin maxim "*ex turpi causa non oritur actio*" ("*ex turpi causa*"). Whether *ex turpi causa* provides a defence to the claim advanced by S&R is the preliminary issue raised by this appeal.

2. Although he was a 'shadow director' acting under power of attorney and the shares in S&R are held in the name of a family trust it has been common ground that Mr Stojevic was the sole directing mind and will and the beneficial owner of S&R.

3. I have had the benefit of reading in draft the opinion of each of your Lordships. Each has summarised the nature of the fraud perpetrated by Mr Stojevic through S&R. It involved S&R obtaining payments under letters of credit by presenting to banks false documents in relation to fictitious commodity trading. My noble and learned friend Lord Mance has explained in a little more detail how the fraud worked. When the fraud was ultimately discovered, the monies fraudulently obtained by S&R had all been paid away to other participants in the fraud. The damages awarded to the Bank against S&R and Mr Stojevic exceed $94 million. Neither defendant could satisfy the judgment. The liquidators have started the present action in the name of S&R in an attempt to recover damages for the benefit of S&R's creditors, who are the banks defrauded by S&R. The claim for breach of Moore Stephens duty of care is brought in both contract and tort.

4. Mr Stojevic had planned to use S&R to perpetrate this fraud before Moore Stephens were engaged, indeed the engagement of Moore Stephens was part of his plot. S&R, which was not at the material time carrying on any significant business, had an auditor who was a sole practitioner based in Rotherhithe. Mr Stojevic decided to replace him with Moore Stephens as part of a strategy to make S&R appear respectable in the eyes of European Banks. In persuading Moore Stephens to become S&R's auditors, Mr Stojevic gave a fictitious account of the business that S&R had been doing and of the business whose accounts Moore Stephens would be auditing.

5. My initial reaction to S&R's claim was that, as a matter of common sense, it could not succeed. There were three reasons for this reaction. The first was that S&R are seeking to put themselves forward as the victims of fraud when they were, in fact, the perpetrators of the fraud. The true victims of the fraud were the banks. True it is that S&R are now subject to a paper liability to the Komercni Bank of over $94m, but common sense would suggest that this is not really a loss that they have suffered. They started with nothing and their alleged losses are sums that they acquired by fraud and then paid away as part of the same fraudulent transaction. If a person starts with nothing and never legitimately acquires anything he cannot realistically be said to have suffered any loss. This was the reasoning of Mummery LJ who, in a short judgment in the Court of Appeal, agreed with Rimer LJ that the claim of S&R should be struck out. Keene LJ agreed with both judgments. Mummery LJ concluded his judgment:

> "119. Does common sense matter? Yes. 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 second reason why common sense led me, initially, to consider that S&R's claim should not succeed was that Moore Stephens were also the victims of S&R's fraud. They were induced to agree to act as S&R's auditors by a fictitious and fraudulent account of S&R's business, given to them on behalf of the company by Mr Stojevic, and they were deceived in carrying out their audits by accounts fraudulently prepared on behalf of the company, albeit that it is for present purposes to be assumed that they were negligent in not detecting the fraud. It does not seem just that, in these circumstances, S&R should be able to bring a claim in respect of the very conduct that S&R had set about inducing. The final reason of common sense that predisposed me against this claim was one which would not, unlike the other two, occur to the man in the street but might occur to a student with knowledge of the principles of the law of negligence. Looking at the realities, this claim is brought for the benefit of banks defrauded by S&R on the ground that Moore Stephens should have prevented S&R from perpetrating the frauds. Why, if this is a legitimate objective, should the banks not have a direct cause of action in negligence against Moore Stephens? One answer, I would suggest, is that a duty of care in negligence will only arise where this is fair, just and reasonable. It would not be considered fair, just and reasonable for auditors of a company to owe a duty of care to an indeterminate class of potential victims in respect of unlimited losses that they might sustain as a result of the fraud of the company. If it would not be fair, just and reasonable for the banks to have a direct claim, then it would 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. In a lecture to the Chancery Bar Association entitled "Common Sense and Causing Loss" given on 15 June 1999 Lord Hoffmann commented adversely on the practice of those judges who justify their decisions by reference to "common sense". He suggested that this was far too often an unsatisfactory alternative to the identification of the relevant principles. The differences of opinion between the members of the committee underline the need to identify the relevant principles that apply in this case. It also underlines the difficulty of that task. The first step is to identify the issues raised by the parties.

The issues raised by the parties

6. This appeal arises out of a strike-out application in which only one of a number of possible defences to the claim is advanced. Mr Sumption QC for Moore Stephens has admitted that his clients owed S&R a duty to exercise reasonable care in relation to the auditing of S&R's accounts and, for the purpose of these proceedings, that they were in breach of that duty. He submits, however, that S&R are precluded from claiming a remedy for that breach of duty by a defence of public policy, namely *ex turpi causa.* He submits that the nature and extent of this defence has been definitively determined by the decision of this House in *Tinsley v Milligan* [1994] 1 AC 340. It involves the application of what he has described as a "*reliance"* test. A claimant cannot succeed if, in order to make good his claim, he has to aver and rely upon his own illegal conduct. This principle, so he submits, is not based as it was once thought to be upon a disinclination by the courts to award a remedy in circumstances where this would be "an affront to the public conscience". It is simply a principle that the court will not allow its process to be used to further an object which is, on its face, illegal. The principle applies automatically and inflexibly. The "effect of illegality is not substantive but procedural" – *Tinsley v Milligan* at p. 374. To apply the test you have to do no more than consider the essential averments of the particulars of claim. Mr Sumption submits that in *Tinsley v Milligan* this House reduced *ex turpi causa* to "the narrowest possible test for the public policy defence short of actually discarding it".

7. Mr Sumption submits that the best explanation of the reason for the *ex turpi causa* defence is that suggested by McLachlin J in *Hall v Hebert* (1993) 101 DLR (4th) 129, at p.165:

> "…to allow recovery in these cases would be to allow recovery for what is illegal. It would put the courts in the position of saying that the same conduct is both legal, in the sense of being capable of rectification by the court, and illegal. It would, in short, introduce an inconsistency in the law. It is particularly important in this context that we bear in mind that the law must aspire to be a unified institution, the parts of which – contract, tort, the criminal law – must be in essential harmony. For the courts to punish conduct with the one hand while rewarding it with the other, would

> be to ‘create an intolerable fissure in the law’s conceptually seamless web’: Weinrib – “Illegality as a Tort Defence” (1976) 26 U.T.L.J.28 at p. 42. We thus see that the concern, put at its most fundamental, is with the integrity of the legal system”.

8. Mr Sumption has accepted that the “reliance” test is subject to one important qualification. The unlawful conduct relied on must be that of the claimant himself, not conduct for which he is vicariously liable or which is otherwise attributed to him under principles of the law of agency.

9. The first answer to Mr Sumption’s case advanced on behalf of S&R by Mr Brindle QC founds on that qualification. He submits that S&R’s liability to the banks for Mr Stojevic’s fraud is vicarious. The second answer is that, whether the first answer is right or wrong, for the purposes of the application of *ex turpi causa*, Mr Stojevic’s fraud cannot be attributed to S&R. In support of this submission Mr Brindle relies (i) on a principle of the law of agency known as the *Hampshire Land* principle after the decision in *In re Hampshire Land Company* [1896] 2 Ch 743, and (ii) on the principles governing the attribution of actions and states of mind to companies identified in the speech of Lord Hoffmann in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500.

10. Both Mr Brindle’s first and second answers proceed on the premise that Mr Sumption’s “reliance” test is correctly formulated. They accept that the reliance test applies to the facts of this case and that, in applying it, a company has to be treated in the same way as a natural person. He has, however, an alternative and more fundamental answer to Mr Sumption. He submits that *ex turpi causa* does not provide a defence where the claimant’s illegal conduct was *the very thing* that the defendant was under a duty to prevent. Here again he founds his argument on jurisprudence that relates to natural persons.

11. Finally, and very much as a fall-back position, Mr Brindle submits that *ex turpi causa* applies only where this is “fair, just and reasonable” and that it is not fair, just and reasonable that the defence should apply in the circumstances that have given rise to this appeal.

12. The debate between the parties has largely centred on the nature and effect of the *Hampshire Land* principle. Mr Sumption summarised this principle as follows in oral argument:

> "There is not to be imputed to a company a fraud which is being practised against it even if it is being practised by someone whose acts and state of mind in the ordinary way are attributed to the company."

Mr Sumption submits that this principle does not prevent attribution to S&R of Mr Stojevic's fraud which was directed not against S&R but against the banks.

13. Mr Brindle does not accept that the *Hampshire Land* principle is as narrow as this. He submits that it also applies in respect of fraud on the part of an agent of the company that is directed against a third party in as much as the fraud is likely ultimately to come home to roost with consequent detriment to the company. Thus the company is a secondary victim of the fraud. That is precisely what has happened in this case, for S&R has been held liable for Mr Stojevic's fraud.

14. Mr Sumption has a fall back position that meets this argument. It turns on the fact that Mr Stojevic was, in effect, the sole shareholder in S&R and also solely responsible for S&R's activities. Mr Sumption submits that where there is no human embodiment of the company other than the fraudster, attribution of the fraud to the company is inevitable.

The decisions of the Courts below

15. Both Langley J at first instance and the Court of Appeal accepted that the relevant issues were those that I have just described. Langley J rejected the first two answers advanced by Mr Brindle to *ex turpi causa*. He held that S&R were primarily, and not just vicariously, responsible for the fraudulent conduct and that the *Hampshire Land* principle did not apply. Mr Stojevic's fraud was properly attributed to S&R. He accepted, however, Mr Brindle's third answer. He held that *ex turpi causa* could not prevent a claim founded on fraud that would not have occurred had Moore Stephens properly complied with their "very duty" as auditors of the company.

16. Rimer LJ, in giving the leading judgment in the Court of Appeal, agreed that *Hampshire Land* did not apply, but for a different reason. He held that the critical question was whether it was right to treat S&R as the villain or the victim. In the former case the fraud would be attributed to S&R; in the latter case it would not. He held that S&R was the villain and not the victim, *Hampshire Land* did not apply and *ex turpi causa* was a defence to S&R's claim. Thus he accepted Mr Sumption's definition of *Hampshire Land* and rejected Mr Brindle's wider definition.

17. Rimer LJ rejected Mr Brindle's argument based on the principle that he described as "the very thing". He accepted Mr Sumption's submission that this was a principle that related to causation and that it did not displace the operation of the defence of *ex turpi causa*.

A Summary of my conclusions

18. In order to assist in following this lengthy opinion I propose at this stage to summarise my conclusions:

1) Under the principle of *ex turpi causa* the court will not assist a claimant to recover compensation for the consequences of his own illegal conduct.

2) This appeal raises the question of whether, and if so how, that principle applies to a claim by a company against those whose breach of duty has caused or permitted the company to commit fraud that has resulted in detriment to the company.

3) The answer to this question is not to be found by the application of *Hampshire Land* or any similar principle of attribution. The essential issue is whether, in applying *ex turpi causa* in such circumstances, one should look behind the company at those whose interests the relevant duty is intended to protect.

4) While in principle it would be attractive to adopt such a course, there are difficulties in the way of doing so to which no clear resolution has been demonstrated.

5) On the extreme facts of this case it is not necessary to attempt to resolve those difficulties. Those for whose benefit the claim is brought fall outside the scope of any duty owed by Moore Stephens. The sole person for whose benefit such duty was owed, being Mr Stojevic who owned and ran the company, was responsible for the fraud.

6) In these circumstances *ex turpi causa* provides a defence to the claim.

The duties of auditors

19. I agree with my noble and learned friend Lord Mance that the starting point for considering the issues raised by this appeal is the duties undertaken by Moore Stephens as auditors. I am grateful for his detailed and helpful analysis. I would summarise the position as follows. The leading authority is *Caparo Industries Plc v Dickman* [1990] 2 AC 603. The duties of an auditor are founded in contract and the extent of the duties undertaken by contract must be interpreted in the light of the relevant statutory provisions and the relevant Auditing Standards. The duties are duties of reasonable care in carrying out the audit of the company's accounts. They are owed to the company in the interests of its shareholders. No duty is owed directly to the individual shareholders. This is because the shareholders' interests are protected by the duty owed to the company. No duty is owed to creditors – *Al Saudi Banque v Clarke Pixley* [1990] Ch 313. The Auditing Standards require auditors who have reason to suspect that the directors of a company are behaving fraudulently to draw this to the attention of the proper authority. The scope of the duty of care owed by auditors is a matter to which I shall return later in this opinion. For present purposes it suffices to note that the duty is unquestionably imposed in the interests of, at least, the shareholders of the company.

Ex turpi causa

20. *Ex turpi causa* is a principle that prevents a claimant from using the court to obtain benefits from his own illegal conduct. In the years immediately before the decision in *Tinsley v Milligan* the courts had developed a flexible approach to the defence of illegality, applying the test of whether, having regard to the illegality involved in the case, it would "shock the public conscience" to afford the claimant the relief sought. This test has been said to have originated from the judgment of

Hutchison J in *Thackwell v Barclays Bank plc* [1986] 1 All ER 676 although reference to shocking the public conscience can be traced back at least to the judgment of Salmon LJ in *Gray v Barr* [1971] 2 QB 554 at p. 581. *Tinsley v Milligan* involved a dispute between two single women as to title to a house. The house had been purchased with their joint funds, but put into the sole name of the appellant. The reason for this was to facilitate fraudulent claims by the respondent on the Department of Social Services. The respondent claimed that, as the property had been bought with joint funds it was held on a resulting trust under which she had an equitable interest. The appellant contended that the respondent was precluded from asserting her claim because of the illegal purpose of the arrangement. The Court of Appeal, by a majority, had found in favour of the respondent, applying a test of whether, having regard to the illegality, it would be "an affront to the public conscience" to grant the relief sought. This House was in agreement that this was not the correct test. There was not, however, unanimity as to the correct approach to illegality. Lord Keith of Kinkel and Lord Goff of Chieveley would have allowed the appeal on the basis that the respondent was not entitled to equitable relief because the effect of the illegality was that she did not come to the court with "clean hands". The reasoning of the majority appears from the following passages of the speech of Lord Browne-Wilkinson at pp. 369, 375 and 377:

> "… it is now clearly established that at law (as opposed to in equity), property in goods or land can pass under, or pursuant to, such a contract. If so, the rights of the owner of the legal title thereby acquired will be enforced, provided that the plaintiff can establish such title without pleading or leading evidence of the illegality. . . .
>
> … A party to an illegality can recover by virtue of a legal or equitable property interest if, but only if, he can establish his title without relying on his own illegality.
>
> . . .
>
> …In a case where the plaintiff is not seeking to enforce an unlawful contract but founds his case on collateral rights acquired under the contract (such as a right of property) the court is neither bound nor entitled to reject the claim unless the illegality of necessity forms part of the plaintiff's case."

21. The House in *Tinsley v Milligan* did not lay down a universal test of *ex turpi causa*. It was dealing with the effect of illegality on title to

property. It established the general principle that, once title has passed, it cannot be attacked on the basis that it passed pursuant to an illegal transaction. If the title can be asserted without reliance on the illegality, the defendant cannot rely on the illegality to defeat the title. This principle had been applied in the case of personalty in *Bowmakers Ltd v Barnet Instruments Ltd* [1945] KB 65. The House held that it also applied in the case of both legal and equitable title to realty. The House did not hold that illegality will never bar a claim if the claim can be advanced without reliance on it. On the contrary, the House made it plain that where the claim is to enforce a contract the claim will be defeated if the defendant shows that the contract was for an illegal purpose, even though the claimant does not assert the illegal purpose in making the claim – see *Alexander v Rayson* [1936] 1 KB 169, approved by Lord Browne-Wilkinson at p. 370.

22. *Hewison v Meridian Shipping Services Pte Ltd* [2002] EWCA Civ 1821; [2003] PIQR P252 illustrates another situation in which *ex turpi causa* defeated a claim albeit that the illegality was not asserted by the claimant.

23. In *Cross v Kirkby* (CA 18.2.2000) Beldam LJ remarked:

> "I do not believe that there is any general principle that the claimant must either plead, give evidence of or rely on his own illegality for the principle to apply. Such a technical approach is entirely absent from Lord Mansfield's exposition of the principle"

I agree with that observation.

24. In *Tinsley v Milligan* the *ex turpi causa* defence failed because the respondent did not need to plead the illegal agreement in order to establish her equitable title. Mr Sumption relies on the decision as establishing a general principle that is the converse of that applied by the majority of the House. This is that if the claimant has to rely on his own illegality to establish his claim the courts will *never* entertain the claim ("the reliance test"). I have already noted that Mr Sumption advanced one qualification to this rule – it only applies where the illegality is personal to the claimant, not vicarious. In the course of argument when dealing with *United Project Consultants Pte Ltd. v Leong Kwok Onn* [2005] SGCA 38; [2005] 4 SLR 214 he accepted

another qualification. The illegality must involve turpitude. The defence may not apply where the claimant's illegality consists of an offence of strict liability of which he is unaware. Those, as I shall shortly show, are valid qualifications to the defence of *ex turpi causa* in the context in which it is raised on this appeal. They are not, however, of general application to the defence of *ex turpi causa*.

25. Although *Tinsley v Milligan* does not establish a general rule that if a claimant founds his claim on his own illegal conduct, the defence of *ex turpi causa* will apply, earlier cases support this principle: *Marles v Philip Trant & Sons Ltd* [1954] 1 QB 29*; Archbolds (Freightage) Ltd v S. Spanglett Ltd* [1961] 1 QB 374. I do not believe, however, that it is right to proceed on the basis that the reliance test can automatically be applied as a rule of thumb. It is necessary to give consideration to the policy underlying *ex turpi causa* in order to decide whether this defence is bound to defeat S&R's claim. As Lord Hoffmann recently remarked in *Gray v Thames Trains Ltd* [2009] UKHL 33; [2009] 3 WLR 167 at para 30:

> "The maxim *ex turpi causa* expresses not so much a principle as a policy. Furthermore, that policy is not based upon a single justification but on a group of reasons, which vary in different situations".

The underlying policy

26. The policy underlying *ex turpi causa* was explained by Lord Mansfield in 1775 in *Holman v Johnson* 1 Cowp. 341, 343; 98 ER 1120, 1121:

> "The objection, that a contract is immoral or illegal as between plaintiff and defendant, sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; but it is founded in general principles of policy, which the defendant has the advantage of, contrary to the real justice as between him and the plaintiff, by accident, if I may so say. The principle of public policy is this; ex dolo malo non oritur actio. 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 causâ, 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. So if the plaintiff and defendant were to change sides, and the defendant was to bring his action against the plaintiff, the latter would then have the advantage of it; for where both are equally in fault, potior est conditio defendentis.

The policy can be subdivided into two principles in relation to contractual obligations:

(i) The court will not enforce a contract which is expressly or impliedly forbidden by statute or that is entered into with the intention of committing an illegal act.

(ii) The court will not assist a claimant to recover a benefit from his own wrongdoing. This extends to claims for compensation or an indemnity in respect of the adverse consequences of the wrongdoing – see *Beresford v Royal Insurance Co Ltd* [1938] AC 586.

It is the second principle that is in play on this appeal.

Qualifications to the second principle

27. The two qualifications recognised by Mr Sumption apply in respect of the second, but not the first principle. Thus they apply to the type of claim with which your Lordships are concerned. S&R are not seeking to enforce an illegal agreement. They are seeking compensation for the adverse consequences of having engaged in unlawful conduct. A number of authorities to which we have been referred support Mr Sumption's acceptance that in these circumstances the defence of *ex turpi causa* will only apply where the claimant was personally at fault and thus where his responsibility for wrongdoing was primary rather than vicarious: *Burrows v Rhodes and Jameson* [1899] 1 QB 816; *Hardy v Motor Insurers' Bureau* [1964] 2 QB 745 at p.760; *Lancashire County Council v Municipal Mutual Insurance Ltd* [1997] QB 897 at p. 908; *United Project Consultants Pte Ltd v Leong*

Kwok Onn [2005] 4 SLR 214. Furthermore, there has never been any suggestion that it is contrary to public policy for a company to insure against liabilities that it may vicariously incur as a consequence of the wrongdoings of its agents. *Arab Bank plc v Zurich Insurance Co* [1999] 1 Lloyd's Rep 262 was such a case.

28. Thus Mr Sumption is correct to accept that, in the context of a claim for compensation for the adverse consequences of wrong-doing, *ex turpi causa* applies where the wrongdoing is personal, or primary, but not where it is vicarious.

The Consequences of Moore Stephens' primary case

29. The consequences of Moore Stephens' primary case are best considered in a case where the facts are not as extreme as those with which your Lordships are concerned. Assume that a company carries on legitimate business, owns legitimate assets and has shareholders who are not complicit in the conduct of the man who runs the company, "the directing mind and will" of the company. Assume that the directing mind and will, in breach of his duties to the company, involves the company in fraudulent trading and that this causes the company to sustain losses. On Moore Stephens' primary case, as Mr Sumption accepted, a claim for damages for misfeasance against the directing mind and will would be defeated by the defence of *ex turpi causa* on the ground that the directing mind and will's turpitude was attributed to the company.

30. Assume that the auditors of the company had negligently failed to identify the fact that the directing mind and will was acting fraudulently, with the consequence that his fraud was permitted to continue. The company's claim against the auditors for the benefit of its shareholders, whose interests the auditors should have protected, would be barred by the very wrongdoing that the auditors' negligence had permitted to occur.

31. Mr Brindle would avoid these consequences in one of two ways. First he says that the fraud of the directing mind and will does not fall to be treated as the fraud of the company for the purposes of *ex turpi causa*. This is because where the company becomes a victim of the fraud, although the fraud is directed at a third party, the *Hampshire Land* principle prevents the fraud from being attributed to the company.

Alternatively he argues that where the fraud is "the very thing" that the defendant was under a duty to prevent, *ex turpi causa* does not apply at all.

The opinions of the Committee

32. My noble and learned friends Lord Walker of Gestingthorpe and Lord Brown of Eaton-under Heywood have not adopted the reasoning of Rimer LJ in finding in favour of Moore Stephens. They have based their decisions on Mr Sumption's fall back position. Each has held that *Hampshire Land* does not apply, that Mr Stojevic's fraudulent conduct is to be treated as the conduct of S&R and that *ex turpi causa* defeats S&R's claim. In doing so, however, their Lordships have restricted their reasoning to the situation where the directing mind and will of the company is also its owner. This leaves open the question of whether *ex turpi causa* will bar a claim by a company with independent shareholders where those shareholders have been unaware that the directing mind and will of the company has been involving the company in fraud.

33. My noble and learned friend Lord Scott of Foscote considers that Mr Stojevic's fraud would not be attributed to S&R so as to bar a claim by S&R against Mr Stojevic. This is because his fraud constituted a breach of the duty that he owed to S&R as an officer of the company. Lord Scott applies the same reasoning to the claim that is brought against Moore Stephens. They too, as auditors, owed duties as officers of S&R and the claim brought by S&R is for breach of those duties. In these circumstances, Mr Stojevic's fraud should not be attributed to S&R. This result is not reached by the application of *Hampshire Land* on the facts of this case. Rather, so it seems to me, Lord Scott accepts the force of "the very thing" argument, at least where the very thing relates to a duty imposed on the defendant as an officer of the claimant company.

34. Lord Mance starts by considering what the position would have been as between S&R and Mr Stojevic if the latter had not been the sole shareholder in S&R. He concludes that if S&R had sued Mr Stojevic *ex turpi causa* would not have applied as there would be no question of Mr Stojevic benefiting from his own wrong and it would be nonsensical to attribute his wrong to the company in such circumstances. He also considers that *Hampshire Land* would apply in that situation, because S&R had to be considered as a separate legal

entity from Mr Stojevic and Mr Stojevic's conduct could properly be characterised as a fraud on S&R.

35. Lord Mance next turns to consider whether the position is affected by the fact that Mr Stojevic was sole shareholder in S&R. He concludes that had S&R been solvent there might have been difficulty in establishing any claim against Mr Stojevic. As, however, it was insolvent, Mr Stojevic was in breach of duty in failing to have regard to the interests of the creditors. S&R would have been able to sue him for breach of this duty and *ex turpi causa* could not be relied upon as a defence.

36. Lord Mance then considers whether S&R could have claimed against Moore Stephens if S&R had had independent shareholders rather than Mr Stojevic. Applying similar reasoning Lord Mance concludes that *ex turpi causa* could not defeat a claim against Moore Stephens for failing to detect the very fraud that was asserted by way of that defence.

37. Does it make a difference that Mr Stojevic was the sole shareholder in the company? Had S&R been solvent Moore Stephens would not have committed any actionable breach of duty in failing to draw the attention of the owner of the company to his own fraud. Lord Mance concludes that the critical factor is that S&R was insolvent. Just as Mr Stojevic was in breach of his duty to have regard to the interests of the creditors, so the auditors' duty to the company extended beyond the interests of the shareholders to the interests of the creditors. *Ex turpi causa* affords no defence to breach of this duty.

38. Having summarised the conclusions reached by your Lordships I turn to consider the topic that has formed the central bone of contention between the parties, namely the application of the *Hampshire Land* principle.

Attribution and Hampshire Land

Attribution

39. The principles governing the attribution of conduct and states of mind to companies have been helpfully analysed by Lord Hoffmann in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500, an appeal to the Privy Council from New Zealand. The appellant company, Meridian, was an investment management company. Its chief investment manager and senior portfolio manager had acquired shares for the company without the knowledge of the managing director or the board of the company. The company was under a statutory obligation to give notice of this acquisition, but failed to do so. It appears to have been common ground that the company was only in breach of this obligation if it had knowledge of the acquisition in question. The issue was whether the company had the requisite knowledge.

40. At p. 506 Lord Hoffmann first dealt with what he described as the "primary rules of attribution" of acts of a company, namely those set out in the articles of association of the company or implied by company law. He then referred to the application to a company of the "general rules of attribution" that apply equally in the case of natural persons, such as principles of agency, estoppel, ostensible authority in contract or vicarious liability in tort.

41. At p. 507 Lord Hoffmann commented:

> "The company's primary rules of attribution together with the general principles of agency, vicarious liability and so forth are usually sufficient to enable one to determine its rights and obligations. In exceptional cases, however, they will not provide an answer. This will be the case when a rule of law, either expressly or by implication, excludes attribution on the basis of the general principles of agency or vicarious liability. For example, a rule may be stated in language primarily applicable to a natural person and require some act or state of mind on the part of that person 'himself', as opposed to his servants or agents. This is generally true of rules of the criminal law, which ordinarily impose liability only for the actus reus and mens

> rea of the defendant himself. How is such a rule to be applied to a company?
>
> One possibility is that the court may come to the conclusion that the rule was not intended to apply to companies at all; for example, a law which created an offence for which the only penalty was community service. Another possibility is that the court might interpret the law as meaning that it could apply to a company only on the basis of its primary rules of attribution, i.e. if the act giving rise to liability was specifically authorised by a resolution of the board or an unanimous agreement of the shareholders. But there will be many cases in which neither of these solutions is satisfactory; in which the court considers that the law was intended to apply to companies and that, although it excluded ordinary vicarious liability, insistence on the primary rules of attribution would in practice defeat that intention. In such a case, the court must fashion a special rule of attribution for the particular substantive rule. This is always a matter of interpretation: given that it was intended to apply to a company, how was it intended to apply? Whose act (or knowledge, or state of mind) was *for this purpose* intended to count as the act etc of the company? One finds the answer to this question by applying the usual canons of interpretation, taking into account the language of the rule (if it is a statute) and its content and policy."

42. While initially Lord Hoffmann had spoken of attribution of *acts* here he spoke of attribution of an *act or knowledge or a state of mind.* Normally the attribution of an act will carry with it the attribution of knowledge of the act, but this is not necessarily the case as Lord Hoffmann made plain at p. 511:

> "But their Lordships would wish to guard themselves against being understood to mean that whenever a servant of a company has authority to do an act on its behalf, knowledge of that act will for all purposes be attributed to the company. It is 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."

Hampshire Land

43. Lord Walker has summarised the relevant authorities where the *Hampshire Land* principle has been applied. The important point to note is that *Hampshire Land* is an exception to the normal rules for the attribution of an agent's *knowledge* to his principal. It is not a rule about the attribution of *conduct. Hampshire Land* applies where an agent has knowledge which his principal does not in fact share but which under normal principles of attribution would be deemed to be the knowledge of the principal. The effect of *Hampshire Land* is that knowledge of the agent will not be attributed to the principal when the knowledge relates to the agent's own breach of duty to his principal. The rationale for *Hampshire Land* has been said to be that it is contrary to common sense and justice to attribute to a principal knowledge of something that his agent would be anxious to conceal from him.

44. The cases demonstrate some confusion as to the precise nature and scope of the *Hampshire Land* principle and doubt has even been expressed as to whether it exists – see *Bowstead & Reynolds on Agency* 18th ed (2006, at 8-188 and 8-213 and Watts, "Imputed Knowledge in Agency Law – Excising the Fraud Exception" (2001) 117 LQR 300 at pp. 319-320. There is a tendency to confuse the *Hampshire Land* principle with a similar principle developed by the courts of the United States, referred to as "the adverse interest exception to imputation".

45. The nature of what I shall call "the adverse interest rule" varies from state to state. It is an exception to the imputation principle under which both the *knowledge* and the *conduct* of an employee or agent are attributed to his principal where that person is acting in the course of his employment or within his apparent authority. Under the adverse interest rule the *knowledge* and *conduct* of an agent will not be attributed to the principal where the agent's actions are adverse to the interests of his principal. In some States the agent's conduct must be targeted against the principal if the rule is to apply. In others, the rule applies more widely, in circumstances where the agent's conduct is done for his personal benefit and is adverse to the interests of his principal, but is not aimed against his principal. A helpful overview of United States law on this topic has been provided by Amelia T Rudolph and Elizabeth V Tanis in a paper entitled "Invoking *In Pari Delicto* to Bar Accountant Liability Actions Brought by Trustees and Receivers" (2008) ALI-ABA Study Materials.

46. The adverse interest rule would, so it seems to me, operate at least in some circumstances as a normal rule of attribution under established principles of the English law of agency, rather than as an exception to the norm. Under it an English court would not attribute to a company the act of its managing director in dishonestly transferring the company's funds into his own account.

47. The operation of a similar principle in the context of the criminal liability of a company for the acts of its directing will and mind is to be found in the decision of the Canadian Supreme Court in *Canadian Dredge & Dock Co Ltd v The Queen* (1985) 19 DLR (4^{th}) 314. In the course of giving the judgment of the court Estey J put the position as follows at p. 351:

> " Where the directing mind conceives and designs a plan and then executes it whereby the corporation is intentionally defrauded, and when this is the substantial part of the regular activities of the directing mind in his office, then it is unrealistic in the extreme to consider that the manager is the directing mind of the company…Where the criminal act is totally in fraud of the corporate employer and where the act is intended to and does result in benefit exclusively to the employee-manager, the employee-directing mind, from the outset of the design and execution of the criminal plan, ceases to be a directing mind of the corporation and consequently his acts could not be attributed to the company under the identification doctrine".

This statement was made in relation to criminal charges brought *against* the company. It describes a principle of attribution that I would accept as applicable under English common law.

48. I believe that Mr Sumption's definition of the *Hampshire Land* principle that I have quoted in paragraph 12 above more accurately describes the adverse interest rule. Confusion between the two principles has tended to obfuscate what, at the end of the day, is a question of attribution that is not difficult to answer on the facts of this case.

Attribution in this case

49. Mr Brindle submits that this case involves two questions of attribution. The first is whether S&R's liability to the banks was primary or vicarious. The second is whether, for the purpose of *ex turpi causa*, Mr Stojevic's fraudulent conduct falls to be attributed to S&R. These are two different ways of posing the same question. The purpose for which the question of attribution has to be answered is in order to decide whether the defence of *ex turpi causa* applies. If Mr Sumption's reliance test is applied, the question that has to be answered is whether S&R is relying upon its own fraud, rather than fraud for which it is only vicariously liable, in order to found its claim. If the underlying principle of public policy is applied, the question that has to be answered is whether S&R is seeking to obtain compensation for the consequences of its own fraud rather than for the consequences of fraud for which it is only vicariously liable. To answer the question it is necessary to decide whether the fraud of Mr Stojevic falls to be treated as the fraud of S&R itself.

50. As between a company that has committed fraud and the victim of the fraud, the question of whether the company's liability is primary or vicarious seldom, if ever, arises. As Estey J remarked in *Canadian Dredge & Dock Co Ltd v The Queen*, at pp 324-325:

> "At common law there was no difficulty in finding liability in a corporation in the law of torts, even though the state of mind of the corporation was established by imputing to that corporation the intentions and the conduct of its servants and agents. Thus, in the law of torts, the courts from the earliest times found vicarious liability in the corporation on the principles of agency."

In this case, however, it is necessary to distinguish between vicarious and primary liability for the purpose of considering the application of *ex turpi causa.* There is no way of doing this other than by applying the same approach as applies in other circumstances where this exercise is necessary. Indeed *Bowstead & Reynolds* at 8-188 identifies "the supposed fraud exception to the rules as to imputation of the agent's knowledge to the principal" as one of the situations where it may be necessary to consider whether conduct ranks as the act of the corporation itself. The words of Lord Reid in *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153 at 170 are directly in point:

> "A living person has a mind which can have knowledge or intention or be negligent and he has hands to carry out his intentions. A corporation has none of these: it must act through living persons, though not always one or the same person. Then the person who acts is not speaking or acting for the company. He is acting as the company and his mind which directs his acts is the mind of the company. There is no question of the company being vicariously liable. He is not acting as a servant, representative, agent or delegate. He is an embodiment of the company or, one could say, he hears and speaks through the persona of the company, within his appropriate sphere, and his mind is the mind of the company. If it is a guilty mind then that is the guilt of the company. It must be a question of law whether, once the facts have been ascertained, a person in doing particular things is to be regarded as the company or merely as the company's servant or agent. In that case any liability of the company can only be a statutory or vicarious liability."

51. Where those managing the company are using it as a vehicle for fraud, or where there is only one person who is managing all aspects of the company's activities, there is no difficulty in identifying the fraud as the fraud of the company. Thus in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378, a case concerning a company, BLT, that was owned and managed by one man, Lord Nicholls of Birkenhead, when giving the advice of the Privy Council, observed at p. 393:

> "Set out in these bald terms, the defendant's conduct was dishonest. By the same token, and for good measure, B.L.T. also acted dishonestly. The defendant was the company, and his state of mind is to be imputed to the company."

52. Lord Nicholls returned to this theme in *Mahmud v BCCI* [1998] AC 20 at p. 34 where he said this about BCCI:

> "The bank operated its business dishonestly and corruptly. On the assumed facts, this was not a case where one or two individuals, however senior, were behaving dishonestly. Matters had gone beyond this. They had reached the point where the bank itself could properly be

> identified with the dishonesty. This was a dishonest business, a corrupt business."

53. A similar issue of attribution arose in *KR v Royal & Sun Alliance plc* [2006] EWCA Civ 1454; [2007] 1 All ER (Comm) 161 in relation to a clause in a policy of liability insurance. The clause excluded the insurers' liability in respect of: "Injury damage or financial loss which results from any deliberate act or omission of the insured…" The insured was a company that operated children's homes. The issue was whether the clause exempted the insurers from liability in respect of the company's liability for physical abuse perpetrated by the managing director and major shareholder in the company. The Court of Appeal held at paragraph 65 that the intention of the clause was to exclude liability for damage or injury caused by the deliberate acts of the person who was to be regarded as, in effect, the company, as opposed to the acts of those who were mere employees. As such it excluded liability in respect of the acts of the managing director:

> "It is not just the case that he was managing director and majority shareholder of the company; he was [the company]. He treated the company as his own and nothing of consequence happened without his say so."

54. In this case it might be said that S&R was not a business being carried on corruptly but rather that there was no business at all. Mr Stojevic, in the name of the company, was pretending to carry on a fictitious business. With false pretences and fabricated documents he was fraudulently inducing Komercni Bank and other banks to pay large sums to S&R. It might be argued that the adverse interest rule, as formulated by Estey J in *Canadian Dredge & Dock Co Ltd v The Queen*, applies, in that Mr Stojevic was, from the outset, acting pursuant to a criminal plan that was exclusively for his own benefit. Such an argument would, however, be fallacious. Mr Stojevic was using S&R for his own dishonest purposes, but in a manner that resulted in substantial payments being made to S&R. It has never been suggested that Mr Stojevic's conduct did not fall to be attributed to S&R so as to render S&R liable in deceit. That S&R was properly held liable is the basis of S&R's claim. The fraudulent business must be treated as the business of S&R carried on, in the first instance, to benefit S&R.

55. Mr Brindle submits that the *Hampshire Land* principle applies so as to prevent attribution in this case. For the reasons that I have given I do not consider that that principle has any application. Nor does the adverse inference rule apply so as to prevent the attribution of Mr Stojevic's fraudulent conduct to the company. Mr Brindle has not suggested that the banks are not to be treated as the primary victims of the fraud that Mr Stojevic has caused S&R to commit. He submits, however, that the fraud should not be attributed to S&R because it has come home to roost, making S&R a secondary victim. Neither authority nor common sense supports this proposition. As Mr Sumption points out, a company that commits fraud is always liable to find itself a secondary victim in this way. Mr Brindle's submission amounts, on analysis, to an argument that *ex turpi causa* should never prevent a company from recovering compensation for the consequences of fraud which those managing the company have caused it to commit. That submission falls to be considered in the context of the alternative way that Mr Brindle advances his case.

56. For the reasons that I have given I find that neither the *Hampshire Land* principle nor the adverse interest rule prevents the attribution of Mr Stojevic's fraud to S&R.

The very thing

57. This argument is founded upon the fact that Mr Sumption has conceded that Moore Stephens owed a duty of care to S&R and that it is to be assumed for the purposes of the *ex turpi causa* issue that the duty of care has been broken. Mr Brindle's argument is, in essence, that if a duty exists to take action that will prevent a claimant from committing an illegal act, the claimant must have a remedy for breach of that duty, otherwise the duty will be rendered nugatory. Mr Brindle relies on reasoning of Buxton LJ to this effect in *Reeves v Commissioner of Police of the Metropolis* [1999] QB 169. The relevant issue under consideration was whether, on the premise that suicide was to be treated as illegal conduct, *ex turpi causa* would bar a claim against the police for negligently permitting a prisoner to commit suicide. In holding that it would not Buxton LJ observed at p. 185:

> "Here, the alleged turpitudinous act is the very thing that the defendant had a duty to try to prevent, imposed by a law of negligence which itself appeals to public conscience or at least public notions of reasonableness"

58. Mr Brindle's argument is that fraud by S&R was one of the very things that Moore Stephens owed a duty of care to prevent. It follows that *ex turpi causa* should not defeat a claim for breach of that duty. I propose, when approaching Mr Brindle's alternative argument, to consider it initially in relation to a solvent company with independent and innocent shareholders which suffers damage because its directing mind and will involves it in fraud.

Claim by the company against the directing will and mind

59. Lord Scott and Lord Mance consider that a company must be able to bring a claim against a director who, in breach of duty, causes the company damage by involving it in fraud. I sympathise with their reaction. Imagine a group of investors who float a company to own and operate a yacht commercially. They engage a skipper to whom they entrust the management of the business. In breach of duty he charters the yacht to drug smugglers, with the consequence that the vessel is seized and confiscated. It would seem contrary to justice if the company could not bring an action against the skipper for misfeasance for the benefit of the shareholders. Why should the skipper be entitled to pray in aid the very thing that his breach of duty had brought about? On what principled basis can one avoid the application of *ex turpi causa* in such circumstances?

60. Lord Mance considers that *Hampshire Land* can be pressed into service. For the reasons that I have given I do not agree. It makes no sense to say that the fraud should not be attributed to the company. The fact that fraud has been attributed to the company is the very thing about which the company is complaining. The company's complaint is that its directing will and mind has infected it with turpitude. If *ex turpi causa* is not to apply in such circumstances, the reason should simply be that the public policy underlying it does not require its application.

61. One can readily reach that conclusion where all the shareholders are innocent. Recovery from the directing mind and will does not result in any individual recovering compensation for his own wrong. The position becomes unclear, however, if some of the shareholders were complicit in the directing mind and will's misconduct. Lord Mance states that in such circumstances some process designed to achieve the ends of justice would "without doubt" prevent the fraudulent

shareholders from profiting from their dishonesty. Lord Mance may well be right, but it is not apparent to me that the law provides a mechanism for achieving this. What would seem to be involved would be a lifting of the veil of incorporation in order to ensure that shareholders who were complicit in the illegal manner of operating the company would not be able to share in the recovery from the directing mind and will. This would, I believe, be without precedent.

62. The situation becomes more complicated when one considers a claim against auditors, such as that with which this appeal is concerned, by a company that has independent shareholders. Here the argument is that auditors should not be entitled to pray in aid the very illegality that their breach of duty has permitted to occur. The same problem arises where some of the shareholders are complicit in the fraud being perpetrated on the banks by the directing mind and will. But more intractable is the problem of contributory negligence. The duty owed by the auditors to the company is a duty of care. It would not seem just for a company to make a full recovery of damages against auditors for the benefit of banks which have themselves negligently failed to carry out appropriate "due diligence" before advancing monies to the company. Mr Brindle recognised this, for he opened his case by submitting that any apparent unfairness in holding Moore Stephens liable to S&R would be met by contribution under the Law Reform (Contributory Negligence) Act 1945. But it is not easy to see how the Act would apply. Moore Stephens' liabilities would reflect S&R's liabilities to the banks and the damages paid by Moore Stephens would be paid, indirectly to the banks. Lack of care on the part of the banks in their dealings with S&R ought to be taken into account for the purposes of contributory negligence. Yet such lack of care could not be prayed in aid by S&R in answer to claims framed by the banks in deceit – *Standard Chartered Bank v Pakistan National Shipping Corpn (Nos 2 and 4)* [2002] UKHL 43; [2003] 1 AC 959. Nor is there any obvious mechanism by which such lack of care could be relied upon by Moore Stephens in answer to the claim brought by S&R.

63. My Lords, I would not think it right to hold as a matter of general principle that *ex turpi causa* does not apply to a claim by a company against its auditors for failing to detect that the company has been operating fraudulently unless it were demonstrated how the difficulties to which I have referred could be resolved. There has been no such demonstration in this case. Thus I am not able to join Lord Scott and Lord Mance in concluding, for the reasons that they have given, that *ex turpi causa* does not apply to S&R's claim. At the same time, I have not been persuaded by Mr Sumption's primary case that the reliance

test, or the principle of public policy that underlies it, would necessarily defeat S&R's claim if S&R were a company with independent shareholders that had been "high-jacked" by Mr Stojevic. In that, at least, I believe that I share common ground with all your Lordships.

The significance of the fact that S&R was a "one man company"

64. I turn to consider Mr Sumption's fall back position. This applies to what, by way of shorthand, is described as a "one man company", that is a company where the sole shareholder is also the person who runs the company or, if there is more than one shareholder, where the shareholders together run the company. Mr Sumption argued that where all who have ownership and control of a company are complicit in a fraud carried out by the company there is no room for the application of the *Hampshire Land* principle. In support of this argument he drew attention to United States jurisprudence that establishes a "sole actor" exception to the adverse interest rule.

65. Lord Brown and Lord Walker have based their decision on Mr Sumption's fall back position. Lord Walker identifies the reason for the *Hampshire Land* principle to be 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. Where there are no honest directors or shareholders there is "*ex hypothesi* no innocent participator". It follows that there is no room for the application of *Hampshire Land.*

66. Lord Scott and Lord Mance do not accept this analysis. They would include among the "innocent participators" the creditors of a company in circumstances where the company is insolvent or is threatened with insolvency. They postulate that the duty owed by auditors is owed for the benefit of these participators also, and that *ex turpi causa* should not defeat a claim brought for their benefit.

67. For the reasons that I have already given, I consider that the real issue is 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. That 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.

68. One fundamental proposition appears to me to underlie the reasoning of Lord Walker and Lord Brown. It is that the duty owed by an auditor to a company is owed for the benefit of the interests of the shareholders of the company but not of the interests of its creditors. It seems to me that here lies the critical difference of opinion between Lord Walker and Lord Brown on the one hand and Lord Mance on the other. Lord Mance considers that the interests that the auditors of a company undertake to protect include the interests of the creditors.

69. I was initially doubtful as to whether it would be right to decide this strike out application on the basis that the interests of creditors fall outside the scope of the duty of care that auditors owe to a company. I was concerned that such an approach was precluded by Mr Sumption's concession of the existence both of a duty and, for the purposes of argument, a breach. In oral submission however, Mr Sumption made it plain that his concession in respect of the duty owed by Moore Stephens was a limited one.

70. Mr Sumption conceded that Moore Stephens owed a duty to S&R to ensure, so far as reasonable care permitted, that S&R's accounts showed a true and fair view of its affairs. He conceded that, for the purpose of the strike out application, it should be assumed that Moore Stephens was in breach of this duty. He further conceded that, had they performed this duty, they would have discovered the fraud that was taking place. Finally he conceded that Moore Stephens would then have reported the fraud to the authorities, which would have brought S&R's operations to a halt. Thus, as a matter of causation, the assumed breach of duty resulted in the losses sustained by S&R as a result of the continuing fraud. What Mr Sumption did not accept, however, was that reporting the fraud to the authorities formed any part of the duty owed to S&R.

71. Mr Sumption submitted that the duty owed to a company by its auditors was exclusively for the benefit of its shareholders. No duty was owed to creditors. The duty of the auditors to exercise due care when reporting on the accounts enabled the shareholders to hold the management of a company to account. Accounting standards and duty to the public went beyond the auditor's duty to the company. Indeed it overrode the duty of confidentiality that would otherwise be owed to the company. It was this public duty that might require an auditor to "shop" a company if there was reason to think that it was involved in crime. Mr Sumption submitted that "against that background it is very

difficult to see how the law can rationally hold an auditor liable when the entire shareholder body and the entire management is embodied in a single individual who knows everything because he has done everything".

72. Those submissions were largely founded on the decision of this House in *Caparo.* While the plaintiff in that case was a company, its primary claim was in its capacity as purchaser of the shares in a public company ("Fidelity") of which the defendants were the statutory auditors. The claim was in the tort of negligence. The plaintiff alleged that the defendants had been negligent in auditing Fidelity in that they had approved accounts which, inter alia, overvalued the assets of the company. The plaintiff alleged that, foreseeably, reliance on the audited accounts had led it to pay an excessive amount for the shares of Fidelity in a successful take-over bid. The question of whether the defendants owed a duty of care to the plaintiff was tried as a preliminary issue.

73. After lengthy consideration of authorities dealing with the duty of care in relation to negligent misstatements Lord Bridge of Harwich remarked at p. 623:

> "These considerations amply justify the conclusion that auditors of a public company's accounts owe no duty of care to members of the public at large who rely upon the accounts in deciding to buy shares in the company. If a duty of care were owed so widely, it is difficult to see any reason why it should not equally extend to all who rely on the accounts in relation to other dealings with a company as lenders or merchants extending credit to the company. A claim that such a duty was owed by auditors to a bank lending to a company was emphatically and convincingly rejected by Millett J. in *Al Saudi Banque v. Clarke Pixley*…"

74. At p. 626, after considering the provisions in the Companies Act 1985 that relate to auditors, Lord Bridge added:

> "No doubt these provisions establish a relationship between the auditors and the shareholders of a company on which the shareholder is entitled to rely for the

> protection of his interest. But the crucial question concerns the extent of the shareholder's interest which the auditor has a duty to protect. The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders, e.g. by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders.
>
> I find it difficult to visualise a situation arising in the real world in which the individual shareholder could claim to have sustained a loss in respect of his existing shareholding referable to the negligence of the auditor which could not be recouped by the company."

75. Lord Oliver of Aylmerton also gave detailed consideration to the role of auditors in the light of the relevant statutory provisions. The following passages from his opinion at pp. 630 and 631 are of particular relevance:

> "It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to regard or control or remove those to whom that conduct has been confided….

> Thus the history of the legislation is one of an increasing availability of information regarding the financial affairs of the company to those having an interest in its progress and stability. It cannot fairly be said that the purpose of making such information available is solely to assist those interested in attending general meetings of the company to an informed supervision and appraisal of the stewardship of the company's directors, for the requirement to supply audited accounts to, for instance, preference shareholders having no right to vote at general meetings and to debenture holders cannot easily be attributed to any such purpose. Nevertheless, I do not, for my part, discern in the legislation any departure from what appears to me to be the original, central and primary purpose of these provisions, that is to say, the informed exercise by those interested in the property of the company, whether as proprietors of shares in the company or as the holders of rights secured by a debenture trust deed, of such powers as are vested in them by virtue of their respective proprietary interests."

76. Both Lord Bridge and Lord Oliver cited with approval the decision of Millett J in *Al Saudi Banque v Clarke Pixley* [1990] Ch 313. That was an action brought in negligence against the auditors of a company by a number of banks. They alleged that they had relied upon favourable auditors' reports, negligently given, in advancing money to the company. Some of the banks were already creditors of the company at the time that the reports were made. The question of whether the auditors owed a duty to the banks was tried as a preliminary issue. Millett J held that no duty was owed, relying in part on the reasoning of the majority in the Court of Appeal in *Caparo* [1989] QB 653. He held that the necessary proximity between the banks and the auditors was not established. He went on, however, to hold that it would not be just and reasonable to impose such a duty on the auditors. This was because breach of the duty would expose the auditors to liability for sums advanced by the banks to the company of an indeterminate amount, which would be unknown to the auditors and unforeseeable by them.

77. Mr Sumption also relied upon the decision of Hobhouse J. in *Berg, Sons & Co Ltd v Mervyn Hampton Adams and Others* [2002] Lloyd's Rep PN 41. The relevant claim in that case was brought by a company in liquidation ("Berg") against its auditors ("Dearden Farrow") for negligently failing to qualify the accounts of the company, as a consequence of which the company incurred further liabilities. The

company had only one active director, a Mr Golechha, who was also the ultimate beneficial owner of all the shares in the company. At p. 44 Hobhouse J outlined the nature of Berg's case:

> "The essence of the claim made by the first Plaintiffs, Berg, against Dearden Farrow is that Mr Surrey ought not to have accepted the statements made, and the assurances given, to him by Mr Golechha. It is no part of the Plaintiffs' case that Mr Golechha, nor any director or shareholder of Berg, was in any way misled by anything which Dearden Farrow said or did; nor is it alleged that Mr Golechha, or any member of the company, in any way relied upon anything Dearden Farrow said or did. It further is not alleged that Mr Golechha was not fully aware of all relevant facts and considerations. Under these circumstances, it will be appreciated that there are serious further difficulties in the way of formulating and substantiating the claim of Berg against the Defendants. The existence of a contractual duty to exercise proper skill and care in and about the audit owed by the Defendants to Berg is not in dispute. But whether, assuming that there has been some breach, there is on any view a right to recover anything more that nominal damages is very definitely in dispute. The Defendants submit that the first Plaintiffs' claim is misconceived and cannot succeed even if some breach of contract is established."

78. Hobhouse J considered the implications of the decision in *Caparo* on the duty of care owed by auditors and reached the following conclusion:

> "It also follows that the purpose of the statutory audit is to provide a mechanism to enable those having a proprietary interest in the company or being concerned with its management or control to have access to accurate financial information about the company. Provided that those persons have that information, the statutory purpose is exhausted. What those persons do with the information is a matter for them and falls outside the scope of the statutory purpose. In the present case the first Plaintiffs have based their case not upon any lack of information on the part of Mr Golechha but rather upon the opportunity that the possession of the auditor's certificate is said to

> have given for the company to continue to carry on business and to borrow money from third parties. Such matters do not fall within the scope of the duty of the statutory auditor.”

79. At p. 53 Hobhouse J referred to an accurate statement of the *Hampshire Land* principle in *Bowstead on Agency* (15th edition, 1985), Art 102:

> “Where an agent is party or privy to the commission of a fraud upon or misfeasance against his principal, his knowledge of such fraud or misfeasance, and of the facts and circumstances connected therewith, is not imputed to the principal.”

He commented, at p 54:

> “In the present case it has not been proved that there was any fraud by Mr Golechha in relation to the 1981 audit, still less that at that time Mr Golechha was practising any fraud upon his principal, Berg. There was no entity which it can be said he misled or in relation to which it can be said that he was acting fraudulently in relation to the audit in October 1982. However one identifies the company, whether it is the head management, or the company in general meeting, it was not misled and no fraud was practised upon it. This is a simple and unsurprising consequence of the fact that every physical manifestation of the company Berg was Mr Golechha himself. Any company must in the last resort, if it is to allege that it was fraudulently misled, be able to point to some natural person who was misled by the fraud. That the Plaintiffs cannot do.”

80. This comment demonstrates that *Hampshire Land* had no application to the facts of that case, but it has wider implications. Taken with the other passages in the judgment to which I have referred, it supports Mr Sumption’s proposition that it is very difficult to see how the law can rationally hold an auditor liable when the entire shareholder body and the entire management is embodied in a single individual who knows everything because he has done everything. If that

proposition is correct, it follows that any breach of duty on the part of Moore Stephens will not sound in damages because it has caused no loss.

81. I have had difficulty in this case in distinguishing between questions of duty, breach and actionable damage and, indeed, it is questionable whether it is sensible to attempt to distinguish between them. In *Caparo* at p. 627 Lord Bridge stated:

> "It is never sufficient to ask simply whether A owes B a duty of care. It is always necessary to determine the scope of the duty by reference to the kind of damage from which A must take care to save B harmless. 'The question is always whether the defendant was under a duty to avoid or prevent that damage, but the actual nature of the damage suffered is relevant to the existence and extent of any duty to avoid or prevent it:' see *Sutherland Shire Council v. Heyman*, 60 A.L.R. 1, 48, *per* Brennan J. Assuming for the purpose of the argument that the relationship between the auditor of a company and individual shareholders is of sufficient proximity to give rise to a duty of care, I do not understand how the scope of that duty can possibly extend beyond the protection of any individual shareholder from losses in the value of the shares which he holds."

Lord Oliver made a similar comment at p. 651:

> "It has to be borne in mind that the duty of care is inseparable from the damage which the plaintiff claims to have suffered from its breach. It is not a duty to take care in the abstract but a duty to avoid causing to the particular plaintiff damage of the particular kind which he has in fact sustained."

82. These comments were made in relation to duty of care in tort. In *Banque Bruxelles Lambert SA v Eagle Star Insurance Co Ltd* (sub nom *South Australia Asset Management Corpn v York Montague Ltd*) [1997] AC 191 Lord Hoffmann held that precisely the same reasoning applied to a duty of care in contract. He said at p. 211:

> "A duty of care such as the valuer owes does not however exist in the abstract. A plaintiff who sues for breach of a duty imposed by the law (whether in contract or tort or under statute) must do more than prove that the defendant has failed to comply. He must show that the duty was owed to him and that it was a duty in respect of the kind of loss which he has suffered. Both of these requirements are illustrated by *Caparo Industries plc. v. Dickman* [1990] 2 A.C. 605. The auditors' failure to use reasonable care in auditing the company's statutory accounts was a breach of their duty of care. But they were not liable to an outside take-over bidder because the duty was not owed to him. Nor were they liable to shareholders who had bought more shares in reliance on the accounts because, although they were owed a duty of care, it was in their capacity as members of the company and not in the capacity (which they shared with everyone else) of potential buyers of its shares. Accordingly, the duty which they were owed was not in respect of loss which they might suffer by buying its shares."

83. Mummery LJ held that Moore Stephens owed no duty of care to S&R, "a fraudster in the total grip of another fraudster". Although Mr Sumption has renounced any reliance on this holding, it is one with which I have sympathy. Moore Stephens were retained by Mr Stojevic by deception and with the object of enhancing the apparent respectability of S&R for the purposes of his proposed fraud. The details of the business that he retained Moore Stephens to audit were wholly fictitious. If these motives and this dishonesty are to be attributed to S&R, as it seems to me they must be, then it is at least arguable that the illegal purpose of the contract under which Moore Stephens were retained rendered it unenforceable at the suit of Moore Stephens by reason of the application of the principle in *Alexander v Rayson* [1936] 1 KB 169. More fundamentally, if party A, by deceit, induces party B to agree to play a part in a venture that is wholly fictitious, I find it hard to see how this can give rise to any duty on the part of party B.

84. If I put those reservations on one side and assume that Moore Stephens undertook a contractual duty to S&R to exercise due care in relation to the auditing of S&R's accounts, the question arises of whether that duty extended further than the exercise of reasonable care in the provision of information to the directors and those who had a

proprietary interest in the company. The authorities relied upon by Mr Sumption lead to the conclusion that it did not.

85. The exercise of an auditor's duties to a company will, in some situations, have the effect of preserving the assets of the company. Such preservation will, whenever there is a risk that the company's assets may prove inadequate to meet its liabilities, protect not merely the interests of the shareholders but those of the creditors. It is arguable that the scope of the duty undertaken by the auditors of a company should extend to protecting the interest that the creditors have in the preservation of the assets of the company. So to hold would involve departing from, or at least extending, the reasoning of this House in *Caparo.* Such an extension would not, however, assist S&R in this case. To recover damages in this case S&R would have to establish that the scope of the duty undertaken by Moore Stephens 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. I see no prospect that such a duty could be established.

86. The scope of Moore Stephens' duty is not directly in issue on this appeal. What is in issue is whether *ex turpi causa* provides a defence to S&R's claim that Moore Stephens was in breach of duty. That is not, however, a question that I have been able to consider in isolation from the question of the scope of Moore Stephens's duty. I have reached the conclusion that all whose interests formed the subject of any duty of care owed by Moore Stephens to S&R, namely the company's sole will and mind and beneficial owner Mr Stojevic, were party to the illegal conduct that forms the basis of the company's claim. In these circumstances I join with Lord Walker and Lord Brown in concluding that *ex turpi causa* provides a defence.

87. For these reasons I would dismiss this appeal.

LORD SCOTT OF FOSCOTE

My Lords,

Introduction

88. I have found this a very difficult case. Three of my noble and learned friends, Lord Phillips of Worth Matravers, Lord Walker of Gestingthorpe and Lord Mance have prepared and circulated lengthy opinions, totalling very nearly 200 paragraphs but reaching differing conclusions. Lord Phillips and Lord Walker have concluded that the *ex turpi causa* principle provides a complete defence to this action and that the appeal by Stone & Rolls Ltd (in liquidation) ("S & R") against the striking out of its action should therefore be dismissed. Both take the view that the fraud and dishonesty of Mr Stojevic is properly to be attributed to S & R. Lord Mance, however, has concluded that this action, brought by S & R against its auditors, Moore Stephens, for contractual and tortious negligence, cannot be defeated, at least at the present strike-out stage, by that attribution. My Lords I have come to the same conclusion as Lord Mance and without, as I hope, adding unnecessarily to the length of the opinions of your Lordships, I must explain why.

89. It is of critical importance, in my opinion, to notice that the case comes before your Lordships as a final appeal on a strike-out application. The application was made by Moore Stephens, defendants in the action but respondents before the House, on the ground that the claim by S&R had no real prospect of success. Many of the facts pleaded by S&R in their Amended Particulars of Claim are admitted by Moore Stephens in their Defence. It is not contended that any of the pleaded facts that are not admitted in the Defence can at this stage be regarded as incapable of proof. It follows that for present striking-out purposes those facts must be assumed to be true.

The facts

90. S&R is a company incorporated in England and Wales. At all material times until its provisional liquidation in November 2002, S&R was controlled by Mr Stojevic. The shares in S&R are, or were, held by an Isle of Man company, Law Investments Ltd, the shares in which

are, or were, held by trustees of what has been described as Mr Stojevic's family trust. S&R had directors but they took no part in the running of S&R's business and, it appears, exercised no control over its finances. Mr Stojevic, via a power of attorney granted to him by S&R's faceless directors, was in complete managerial control of every aspect of S&R.

91. Moore Stephens were, for the years 1996, 1997 and 1998, the auditors of S&R and signed unqualified audit reports for those three financial years. During this period, therefore, Moore Stephens were officers of S&R for the purposes, for example, of section 212 of the Insolvency Act 1986 and had a contractual relationship with S&R for the purpose, at least, of the preparation of the annual audit reports.

92. Mr Stojevic, throughout the period that Moore Stephens were S&R's auditors but unknown to Moore Stephens, used S&R as a vehicle of fraud. He used S&R as a vehicle through which funds, fraudulently extracted from banks which believed they were financing *bona fide* commodity trades, were then paid away to third parties under the influence or control of (or in league with) Mr Stojevic. The moneys paid by the defrauded banks to S&R and paid away by S&R to the third parties were the proceeds of the frauds. The most substantial of the frauds was committed against a Czech bank, Komercni Banka AS ("KB") which eventually, and inevitably, brought proceedings against S&R and Mr Stojevic for fraud. The proceedings led to Toulson J on 15 November 2002, giving judgment against both defendants for over US$94 million. The result of the judgment was that S&R went into provisional liquidation on 15 November 2002 and on 15 January 2003 the provisional liquidatiors were appointed liquidators of S&R. There were other defrauded banks and companies as well as KB and S&R was hopelessly insolvent. Mr Stojevic has, apparently, no assets worth pursuing or at any rate none that the liquidators have been able to discover.

93. The appointment of the provisional liquidators brought to an end Mr Stojevic's control over S&R and on 22 December 2006 S&R, under the control of the liquidators, commenced the action against Moore Stephens that is the target of the striking-out application that has now reached your Lordships' House.

The issue

94. S&R's action against Moore Stephens seeks damages for negligence. The pleaded case is, in very brief summary, that Moore Stephens, when carrying out their audit and preparing their audit report in each of the three audit years, were negligent in not detecting "(a) Mr Stojevic's dishonesty; and (b) a pattern of fraud involving numerous fraudulent and/or irregular payments out by S&R to entities controlled by Mr Stojevic and his associates" (see para.12 of the Amended Particulars of Claim). It is pleaded that if this alleged negligence had not occurred Mr Stojevic would have been unable to procure the continuance of the fraudulent and irregular payments made out of S&R. In short, the fraudulent scheme would have come to an end.

95. Moore Stephens, in their Defence, deny any negligence or other breach of duty owed to S&R but plead that, in any event, "the claim advanced is inextricably linked with [S&R's] own dishonest acts" (para.3(1)) and that the claim is barred by the *ex turpi causa* rule.

96. The issue – an easy one to state but, at any rate for me, a difficult one to decide – is whether S&R's claim as pleaded must inevitably founder on the *ex turpi causa* rule.

The ex turpi causa rule

97. Both Langley J at first instance and Rimer LJ in the Court of Appeal commenced their consideration of the *ex turpi causa* rule by citing the well known statement made by Lord Mansfield in *Holman v Johnson* 1(1775) Cowp.341 at 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 …. there the court says he has no right to be assisted."

The *ex turpi causa* rule was the subject of careful consideration in *Tinsley v Milligan* [1994] 1 AC 340 where this House unanimously rejected the proposition that the application of the rule depended "on such an imponderable factor as the extent to which the public conscience would be affronted by recognising rights created by illegal transactions" (per Lord Browne-Wilkinson at 369). It is necessary, therefore, to put firmly to one side any question of whether, or to what extent, public conscience would be affronted by the spectacle of Moore Stephens being held liable to pay negligence damages to S&R, thus enabling the liquidators to pay dividends to the defrauded creditors of S&R, and to concentrate on whether S&R is founding its action on its "own dishonest acts" (para.3(1) of the Defence).

98. For that purpose it is desirable to be clear about what cause of action one is talking about. S&R has pleaded its case as one based both on contractual negligence and on tortious negligence. I doubt whether at the end of the day the point makes any difference but, for my part, I regard a case based on contractual negligence as the more apt approach. The complaint is a complaint of negligent auditing and Moore Stephens' duty to conduct the audit with due professional skill and care was a duty owed to S&R pursuant to the contract between them. There was no relationship between them other than the contractual one. It was that relationship that imposed the duty of care and, although it is now common to regard such a duty not only as contractual but also as tortious, it seems to me more logical to speak of it as a contractual duty. It is to be noted, moreover, that the Amended Particulars of Claim, in describing the scope of the duty of care relied on (paras.51 and 52), relies on "an implied term of Moore Stephens' retainer" and that para.53 simply says that "Moore Stephens owed the claimants tortious duties co-extensive with the contractual duties set out above." I propose, therefore, to address myself to the question whether S&R's contractual cause of action is founded upon its "own dishonest acts."

S&R's contractual cause of action

99. A cause of action for breach of contract requires no more than a valid contract and a breach of that contract. If the complaint is one of professional negligence made against a professional, such as an auditor who has been retained by the complaining client, no more need be pleaded and proved than that in the performance of his contractual duties the professional failed to exercise the standard of professional care that was owing to the client under their contract. For an action in tort, on the other hand, recoverable damage must be alleged and proved, for without such damage the tortious cause of action is not complete. Not so for an action based on breach of contract. If the breach is proved the complainant is entitled to judgment and to nominal damages at least.

100. The retainer of Moore Stephens by S&R to act as S&R's auditors for the years 1996, 1997 and 1998 is admitted in Moore Stephens' Defence (see paras.15 and 16). The implied term alleged in para.51 of the Amended Particulars of Claim is admitted, and so, too, is the bulk of the alleged requirements of a duty of "reasonable skill and care" (para.17). What is, of course, denied is that Moore Stephens failed to meet the requisite standard of reasonable skill and care (para.18). But their contractual duty to exercise that care is not in issue. And their failure to meet that standard is, for present striking-out purposes, to be assumed.

101. So, as it appears to me, S&R can found a cause of action against Moore Stephens without reliance on the fraudulent nature of Mr Stojevic's scheme.

102. But, of course, this action is not being brought in order to recover merely nominal damages. It is being brought in order to recover substantial damages, namely, damages representing the losses incurred by S&R in having paid out large sums to the third parties and thereby having denuded itself of funds which could have been set against the liabilities it has incurred to those who were defrauded. Prominent among them, of course, is KB with its $94 million odd judgment debt.

103. Whether, even if the *ex turpi causa* rule did not stand in the way, S & R could recover as damages anything like the full amount of its losses, or indeed anything at all, will, I do not doubt, raise all sorts of issues of causation. These causation issues are for later, to be addressed at trial if S&R can surmount the *ex turpi causa* hurdle. For present purposes, however, it must be assumed that some amount of substantial loss could be shown to have been caused by Morre Stephens' breaches of duty and would, subject to the *ex turpi causa* rule, be recoverable as damages. But it has to be accepted that in order to succeed in recovering more than nominal damages S&R has had to plead the dishonest scheme under which the money extracted from the banks went via S&R to the third parties. So although, in my opinion, S&R does not have to found its cause of action on the dishonesty of the scheme, it cannot recover substantial damages without pleading the details that show the scheme to have been dishonest. Does this involve S&R in relying "on its own dishonest acts"? The answer depends on whether the dishonesty of Mr Stojevic should be attributed to S&R for the purposes of S&R's claim against Moore Stephens. This is, in my opinion, the short but determinative issue in the case.

Attribution

104. An incorporated company is a statutory legal person. It has corporate personality but can act only by agents and, as Lord Haldane LC memorably said in *Lennard's Carrying Co.Ltd v Asiastic Petroleum Co.Ltd* [1915] AC 705 at 713,

> "It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation."

Lord Haldane's remarks were examined by Lord Hoffmann in giving the judgment of the Board in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500, on an appeal from the Court of Appeal of New Zealand. Lord Hoffmann, at 506, noted that any proposition about a company's directing mind and will necessarily involved a reference to a set of rules of attribution. The company's primary rules would, he said, generally be found in the company's constitution, typically its articles of association, but would include also rules implied by company law, such as, for example, the rule that the unanimous decision of all the shareholders in a solvent company to do something that the company had power to do under its memorandum of association would be the decision of the company. He went on to say this :

> "These primary rules of attribution are obviously not enough to enable a company to go out into the world and do business. Not every act on behalf of the company could be expected to be the subject of a resolution of the board or a unanimous decision of the shareholders. The company therefore builds upon the primary rules of attribution by using general rules of attribution which are equally available to natural persons, namely, the principles of agency. It will appoint servants and agents whose acts, by a combination of the general principles of agency and the company's primary rules of attribution, count as the acts of the company."

105. These remarks of Lord Hoffmann have, as it seems to me, a particular resonance in the present case. Your Lordships have not been shown the Memorandum of Association or the articles of association of S&R nor the power of attorney granted to Mr Stojevic. It may reasonably be assumed, I think, that the articles gave the directors power to grant a power of attorney to Mr Stojevic to enable Mr Stojevic to take management decisions on behalf of S&R. But it may confidently be asserted also that the directors' power could not have extended so as lawfully to authorise Mr Stojevic to treat the company as a vehicle for defrauding the banks and others in the way that he did or, indeed, in any other way to cause S&R to engage in fraudulent trading. Either the power of attorney would have been on its face unlawful and devoid of effect or, much more likely, Mr Stojevic's actions in using S&R as a vehicle for implementing the fraudulent scheme he had devised would have been outside the powers conferred on him by the power of attorney. This feature of the relationship between Mr Stojevic and S&R has no relevance whatever so far as dealings between S&R and those defrauded by the scheme are concerned. They were entitled to hold S&R liable for the frauds in which S&R had participated. But it does have relevance, in my opinion, to the question whether S&R was itself a victim of Mr Stojevic's fraudulent scheme and, thus, to the critical question whether, for the purposes of S&R's action against Moore Stephens, Mr Stojevic's dishonesty should be attributed to S&R.

106. *In re Hampshire Land Company* [1896] 2 Ch.743 established the rule that the knowledge of an officer of a company of his own fraud or breach of trust directed at third parties will not necessarily be imputed to that company (see the statement of the rule by Rimer LJ in paragraph 39 of his judgment in the Court of Appeal). Where the knowledge in question was the officer's knowledge of his own fraud or breach of duty, Vaughan Williams J declined in *In re Hampshire Land Company* to hold that the knowledge was to be attributed to the company (see pp 749-750). In particular, if the director in breach of duty has an adverse interest to that of the company, the knowledge of the breach of duty will not be imputed to the company : see *J.C.Houghton and Co. v Nothard, Lowe and Wills Ltd* [1928] AC 1 where Lord Sumner said that it would be

> "… contrary to justice and common sense to treat the knowledge of such persons as that of their company, as if one were to assume that they would make a clean breast of their delinquency" (p.19)

107. There are, however, cases, sometimes referred to as "sole actor" cases, where the company has no human embodiment other than the fraudster and where, therefore, there is no one in the company for the fraudster to deceive, no one in the company to whom "a clean breast of … delinquency" could be made. In these "one actor" cases, it is said, the *Hampshire Land Company* rule can have no sensible application. The knowledge of the fraudster simply *is* the knowledge of the company. An example of this proposition in action is *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 328. This was a case in which the issue was whether the company, BLT, had been guilty of fraud or dishonesty in relation to money it held in trust for the plaintiff airline. The company had become insolvent and the airline sued its controlling director, Mr Tan, on the ground that he had knowingly assisted in the dissipation by BLT of the money. Lord Nicholls of Birkenhead, at 393, said this:

> "The defendant accepted that he knowingly assisted in that breach of trust. In other words, he caused or permitted his company to apply the money in a way he knew was not authorised by the trust of which the company was trustee. Set out in these bald terms, the defendant's conduct was dishonest. By the same token, and for good measure, BLT also acted dishonestly. The defendant was the company, and his state of mind is to be imputed to the company."

108. But the attribution to BLT of Mr Tan's dishonesty for the purposes of the airline's claim against, in effect, BLT and Mr Tan, could not be taken to bar misfeasance proceedings by the liquidator of BLT against Mr Tan or against any other officer of BLT who, in relation to the trust money, "has… been guilty of any misfeasance or breach of any … other duty in relation to …" BLT (s.212(1), Insolvency Act 1986 – assuming, of course, that s.212 or some similar statutory provision were applicable to BLT's insolvent liquidation.

109. It is noteworthy that there appears to be no case in which the "sole actor" exception to the *Hampshire Land Company* rule has been applied so as to bar an action brought by a company against an officer for breaches of duty that have caused, or contributed to, loss to the company as a result of the company engaging in illegal activities. I can easily accept that, for the purposes of an action against the company by an innocent third party, with no notice of any illegality or impropriety by the company in the conduct of its affairs, the state of mind of a "sole

actor" could and should be attributed to the company if it were relevant to the cause of action asserted against the company to do so. But it does not follow that that attribution should take place where the action is being brought by the company against an officer or manager who has been in breach of duty to the company.

110. It appears that the liquidators of S&R know of no assets of Mr Stojevic that could become the fruits of successful proceedings against him for breach of duty. But suppose that were not so. There can surely be no doubt that the liquidators could issue a misfeasance summons against him under section 212(1)(c) of the Insolvency Act 1986. Could Mr Stojevic, on such a summons, contend that his dishonesty should be attributed to the company that, in breach of his fiduciary duties under the power of attorney, he had turned into his vehicle for fraud? It is long established that section 212, like its statutory predecessors, is procedural and does not create a cause of action where none previously existed – although it is to be noted that section 212(3)(b) confers on the court a judgmental discretion as to the quantum of compensation that would not in an ordinary damages action be applicable. But Mr Stojevic could not, in my opinion, reduce his liability for breach of duty to S&R by attributing to S&R his own dishonesty, praying in aid the "sole actor" exception and the application of the *ex turpi causa* rule.

The liability of Moore Stephens

111. It is not clear to me why Moore Stephens, or any other officer of S&R whose breach of duty had contributed to the liabilities to which S&R is now subject, should be in any different position, so far as attribution to S&R of Mr Stojevic's dishonesty is concerned, to that of Mr Stojevic himself. Moore Stephens were not, as Lord Walker in para. 190 of his opinion has pointed out, directors or managers of the company's business. But they, too, as officers of the company (see s. 212(1)(a)) could have been, and could still be, the recipients of a section 212 misfeasance summons. The damages claimed in this action could have been claimed as compensation under section 212(3). Indeed this action is, to my mind, indistinguishable in substance from a section 212 misfeasance application and, if necessary, a simple amendment to the pleadings could make that clear. The same causation problems as lie beneath the surface in the present action would apply equally to a section 212 misfeasance application. No doubt the same *ex turpi causa* objection would have been taken but the nature of the claim, as one being brought for the benefit of S&R's creditors, would

have been more openly apparent and not in the least a matter of objection.

112. So I return to what I regard as the determinative issue, short but difficult. Why should the dishonesty of Mr Stojevic be attributed to S&R for the purposes of an action by S&R against its auditors, officers of the company who, on the assumed facts, had committed breaches of contractual duty that had a causative role in producing the liabilities to which S&R is subject? There are, in my opinion, two reasons why that attribution should not be made, the first is a procedural reason, the second is substantive.

The procedural reason

113. This is a strike-out application. There has been no trial and no factual findings but, nonetheless, the argument has proceeded on the footing that Mr Stojevic was the beneficial owner of the S&R shareholding. This derives, I think, from paragraph 2 of the Agreed Statement of Facts and Issues, which says that "Mr Stojevic was, indirectly through his family trust and a company incorporated in the Isle of Man, [S&R's] ultimate beneficial owner". It is not clear to me what was meant in this context by "ultimate" or whether an "ultimate beneficial owner" is the same as an owner who is absolutely beneficially entitled. There is nothing in the pleadings that says Mr Stojevic was the absolute beneficial owner of the S&R shares. Paragraph 2 of S&R's Amended Particulars of Claim says that he was a "shadow director" of S&R and held a power of attorney on behalf of S&R and paragraph 14 says that

> "S&R was controlled by Mr Stojevic and owned by Law Investments Limited …, an Isle of Man company which was in turn owned by Mr Stojevic's family trust …"

None of this justifies the assumption that Mr Stojevic was absolutely beneficially entitled to the S&R shares.

114. In the action in the Commercial Court brought by KB against S&R and Mr Stojevic, evidence was given about the relationship between Mr Stojevic and S&R. In paragraph 7 of his judgment, [2003] 1 Lloyd's Rep 383 at 384, Toulson J described Mr Stojevic as S&R's chief executive officer and continued:

> "SR's ultimate ownership is obscure, but Mr Stojevic was in command of its dealings with BCL and the bank"

He returned to the point in paragraph 25:

> "The shares in SR are held by an Isle of Man company called Law Investments Ltd, whose shareholders are nominee companies operating under an Isle of Man trust known as the Lucia trust. Mr Stojevic acknowledged that he was one of the beneficiaries of the trust. Objection was taken to his being asked to identify the other beneficiaries or the extent of his own beneficial interest, and the matter was not ultimatedly pressed by Mr Doctor QC on behalf of [KB]"

None of this justifies the assumption that Mr Stojevic was the absolute beneficial owner of the shares in S&R.

115. Langley J, in his judgment on the striking out application, referred to paragraphs 2 and 14 of S&R's pleading (cited in para 113 above) and said, in paragraph 21, that it was part of S&R's case that Mr Stojevic was "the controlling mind and will of S&R". He went on "There was no one else. In a real sense he was the company." The judge could not have meant that Mr Stojevic was the absolute beneficial owner of the S&R shares. There was nothing in the pleadings to justify such an assumption. In the Court of Appeal, on the other hand, Rimer LJ did say, in paragraph 5 that Mr Stojevic "owned, controlled and managed [S&R]" and in paragraph 9, that

> "In a real sense the company was [Mr Stojevic's] company. It was, for practical purposes, a 'one man company'."

And Mummery LJ, at paragraph 114, referred to S&R as "the one-man company owned and controlled by Mr Stojevic".

116. These references to S&R as being wholly controlled by Mr Stojevic were fully justified on S&R's own pleading; but references to S&R as "owned" by Mr Stojevic were not. A trial, if there is one, may establish that Mr Stojevic was indeed the absolute beneficial owner of

the S&R shares but a conclusion to that effect cannot be reached at the present stage and I do not regard the single sentence in paragraph 2 of the Agreed Statement as justifying the description of S&R as a "one-man company" otherwise than for the purpose of emphasising that he was in complete managerial control.

117. This point bears on the status of S&R as a victim of Mr Stojevic's dishonesty. Mr Stojevic derived his powers of control of S&R not from the status of director, for he was not one, but from the power of attorney that he had been granted by, presumably, Law Investments Ltd or nominees of theirs. That power of attorney had been used by Mr Stojevic to turn S&R into, so to speak, a corporate automaton. The power of attorney, if valid, could not have authorised the frauds in which S&R at Mr Stojevic's direction participated. Everything done by S&R at the direction of Mr Stojevic and in pursuance of his scheme of fraud must have been *ultra vires* his powers under the power of attorney. This feature could not enable S&R to resist the claims made by the defrauded third parties such as KB but, in my opinion, establishes S&R as a victim of the fraudulent scheme. In causing S&R to pay away to third parties the money fraudulently extracted from KB and the other victims of the frauds Mr Stojevic was abusing his powers under the power of attorney. That abuse was an essential feature of Mr Stojevic's fraudulent scheme and, as it seems to me, S&R was a victim of that abuse.

118. The emphasis placed by my noble and learned friends Lord Walker and Lord Phillips, and also by my noble and learned friend Lord Brown of Eaton-under-Heywood, on the assumed absolute beneficial ownership by Mr Stojevic of the S&R shareholding, coupled with his undoubted absolute managerial control, indicates, I suggest, that they are, in effect, lifting the corporate veil and treating S&R as if it were Mr Stojevic himself who was seeking to repel the *ex turpi causa* defence. But if the corporate veil cannot be lifted, and it cannot, in my opinion, if Mr Stojevic was not the absolute beneficial owner of the shares, the attribution of Mr Stojevic's dishonesty to S&R for the purpose of defeating an admitted breach of duty by S&R's officers, a breach of duty that had caused S&R to incur liabilities that it would not otherwise have incurred, cannot, in my opinion, be justified either in principle or on authority. S&R is a *legal persona* in its own right.

The substantive reason

119. *Caparo Industries plc v Dickman* [1990] 2 AC 605 established that auditors who prepare and submit to the company of which they are auditors negligently prepared accounts and reports may be in breach of the duty they owe to the company but are not in breach of any duty they owe to the shareholders. The company can recover in damages any loss caused by the breach of duty and the shareholders have no independent cause of action. Where a company is insolvent, loss caused to the company by a similar breach of duty by its auditors can similarly be remedied by an action in damages brought by the company. Its creditors, like the shareholders of a solvent company, are owed no duty of care by the auditors and can have no independent cause of action. None of this is in doubt. There is, however, a difference between a cause of action in negligence brought by a solvent company and a similar cause of action brought by an insolvent company. In the former case any damages recovered will benefit the shareholders; in the latter case the damages will benefit the creditors.

120. The *ex turpi causa* rule is a procedural rule based on public policy. The perpetrators of illegality, *a fortiori* of dishonest illegality, ought not to be allowed to benefit from their reprehensible conduct. If S&R had remained a solvent company an action against Moore Stephens that would have enabled Mr Stojevic to benefit from any damages that were recovered would have offended the *ex turpi causa* rule. Take the case of a solvent company that under the direction of its managing director engages in an unlawful and, in the event, loss making activity that could and should have been prevented by a timely report made by its auditors. Let it be supposed the managing director is also a shareholder and that he and the auditors are together sued for negligent breach of duty. I know of no authority that would bar such an action on *ex turpi causa* grounds. The action, assuming it succeeded against both defendants, could be expected, via contribution proceedings, to leave the delinquent managing director with no benefit from any damages recovered from the auditors. And why, if that were so, should public policy require the auditors to be relieved of liability for their breach of duty?

121. In a case, such as the present, where the company is insolvent and will stay so whatever damages are recoverable from the auditors, the need to ensure that the delinquent director does not benefit from the damages does not present a problem. There is no possibility of Mr Stojevic benefiting from any damages recoverable from Moore

Stephens. So, I repeat, why should the *ex turpi causa* rule, a rule based on public policy, bar an action against the auditors based on their breach of duty?

122. The wielding of a rule of public policy in circumstances where public policy is not engaged constitutes, in my respectful opinion, bad jurisprudence.

123. For all these reasons, and in general agreement with the reasons given by Lord Mance, I would allow this appeal and allow this action to proceed to trial.

LORD WALKER OF GESTINGTHORPE

My Lords,

Introduction

124. This is an appeal by Stone & Rolls Ltd (in liquidation) ("S&R") against an order of the Court of Appeal made on 18 June 2008, [2008] EWCA Civ 644, [2008] 3 WLR 1146. The Court of Appeal (Mummery, Keene and Rimer LJJ) allowed an appeal by Moore Stephens, a firm of chartered accountants, from an order of Langley J made on 11 September 2007, [2007] EWHC 1826 (Comm), [2008] Bus LR 304, [2008] 1 BCLC 697, and struck out S & R's claim against Moore Stephens (who had been its auditors) as barred by the *ex turpi causa* principle of public policy.

125. The fullest account of the facts is to be found in the judgment of Toulson J in *Komercni Banka AS v Stone and Rolls Ltd* [2002] EWHC 2263 (Comm), [2003] 1 Lloyd's Rep 383. There is also a full statement of the facts which must be assumed (for the purposes of Moore Stephens' strike-out application) in the lengthy amended statement of claim (running to 398 paragraphs, with supporting schedules) setting out S & R's case against Moore Stephens. The brief summary that follows is based on these sources as well as the judgments below.

126. S & R, a company registered in England, was dormant when in 1995 it came under the control of Mr Stojevic, the second defendant in the action brought by Komercni Banka AS ("KB"), a Czech bank. Mr Stojevic, a Croatian, was at all material times in sole control of S & R and (through artificial arrangements set up in the Isle of Man) effectively the beneficial owner of its share capital. He was described by Toulson J as having a very quick mind, but as having been evasive and untruthful. He was in fact the mastermind behind a fraudulent scheme which eventually resulted in KB obtaining judgment against S & R and Mr Stojevic for a sum in excess of $94m. Provisional liquidators of S & R were appointed on 15 November 2002 followed by a full winding-up order on 15 January 2003. The consequential claim against Moore Stephens is for about $94m together with several years' accrued interest.

127. The frauds were effected by means of letters of credit issued by KB in favour of S & R at the request of an Austrian company named BCL Trading GmbH ("BCL"). BCL was controlled by Mr Barak Alon, who appears to have been an accomplice of Mr Stojevic. Payment under the letters of credit was obtained by the presentation of false documents certifying the existence in distant warehouses of non-existent stocks of agricultural produce. These payments were promptly passed on to BCL, which initially met its liabilities to KB, so building up its confidence (KB was also found to have been negligent, but that was immaterial in a claim for deceit). Eventually however there were 30 letters of credit (totalling $94m) for which KB was not reimbursed. About $80m of this was promptly passed on to BCL, or companies connected with it, and it has never been traced.

The illegality defence

128. No one can found a cause of action on his own criminal conduct. This is not a technical rule, but a fundamental principle of public policy. In the well-known words of Lord Mansfield CJ 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."

The same principle has been described by McLachlin J in the Supreme Court of Canada, writing for the majority, as based on the need to preserve the integrity of the legal system: *Hall v Hebert* (1993) 101 DLR (4th) 129,160, 165.

129. The leading modern English authority on the scope of the principle is the decision of this House in *Tinsley v Milligan* [1994] 1 AC 340. In that case the House was unanimous in disapproving the "public conscience" test applied by the Court of Appeal (in reliance on the earlier decisions of the Court of Appeal in *Saunders v Edwards* [1987] 1 WLR 1116, *Euro-Diam Ltd v Bathurst* [1990] 1 QB 1 and *Howard v Shirlstar Container Transport Ltd* [1990] 1 WLR 1292). But the House was divided over the correct test. The majority identified the test as whether the claimant had to plead or rely on his own illegality (see Lord Browne-Wilkinson at p 376). The minority favoured a broader test of whether the claim was tainted by illegality (see Lord Goff of Chieveley at p 363).

130. *Tinsley v Milligan* is in some ways a difficult and controversial decision. It raised issues as to equitable interests in property, and the equitable "clean hands" doctrine, which do not arise here. The Law Commission is well advanced, after lengthy deliberation and consultation, with proposals for the reform of this area of the law (Consultation Paper No. 160, The Illegality Defence in Tort (2001) and Consultation Paper No. 189, The Illegality Defence (2009)). These proposals, if enacted by Parliament, would introduce more flexibility into this area of the law (although without reintroducing a general "public conscience" discretion).

131. It is not necessary to go further into the Law Commission's proposals. The present state of the law is as laid down by the majority of the House in *Tinsley v Milligan*. Any legislative change is likely to widen the test, not to narrow it. It is common ground that if Mr Stojevic had carried out his frauds on his own, and not through a corporate vehicle, neither he nor his trustee in bankruptcy would have had a claim against the auditors, since the illegality defence would have been unanswerable. The main area of dispute is as to the imputation to S & R of Mr Stojevic's criminal acts and intentions.

Primary or vicarious liability?

132. The first issue, within this main area of dispute, is whether S & R was primarily (or directly, the term used by Rimer LJ) liable for the fraud practised on KB, or was merely vicariously liable for the fraud of Mr Stojevic. In the Court of Appeal and before your Lordships Mr Brindle QC contended that S & R's liability was vicarious only, while also contending (rather more vigorously) that the point was in any case of no real significance. Even if S & R's liability was more than merely vicarious, he submitted, the principle in *Re Hampshire Land Co.* [1896] 2 Ch 743 was still capable of applying in the context of a claim by S & R against its auditors. He criticised Rimer LJ for failing to distinguish between the attribution exercise called for in two different situations, that is (i) KB's claim for fraud against S & R, and (ii) S & R's claim for negligence against the auditors.

133. In my opinion Rimer LJ (with whom Mummery and Keene LJJ agreed) was clearly right in holding that S & R was primarily (or directly) liable for the frauds. He recognised that *Citizens' Life Assurance Co Ltd v Brown* [1904] AC 423 (a case of malicious libel on appeal to the Judicial Committee from New South Wales) was decided on the basis of vicarious liability. But its historical importance is as a decisive rejection of Lord Bramwell's view (in *Abrath v North Eastern Railway Co.* (1886) 11 App Cas 247) that a company could never have a dishonest motive attributed to it. The present law was clearly explained by Lord Reid in a passage which Rimer LJ cited from *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153, 170:

> "I must start by considering the nature of the personality which by a fiction the law attributes to a corporation. A living person has a mind which can have knowledge or intention or be negligent and he has hands to carry out his intentions. A corporation has none of these: it must act through living persons, though not always one or the same person. Then the person who acts is not speaking or acting for the company. He is acting as the company and his mind which directs his acts is the mind of the company. There is no question of the company being vicariously liable. He is not acting as a servant, representative, agent or delegate. He is an embodiment of the company or, one could say, he hears and speaks through the persona of the company, within his appropriate sphere, and his mind is the mind of the

> company. If it is a guilty mind then that guilt is the guilt of the company."

134. In this case there is no doubt that Mr Stojevic was the persona of S & R. He was "really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation" (Viscount Haldane LC in *Lennard's Carrying Co. Ltd v Asiatic Petroleum Co. Ltd* [1915] AC 705, 713). In his written case Mr Brindle criticised Rimer LJ for a meaningless inquiry for a single directing mind and will. He drew attention to a leading textbook suggesting that Lord Hoffmann has castigated that approach as a misleading "general metaphysic of companies" (Gower and Davies, The Principles of Modern Company Law, 8th edition, 2008, para 7-29, commenting on *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500, 509). That comment is, I think, overstated. In *Meridian* Lord Hoffmann approved Viscount Haldane's search for the person who was, within Lennard's Carrying Company, the equivalent of an individual ship-owner. He then pointed out that as the company seemed to have no business other than ship-owning, the functions of general management and responsibility for ship-owning coincided; and (p 509):

> "It was this coincidence which left Viscount Haldane LC's speech open to the interpretation that he was expounding a general metaphysic of companies."

In short not every company has a single directing mind and will, but some companies do.

135. The criticism is therefore quite inapposite in relation to S & R, because it is common ground that Mr Stojevic really was the embodiment of S & R for all purposes. As Rimer LJ put it (in para 9 of his judgment):

> "It is the essence of [S & R's] claim that Mr Stojevic was its controlling mind and will. Nobody else was in a like position. In a real sense the company was his company. It was, for practical purposes, a 'one man company'. It is a further part of the claim that the company was throughout used by Mr Stojevic as a vehicle for fraud, by extracting money from KB so that it could then be paid away to the fraudsters."

136. I conclude that S & R was primarily liable for the frauds and on that basis I go on to the *Hampshire Land* principle, bearing in mind that I have not yet fully addressed Mr Brindle's submissions about the importance of context—that is, the type of claim, by or against the company, in which the question of attribution arises.

The Hampshire Land principle

137. In *Re Hampshire Land Company* [1896] 2 Ch 743 Mr Wills was secretary of a trading company, Hampshire Land, and of a building society, Portsea Island. The company borrowed £30,000 from the building society. This was irregular because it was done without the authority of the company given at a properly-convened general meeting. The company then went into liquidation, and the building society claimed to be a creditor for £30,000. The claim depended on whether the building society was to be imputed, through Mr Wills, with knowledge of the irregularity. It was accepted that if Mr Wills had been fraudulent, his knowledge would not have been imputed to the building society; and Vaughan Williams J applied the same principle to a breach of duty (even if it did not amount to fraud) since Mr Wills could not be expected to disclose something to his own detriment.

138. That principle (which is a general principle of agency) was applied by this House in *J C Houghton and Co v Nothard, Lowe and Wills Ltd* [1928] AC 1. Two brothers, the Lowes, owed duties to two different trading companies, NLFP (an old-established company) and NLW (a new joint venture company partly owned by a competitor). The Lowes committed NLW to commercial arrangements that were against its best interests, and favourable to NLFP. The issue was whether the Lowes' guilty knowledge estopped NLW from obtaining relief. This House held that there was no estoppel. Viscount Dunedin observed (at p 14):

> "My Lords, there can obviously be no acquiescence without knowledge of the fact as to which acquiescence is said to have taken place. The person who is sought to be estopped is here a company, an abstract conception, not a being who has eyes and ears. The knowledge of the company can only be the knowledge of persons who are entitled to represent the company. It may be assumed that the knowledge of directors is in ordinary circumstances the knowledge of the company. The knowledge of a mere

> official like the secretary would only be the knowledge of the company if the thing of which knowledge is predicated was a thing within the ordinary domain of the secretary's duties. But what if the knowledge of the director is the knowledge of a director who is himself particeps criminis, that is, if the knowledge of an infringement of the right of the company is only brought home to the man who himself was the artificer of such infringement? Common sense suggests the answer, but authority is not wanting."

He then referred to *Hampshire Land.* Similarly Viscount Sumner said of the Lowes (at p19):

> "Their silence was accordingly a notable breach of duty. It has long been recognised that it would be contrary to justice and common sense to treat the knowledge of such persons as that of their company, as if one were to assume that they would make a clean breast of their delinquency. Hence, for the purpose of estopping the company, some knowledge other than theirs has to be brought home to other directors, who can be presumed not to be concerned to suppress it. This was laid down, following earlier cases, in *Re Hampshire Land Co*, and was even then treated as incontestable."

139. The same principle was applied by the Court of Appeal in *Belmont Finance Corporation Ltd v Williams Furniture Ltd* [1979] Ch 250. It was an appeal against the summary dismissal of Belmont's claim on the ground that Belmont was a party to the fraudulent conspiracy, and so shut out by the *ex turpi causa* rule. Belmont's directors (apparently in collusion with the shareholders in a company that I shall call Maximum) agreed to buy Maximum for £500,000, although it was said to be worth little more than £60,000. Maximum's ex-shareholders then bought all the shares in Belmont from the Williams Furniture group for £489,000, so committing an offence under section 54 of the Companies Act 1948. Later Belmont, in liquidation, brought proceedings for misfeasance against its former holding companies and various individuals. The Court of Appeal allowed the appeal and directed that the claim should go to trial. The leading judgment was given by Buckley LJ, who did not refer to *Hampshire Land* or *J C Houghton and Co v Nothard, Lowe and Wills Ltd*, but stated the same principle (at pp 261-262):

> "It may emerge at a trial that the facts are not as alleged in the statement of claim, but if the allegations in the statement of claim are made good, the directors of the plaintiff company must then have known that the transaction was an illegal transaction.
>
> But in my view such knowledge should not be imputed to the company, for the essence of the arrangement was to deprive the company improperly of a large part of its assets. As I have said, the company was a victim of the conspiracy. I think it would be irrational to treat the directors, who were allegedly parties to the conspiracy, notionally as having transmitted this knowledge to the company; and indeed it is a well-recognised exception from the general rule that a principal is affected by notice received by his agent that, if the agent is acting in fraud of his principal and the matter of which he has notice is relevant to the fraud, that knowledge is not to be imputed to the principal.
>
> So in my opinion the plaintiff company should not be regarded as a party to the conspiracy, on the ground of lack of the necessary guilty knowledge."

It should be noted that Belmont was not, on any view, a one-man company; and it was, as Buckley LJ observed, the victim of a conspiracy.

140. The decision in *Belmont* was not entirely straightforward, but in my view it was correct. The case can be understood only by reference to the fuller statement of its facts in the judgments in the second appeal to the Court of Appeal, *Belmont Finance Corporation v Williams Furniture Ltd (No 2)* [1980] 1 All ER 393. The first appeal was from Foster J's order striking out Belmont's claim on the ground that it was seeking to rely on its own illegality. The second appeal, paradoxically, was from the same judge's dismissal of the claim at trial, on the ground that what had taken place was a bona fide commercial transaction involving no illegality.

141. The alleged illegality was in the company providing financial assistance for the purchase of its shares, contrary to what was then section 54 of the Companies Act 1948. That provision is one reflection of the basic principle of company law requiring a limited company to

maintain its capital: see the explanation by Lord Watson in the leading case of *Trevor v Whitworth* (1887) 12 Ch App 409, 423-424. The general prohibitions on a limited company purchasing its own shares, or providing financial assistance for their purchase by another person (both now subject to carefully limited exceptions) have the purpose of preserving the limited company's capital for the protection of those who trade with it.

142. For present purposes there are two essential points to note in regard to the complicated manoeuvres undertaken in *Belmont*. First, there was a purchase (of the shares in Maximum) at a gross overvalue, and this (quite apart from section 54 of the Companies Act 1948) was a breach of fiduciary duty by those of Belmont's directors who were complicit (see especially the judgment of Goff LJ in *Belmont (No 2)* at p 411). Secondly, as part of the same prearranged plan the £0.5m extracted from Belmont was then recycled by purchasing the shares in Belmont, so infringing section 54. The former shareholders in Belmont did not suffer under the prearranged scheme, since they wanted to sell the company and were no worse off through the purchase of Maximum at an overvalue (but they were held accountable as constructive trustees). The real victims, after predictions as to Maximum's profit-earning capacity proved mistaken, were Belmont's creditors (and especially its depositors, who apparently took priority to the debenture-holders).

143. Looking at the earlier *Belmont* decision again in the light of the fuller facts in *Belmont (No 2)* I think that Buckley LJ was right to say that Belmont was a victim. It lost over £0.4m in assets (though its former shareholders did not suffer that loss until the court made them accountable) and, on the *Hampshire Land* principle, the guilty knowledge of some of the directors was not to be attributed to Belmont. Section 54 was certainly enacted to protect company funds and the interests of shareholders as well as creditors, as Scarman LJ said in *Wallersteiner v Moir* [1974] 1 WLR 991, 1032-1033 but I do not see that this undermines the reasoning of Buckley LJ (who referred to *Wallersteiner v Moir* at p 261).

144. In all these cases there was a company which was the victim of a fraud or serious breach of duty, and the court held that it was not to be prejudiced by the guilty knowledge of an individual officer who could not be expected to disclose his own fault. (The fact that duties were owed to two different companies in *Hampshire Land* and *Houghton* is, I think, an irrelevant coincidence). This principle is sometimes referred

to in the United States of America as the "adverse interest" exception to the usual rule of imputation (see for instance Rudolph and Tanis, "Invoking *In Pari Delicto* to Bar Accountant Liability Actions Brought by Trustees and Receivers" (2008) ALI-ABA Study Materials). It is applied, typically, in cases in which the corporate victim is the claimant and the defence seeks to rely on the corporate victim's notice, knowledge or complicity. It will be necessary to consider some recent English cases which do not fit so neatly into the same mould.

145. In reviewing some of the recent cases Rimer LJ expressed surprise (in para 71 of his judgment) at the *Hampshire Land* principle being referred to in the context of fixing liability on a party. He saw the principle as "primarily concerned not with a company's *liabilities* to others but rather with its *claims* against others." Most of the early cases do fall into that category (though in *Houghton* NLW's claim was a counterclaim against a third party which was seeking delivery of bills of lading). But I can see no reason why the principle should be limited to claims. It is, as I have said, a general principle of agency which can apply to any issue as to a company's notice, knowledge or complicity, whether that issue arises as a matter of claim or defence.

Sole actors and secondary victims

146. Mr Brindle has relied on the *Hampshire Land* principle to insulate S & R, for the purposes of the *ex turpi causa* rule, from Mr Stojevic's fraudulent conduct. Mr Sumption QC, for Moore Stephens, has in the Court of Appeal and before the House deployed two lines of argument against that. The first is that the principle has no application in a case where the person or persons with ownership and control of the company are entirely complicit in the fraud, so that there is no single individual connected with the company who can be regarded as an innocent party deceived and prejudiced by the fraud. This is, in the terminology used in the United States, the "sole actor" exception to the "adverse interest" rule—which is itself an exception to the ordinary rules of imputation. In England the phrase "one-man company" is sometimes used, but it is an imprecise expression which calls for explanation. The other line of argument is that the *Hampshire Land* principle does not apply to cases where the victim of the fraud is not the company itself, but a third party. This leads on to arguments as to whether the company in question, although not a primary victim, should be regarded as a secondary victim (and so within the principle).

147. In the Court of Appeal Rimer LJ (with the concurrence of the other members of the Court) rejected the first line of argument (paras 45 and 46) but acceded to the second (paras 65 to 73). I would add, however, that Rimer LJ's summary of his reasoning, (in para 73 of his judgment, quoted in para 169 below) begins with a couple of sentences which suggest to me that his discussion on the "victim" issue may have begun to raise some degree of doubt about his conclusion on the "sole actor" issue. I shall discuss these issues in turn. But as some of the modern cases touch on both issues it is convenient to summarise them first, in chronological order.

The modern cases

148. Both sides relied on the decision of the Court of Appeal in *Attorney General's Reference (No. 2 of 1982)* [1984] QB 624. This was concerned with a point of criminal law:

> "Whether a man in total control of a limited liability company (by reason of his shareholding and directorship) is capable of stealing the property of the company; and whether two men in total control of a limited liability company (by reason of their shareholdings and directorships) are (while acting in concert) capable of jointly stealing the property of the company."

Two men, who were between them in total control of a company, had plundered its assets in extravagant living and it was insolvent to the extent of about £2.5m. The case was largely concerned with the application to that situation of the language of section 2(1)(a) and (b) of the Theft Act 1968. For my part I do not think that the decision assists either side. It is really concerned with the correct construction of a criminal statute and its application to a situation which Parliament may not have contemplated when the Theft Act 1968 was being enacted.

149. *Brink's-Mat Ltd v Noye* [1991] 1 Bank LR 68 was not cited to the Court of Appeal (indeed Mr Sumption told us that it seems never to have been cited in any reported case before). Brink's-Mat was bailee of very valuable gold bullion stolen in a notorious armed robbery which took place in 1983. Two of the conspirators, Chappell and Palmer, smelted and recast some of the bullion and used a company, Scadlynn Ltd, to sell the recast gold (some was sold to its true owner, Johnson Matthey). Scadlynn had a small issued capital owned by Chappell and

Palmer. Between September 1984 and the end of January 1985 over £10m was withdrawn in cash from Scadlynn's account with Barclays Bank. Brink's-Mat sued Chappell, Palmer, Scadlynn and Barclays Bank. The issue before the Court of Appeal was a proposed re-amendment of the statement of claim to add new claims against Barclays Bank. These were claims for wrongs to Scadlynn which Brink's-Mat claimed to be able to enforce as beneficiary under a constructive trust. That was the very unusual context in which Mustill LJ said (at p 72):

> "Here the corporate entity named Scadlynn was, however odd the notion may seem at first sight, the victim of wrongful arrangements to deprive it improperly of a large part of its assets: see *Belmont Finance Corporation Ltd v Williams Furniture Ltd* [1979] Ch 250, at pp 261-262. If the facts were such that the bank should have recognised the possibility of such an impropriety, and if the scope of the bank's duty of care was wide enough to impose an obligation to take steps to forestall it, I see no reason why the cause of action should not be enforced by Scadlynn for the ultimate benefit of the creditors who would look to those assets for satisfaction of their debts."

Similarly Nicholls LJ said (at 73):

> "On the facts alleged in the proposed amendments, Scadlynn was at all material times being used by Chappell and Palmer and others for a fraudulent purpose, viz, to realise the proceeds of sale of the robbery. But the plaintiff was not implicated in any such fraudulent purpose. On the contrary, along with the owners of the gold, the plaintiff was the intended victim of the scheme. Likewise, Scadlynn itself was an intended victim, in that Scadlynn was being used as a vehicle for committing a fraud on its creditors and a fraud on those beneficially interested in property held by Scadlynn. In those circumstances the fraudulent purposes of those controlling Scadlynn are not to be imputed to the company itself: see *Belmont Finance Corpn Ltd v Williams Furniture Ltd* [1979] Ch 250, per Buckley LJ at pp 261-262."

150. In *Berg, Sons & Co Ltd v Mervyn Hampton Adams* (1992) [2002] Lloyd's Rep PN 41, Berg was, on any view, a one-man

company. Mr Golechha was the only active director and sole beneficial owner of its shares. Berg became insolvent (without fraud being proved or, so far as I can see, alleged) and its liquidator sued some former partners in the auditors, Dearden Farrow. Hobhouse J held that the auditors had negligently treated certain bad debts as recoverable, but that only nominal damages could be recovered. The reason was explained by Hobhouse J, at p 54:

> "In the present case it has not been proved that there was any fraud by Mr Golechha in relation to the 1981 audit, still less that at that time Mr Golechha was practising any fraud on his principal, Berg. There was no entity which it can be said he misled or in relation to which it can be said that he was acting fraudulently in relation to the audit in October 1982. However one identifies the company, whether it is the head management, or the company in general meeting, it was not misled and no fraud was practised upon it. This is a simple and unsurprising consequence of the fact that every physical manifestation of the company Berg was Mr Golechha himself. Any company must in the last resort, if it is to allege that it was fraudulently misled, be able to point to some natural person who was misled by the fraud. That the plaintiffs cannot do."

Hobhouse J distinguished *Belmont* because there was no conspiracy to defraud Berg. He referred to *Attorney General's Reference (No 2 of 1982)* as "nearer to the point" but only, as I understand it, because in that case also there was no individual victim. But again the case was distinguishable because it involved fraud, and there was no fraud against Berg.

151. *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152 was concerned with contracts of reinsurance which (lacking statutory authorisation) were void for illegality. It is of interest as being the first of the modern cases decided after *Meridian*. After referring to *Meridian* Saville LJ said (at p 1170):

> "In the present case the reinsurers rely upon cases where knowledge has been attributed, while the reinsured rely upon cases dealing with what has been called 'the fraud exception' or the rule in *Re Hampshire Land Co* [1896] 2 Ch 743, i.e. cases where knowledge of the fraudsters of a

> fraud on a corporation has been unsuccessfully sought to be attributed to the corporation.
>
> Mr Bartlett [for the reinsurers] accepted that there were circumstances in which the 'fraud exception' meant that knowledge was not attributed. In his submission, the essence of the relevant principle is that the court will not infer that a company has knowledge of a fact known to an agent or director of the company where, because of the agent's or director's fraud or other breach of duty to the company, *it would be contrary to justice and common sense to draw such inference.*
>
> For the purposes of this case at least, I am prepared to proceed on the basis of this proposition."

152. *Arab Bank plc v Zurich Insurance Co* [1999] 1 Lloyd's Rep 262 involved a fraudulent valuation made by a managing director, Mr Browne (who was not however the directing mind and will of his company, JDW). Both JDW and Mr Browne were separately covered by a fidelity policy, subject to a proviso excluding from indemnity "any person knowingly committing, making or condoning [a dishonest or fraudulent] act." This context had an important bearing on the way in which Rix J approached the issue of attribution (see at p 279, where he said that the position might have been different with a "one man company"). But Rix J also discussed the "victim" issue. He observed at pp 282-283:

> "There remains the question, . . . whether the *Hampshire Land* doctrine is confined to cases of fraud where the principal is himself the victim of the fraud, or whether, as Mr Justice Vaughan Williams put it in *Hampshire Land* itself, the doctrine extends to other breaches of duty where common sense would destroy the inference of transfer of knowledge. In the typical case in which the doctrine has been applied, *Houghton, Belmont, PCW* and *Group Josi Re*, fraud has been found or assumed. In the present case, fraud is also assumed, but the primary victim of the fraud has been the lending institution which has relied on the valuation. I would accept, however, the plaintiffs' submission that JDW was also a victim, even if only a secondary victim, of the assumed fraud. One consequence of that assumed fraud has been JDW's liability to the plaintiffs, albeit in negligence. Moreover, even if it could

> be said that JDW, unlike the plaintiffs, was *not* the victim of Mr Browne's fraud, Mr Browne has, on the assumed facts, been guilty of dishonesty, and one can hardly visualise a graver dereliction of his duty to his company. Although the cases often involve fraud, *Hampshire Land* itself did not necessarily do so, and I note that in *Group Josi Re*, Lord Justice Saville was prepared to accept as a working definition of the scope of the principle the cases of 'the agent's or director's fraud or other breach of duty to the company' (at p 367). In my judgment, Mr Browne's fault comes within the concept of an agent's fraud on his principal, but, even if it does not, his fault is such a breach of duty to JDW as in justice and common sense must entail that it is impossible to infer that his knowledge of his own dishonesty was transferred to JDW."

153. *McNicholas Construction Co Ltd v Customs & Excise Commissioners* [2000] STC 553 is the first of the cases in which Rimer LJ was surprised to find *Hampshire Land* being used in the context of a claim against a company. *McNicholas* was a civil contractor and often had contracts to dig trenches for cable ducts. It had some employed staff but also used gangs of self-employed labourers. Customs & Excise suspected that McNicholas was paying fraudulent invoices for VAT on services which had never been provided, and was then claiming to deduct this as input tax. Customs & Excise raised assessments to recover lost tax and (so far as the assessments went back more than three years) had to establish dishonesty on the part of McNicholas. The Tribunal found that some of its site managers were complicit in the fraud, and that their dishonesty was to be attributed to McNicholas for the purposes of the VAT legislation.

154. Dyson J dismissed McNicholas's appeal. He approved the Tribunal's reliance on the context of the VAT legislation as calling for a special rule of attribution. He also made some interesting observations touching on the "victim" issue (para 55):

> "In my judgment, the tribunal correctly concluded that there should be attribution in the present case, since the company could not sensibly be regarded as a victim of the fraud. They were right to hold that the fraud was 'neutral' from the company's point of view. The circumstances in which the exception to the general rule of attribution will apply are where the person whose acts it is sought to

> impute to the company knows or believes that his acts are detrimental to the interests of the company in a material respect. This explains, for example, the reference by Viscount Sumner in *J C Houghton and Co v Nothard, Lowe and Wills Ltd* [1928] AC 1 at p19 to making 'a clean breast of their delinquency'. It follows that, in judging whether a company is to be regarded as the victim of the acts of a person, one should consider the effect of the acts themselves, and not what the position would be if those acts eventually prove to be ineffective."

I have to say that I find it difficult to understand, as a matter of fact, why the fraud was "neutral" from the point of view of McNicholas. But the important point is Dyson J's view that in principle "in judging whether a company is to be regarded as the victim of the acts of a person, one should consider the effect of the acts themselves, and not what the position would be if those acts eventually prove to be ineffective."

155. The last of the recent cases is the decision of the Court of Appeal in *Bank of India v Morris* [2005] BCC 739, one of the many cases concerned with the fallout from the collapse of BCCI. Mr Samant, a senior manager (but not a director) of the Bank of India, committed it to a series of transactions which amounted to assisting BCCI to defraud its creditors. The Court of Appeal upheld Patten J, who had held Bank of India liable under section 213 of the Insolvency Act 1986. Again, the statutory context guided the court's approach to the appropriate rule of attribution. Patten J had been right to follow *McNicholas* (para 118):

> "As in *McNicholas*, the acts of Mr Samant were not in fact targeted at BoI. He was acting for, and in what he apparently believed to be the interests of, BoI in seeking to gross up the balance sheet for the purposes of the year end accounts. The potential liability of BoI under s213 is irrelevant in deciding whether BoI was a victim of Mr Samant and whether his knowledge should be attributed to it for the purposes of s 213."

156. The Court of Appeal also commented on *Arab Bank* (para 124):

> "In our judgment, the facts and the contractual context make *Arab Bank* a different case. It did not lay down a general principle of attribution of knowledge which

> governs this case of statutory liability to make compensation to victims of fraudulent trading. *Arab Bank* is not, as Mr Moss contended, authority for the proposition that knowledge of fraud can only be attributed to a company if the individual with the relevant knowledge was a director or directing mind of the company, or where it can be inferred from all the circumstances that the individual transferred his knowledge to the company or to its directing mind and will; nor is it authority for the proposition that there can be no attribution of knowledge where the company is a 'secondary victim' of the individual's wrongdoing or breach of duty."

Discussion of the 'sole actor' exception

157. The 'sole actor' exception was applied (although not by that name) by the Privy Council (on appeal from Brunei) in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378. The airline had been defrauded by Mr Tan who was the principal director and shareholder in a travel agency company called Borneo Leisure Travel ("BLT"). The only other director and shareholder was Mr Tan's wife. BLT owed fiduciary duties to the airline for money which it received, but misappropriated it for its own purposes. Lord Nicholls of Birkenhead formulated the issue (p.384) as "whether the breach of trust which is a prerequisite to accessory liability must itself be a dishonest and fraudulent breach of trust by the trustee." He answered that question in the negative, adding (at p 392) "although this will usually be so where the third party who is assisting him is acting dishonestly" (as Mr Tan was). But as BLT was a one-man company it was itself dishonest (at p 393):

> "Set out in these bald terms, [Mr Tan's] conduct was dishonest. By the same token, and for good measure, BLT also acted dishonestly. [Mr Tan] was the company, and his state of mind is to be imputed to the company."

Belmont was referred to in the Judicial Committee's judgment, but only on the issue of the degree of improbity required for accessory liability.

158. *Berg* was another clear case of a one-man company. It was not a case involving fraud, but Hobhouse J's judgment explains why it can be seen as a sort of mirror-image of the *Hampshire Land* situation. In

Hampshire Land the company secretary had been guilty of a serious breach of duty which he could be expected to keep quiet about, and not disclose to the directors and members of the building society. His guilty knowledge was not therefore attributed to the building society. In *Berg,* by contrast, Mr Golechha knew all about the irrecoverable loans, and there was no other individual concerned in the management or ownership of his company from whom his knowledge could be concealed, because there simply was no such individual—"a simple and unsurprising consequence," as Hobhouse J put it, "of the fact that every physical manifestation of the company Berg was Mr Golechha himself."

159. In situations like those in *Royal Brunei* and *Berg* denial of attribution on "adverse interest" grounds would not serve the ends of justice. It would on the contrary operate as a reversion to the views of Lord Bramwell in *Abrath v North Eastern Railway Company*, reducing a one-man company to a mindless creature in the eyes of the law. Instead it has the mind of its human embodiment, though that is not treated as a *separate* mind for the purposes of the crime of conspiracy (*R v McDonnell* [1966] 1 QB 233, 245).

160. As I have said, the concept of a one-man company calls for some explanation. It was severely criticized by Lord Macnaghten in the leading case of *Salomon v Salomon & Co Ltd* [1897] AC 22, 53:

> "It has become the fashion to call companies of this class 'one man companies.' That is a taking nickname, but it does not help one much in the way of argument. If it is intended to convey the meaning that a company which is under absolute control of one person is not a company legally incorporated, although the requirements of the Act of 1862 may have been complied with, it is inaccurate and misleading: if it merely means that there is a predominant partner possessing an overwhelming influence and entitled practically to the whole of the profits, there is nothing in that that I can see is contrary to the true intention of the Act of 1862, or against public policy, or detrimental to the interests of creditors."

161. But *Salomon's* case was not concerned with the attribution of any state of mind to Mr Aron Salomon's company. On the contrary, it was argued (successfully at first instance and in the Court of Appeal:

Broderip v Salomon [1895] 2 Ch 323) that the company was a sham, a mindless mask for Mr Salomon as the real owner of the business. In this appeal, by contrast, the issue is the attribution to S & R of a dishonest state of mind. Where that is the issue the notion of a one-man company does become meaningful, as *Royal Brunei* demonstrates. In this context I would treat the expression as covering cases where there is one single dominant director and shareholder (such as Mr Tan in *Royal Brunei*, Mr Golechha in *Berg*, or Mr Stojevic in the present case) even if there are other directors or shareholders who are subservient to the dominant personality (such as Mr Tan's wife in *Royal Brunei*, the inactive solicitor-director in *Berg*, or S & R's nominee directors). I would also treat it as covering cases where there are two or more individual directors and shareholders acting closely in concert, such as the anonymised directors in *Attorney General's Reference (No 2 of 1982)* or Mr Chappell and Mr Palmer in *Brink's-Mat*. It may be simplest to propose a test in negative terms, on the lines of what Hobhouse J said in *Berg*, that is a company which has no individual concerned in its management and ownership other than those who are, or must (because of their reckless indifference) be taken to be, aware of the fraud or breach of duty with which the court is concerned.

162. The principle of the "sole actor" is more fully developed in United States case law. In his printed case Mr Sumption referred to a number of United States authorities (not cited to the Court of Appeal) while accepting that they have to be treated with caution, both because of variations between state laws and because of the rather different basis of the public policy defence in the United States (which inclines to *in pari delicto potior est conditio defendentis* as the guiding principle). I accept that caution is needed, but I find the general reasoning in these cases persuasive and in line with the English authorities just mentioned.

163. In *The Mediators Inc v Manney* 105 F 3d 822 (1997), a decision of the Second Circuit of the United States Court of Appeals, applying the law of New York, the court upheld the rejection (on grounds of illegality) of a claim on behalf of a company's unsecured creditors against bankers, lawyers and accountants said to have assisted Mr Manny, the company's president and sole shareholder, in breach of fiduciary duties to the company. The court stated the principle as follows (at p 827, omitting references):

> "Second, the adverse interest exception does not apply to cases in which the principal is a corporation and the agent

> is its sole shareholder. As noted, the adverse interest exception is to a presumption that an agent has discharged the duty of disclosing material facts to the principal. Under New York law, where the agent is defrauding the principal, such disclosure cannot be presumed because it would defeat—or have defeated—the fraud. However, where the principal and agent are one and the same, the adverse interest exception is itself subject to an exception styled the 'sole actor' rule. This rule imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal. Where, as here, a sole shareholder is alleged to have stripped the corporation of assets, the adverse interest exception to the presumption of knowledge cannot apply."

164. In *Official Committee of Unsecured Creditors v R F Lafferty & Co Inc* 267 F 3d 340 (2001) the Third Circuit of the United States Court of Appeals, applying the law of Pennsylvania, reached a similar conclusion. Two companies, Walnut and its wholly-owned subsidiary ELCOA, were run and owned by Mr William Shapiro and other members of the Shapiro family, assisted by various professionals. The two companies ran a fraudulent Ponzi scheme. The court decided (at p357) that it must evaluate the *in pari delicto* defence without regard to whether the Committee was an innocent successor. On that basis the court applied the sole actor exception (treating the Shapiro family as a single entity) and held the companies to be *in pari delicto* (at p 359, references omitted):

> "The second part of the imputation test—whether fraudulent conduct was perpetrated for the benefit of the debtor corporation—is often analysed under the 'adverse interest exception.' Under this exception, fraudulent conduct will not be imputed if the officer's interests were adverse to the corporation and 'not for the benefit of the corporation.'
>
> The Committee argues that the Shapiro family's fraud was adverse to the interests of the Debtors, and indeed, caused damage to them through 'deepening insolvency.' Thus, the Committee maintains that the Shapiros did not act for the benefit of the Debtors and their fraudulent conduct cannot be imputed to those corporations. However, even assuming that the Shapiros' interests were adverse to the

> Debtors' interests, the Committee cannot prevail because the 'adverse interest exception' is itself subject to an exception—the 'sole actor' exception. The general principle of the 'sole actor' exception provides that, if an agent is the sole representative of a principal, then that agent's fraudulent conduct is imputable to the principal regardless of whether the agent's conduct was adverse to the principal's interests. The rationale for this rule is that the sole agent has no one to whom he can impart his knowledge, or from whom he can conceal it, and that the corporation must bear the responsibility for allowing an agent to act without accountability."

165. There is also a very interesting discussion of these problems in the judgment of the Supreme Court of Canada in *Canadian Dredge & Dock Co Ltd v The Queen* (1985) 19 DLR (4^{th}) 314. It was the final appeal in a major criminal trial of both corporate and individual defendants for bid-rigging of tenders in the dredging industry. Top executives had conspired together and companies which had won contracts by illegal means divided their ill-gotten gains, some of which ended up in the hands of individual executives. The whole judgment (given by Estey J) deserves study. Its general conclusion (at the end of the headnote on p316) is this:

> "The corporation could not be said to have been defrauded in any relevant sense when the only thing of which it was deprived was part or indeed all of the product of the crime with which it was charged. It was no defence that some of the illegal compensation was diverted to the individuals."

166. Rimer LJ did not accept Mr Sumption's submissions on this point (and did not, as I have noted, have the United States and Canadian authorities cited to him). He did so primarily in reliance on the statement in *Attorney General's Reference (No 2 of 1982)* that the principle in *Belmont* can apply even though it was true of the two controlling directors (p 642) "that their acts are necessarily the company's acts; that their will, knowledge and belief are those of the company, and that their consent necessarily implies consent by the company." But the Court of Appeal rejected that reasoning, as I see it, only because it could not be reconciled with the words "the other" in section 2(1)(b) of the Theft Act 1968. The Court of Appeal felt itself compelled by the wording of the statute to look for a *separate* will as it had in *R v McDonnell*, the case about conspiracy.

167. There is no special statutory context of that sort here. On this point I respectfully disagree with Rimer LJ and the other members of the Court of Appeal. In the case of a one-man company (in the sense indicated above) which has deliberately engaged in serious fraud, I would follow *Royal Brunei* (and the strong line of United States and Canadian authority) in imputing awareness of the fraud to the company, applying what is referred to in the United States as the "sole actor" exception to the "adverse interest" principle.

168. In particular I would apply the "sole actor" principle to a claim made against its former auditors by a company in liquidation, where the company was a one-man company engaged in fraud, and the auditors are accused of negligence in failing to call a halt to that fraud. Here I return to Mr Brindle's point (para 132 above) about the need to decide any question of attribution by reference to its context. Looking at the context, I cannot accept his submission that a claim against auditors is a context in which S & R should not be treated as primarily (or directly) liable for its fraud against KB, and so disabled by the *ex turpi causa* principle. Mr Sumption conceded, in line with the pleadings, that the auditors did owe a duty of care to S & R, although Mummery LJ (with whom, as with Rimer LJ, Keene LJ agreed) considered (para 115) that

> "the firm did not owe a duty of care to the company, which was a fraudster in the total grip of another fraudster."

On the assumption that the auditors did owe a duty of care to S & R, it was a duty owed to that company as a whole, not to individual shareholders, or potential shareholders, or current or prospective creditors, as this House decided in *Caparo Industries plc v Dickman* [1990] 2 AC 605. If the only human embodiment of the company already knew all about its fraudulent activities, there was realistically no protection that its auditors could give it. In *Caparo* this House approved the decision of Millett J in *Al Saudi Banque v Clarke Pixley* [1990] Ch 313, the facts of which were comparable to those of the present case.

Discussion of secondary victims

169. In para 73 of his judgment Rimer LJ set out his conclusions on what he called the *Hampshire Land* issue:

> "In these circumstances I am of the opinion that this is not a case in which the *Hampshire Land* principle has any application. The essence of the case is that it is one in which the sole directing mind and will of the company procured it to enter into fraudulent transactions with banks. It was the company that dealt with the banks and, so it seems to me, clear that, as between the company and the banks, the principles of attribution require the dishonesty of the company's sole human agent to be imputed to the company. Mr Sumption's submissions satisfied me that this is a case in which such an imputation should be made and that the company should therefore *itself* be liable for the frauds. Whilst, as I have said, Mr Brindle did not accept that this is the correct analysis, he did not argue against it and he was prepared to accept it for the purposes of the present debate. It is not therefore a case in which the company was the target, or the victim, of its agent's dishonesty. It was itself the fraudster, and it was not the target of the fraud, and in my view it can make no difference that its frauds were likely, when and if found out, to result in the incurring of liabilities by the company itself."

170. As I have mentioned (para 147 above), at the beginning of this passage Rimer LJ seems to be showing some sympathy for the one-man company approach which he had earlier rejected. In the latter part of the passage he draws a clear distinction between a company as victim and a company as villain. Where a company has carried out large-scale frauds it is likely to end up in insolvent liquidation, and facing claims from those whom it has defrauded. It can therefore be regarded as a sort of secondary victim. But in the last sentence of the passage quoted Rimer LJ (without using that term) discounts the "secondary victim" theory as not material to the rules of attribution which he has been considering.

171. The expression "secondary victim" seems to have originated (at any rate in this context) in *Brink's-Mat*. That case was concerned with large-scale, flagrant, organised crime. From beginning to end legal title in the stolen bullion was shared between Brink's-Mat as bailee and Johnson Matthey as owner. But if it is necessary to construct a sort of parallel universe in which the conspirators' activities are supposed to have been lawful, I can see no reason to suppose that Scadlynn would have been the owner of the bullion. The bullion would surely have belonged to the conspirators as a sort

of partnership. Scadlynn (with a small capital and only two of the conspirators as shareholders) would have been a bailee for reward, entrusted with the task of recasting the bullion and selling it as an agent. The directors of Scadlynn would have expected remuneration for their services. In short I can see no basis for the assumption by Mustill LJ that Scadlynn was "the victim of wrongful arrangements to deprive it improperly of a large part of its assets." I do not think that the decision can be given much weight; as my noble and learned friend Lord Phillips of Worth Matravers observes in para 5 of his opinion, "if a person starts with nothing and never legitimately acquires anything he cannot realistically be said to have suffered any loss."

172. A similar point may arise in the present case, since it is pleaded that money fraudulently obtained by S & R became the subject of "numerous fraudulent and/or irregular payments out by S & R to entities controlled by Mr Stojevic and his associates." Any contractual arrangements between S & R and BCL (or similar companies) for division of the fruits of their fraud would of course have been void for illegality. To describe such arrangements as fraudulent and/or irregular does not to my mind turn S & R into a victim in any ordinary sense. Mr Sumption's submissions on this point, which I am inclined to accept, are recorded in para 49 of Rimer LJ's judgment.

173. However it is unnecessary to speculate further about the commercial terms on which gangs of robbers or fraudsters might be expected to organize their criminal activities. There is in my opinion a clearer and firmer basis on which to determine what (if any) significance to give to the notion of a company being the secondary victim of the fraud (aimed at a third party) of one or more of its directors. It is necessary to keep well in mind why the law makes an exception (the adverse interest rule) for a company which is a primary victim (like the *Belmont* company, which was manipulated into buying Maximum at a gross overvaluation). The company is not fixed with its directors' fraudulent intentions because that would be unjust to its innocent participators (honest directors who were deceived, and shareholders who were cheated); the guilty are presumed not to pass on their guilty knowledge to the innocent. But if the company is itself primarily (or directly) liable because of the "sole actor" rule, there is *ex hypothesi* no innocent participator, and no one who does not already share (or must by his reckless indifference be taken as sharing) the guilty knowledge. That is consistent with the analysis by Rix J in *Arab Bank*. In that case Mr Browne was not the directing mind of JDW,

which was not a one-man company; Rix J accepted that the position might have been different if it had been.

174. I would therefore limit my ground of decision in this appeal to the proposition that one or more individuals who for fraudulent purposes run a one-man company (in the sense described above) cannot obtain an advantage by claiming that the company is not a fraudster, but a secondary victim. *McNicholas* and *Bank of India* may be best analysed as depending on a special rule of attribution required by the scheme of the legislation relating to VAT or fraudulent trading (as the case may be). It is not necessary to the disposal of this appeal, or prudent, to address every situation that may be described as involving a secondary victim.

Three cases relied on by S & R

175. Mr Brindle argued that if an *ex turpi causa* defence is available in this case, it must have been overlooked in other well-known cases conducted by skilled and experienced counsel and solicitors. In particular, he referred to three pieces of litigation which he had cited to the Court of Appeal, but which had not been mentioned in the judgment of Rimer LJ: *Barings, BCCI* and *Sasea*. The actual decisions cited to the Court of Appeal are listed as *Bank of Credit and Commerce International (Overseas) Ltd v Price Waterhouse* 24 March 1998, Laddie J, *Barings plc v Coopers & Lybrand* [2003] 1 Lloyd's Rep IR 566 and *Sasea Finance Ltd (in liquidation) v KPMG* [2000] 1 All ER 676, but there were some other strands in the litigation about *Barings*, and many other strands in the *BCCI* litigation (Mr Brindle's printed case refers in particular to the judgment of Lightman J in *Bank of Credit and Commerce International SA (in liquidation) v Ali (No 2)*[2000] ICR 1354, [1999] 4 All ER 83 and to *Bank of Credit and Commerce International (Overseas) Ltd v Price Waterhouse* [1998] BCC 617, the judgment of the Court of Appeal reversing Laddie J).

176. In an earlier draft I commented on these cases at some length. I have omitted that passage because it is not necessary, I think, or helpful, to try to reach any firm conclusion about these other litigious struggles. Mr Brindle is right to say that S & R's public policy defence is novel (at least in England). Mr Sumption's comments on *Barings, BCCI* and *Sasea* do suggest that there may have been good reasons why skilled and experienced counsel and solicitors did not attempt to deploy the public policy defence in those cases. But however novel the issues

in this appeal, they must be decided on their merits, and not by reference to other cases in which (for whatever reason) they were not raised.

The 'very thing' issue

177. In the context of 'the very thing that the defendant was under a duty to take care to prevent' the phrase the 'very thing' may first have been used over sixty years ago by the unnamed County Court judge whose judgment was upheld by the Court of Appeal in *Stansbie v Troman* [1948] 2 KB 48. That was the case of the decorator who left the door of his client's house unlocked when he went out to buy more wallpaper, with the result that some of the client's jewellery was stolen by an opportunistic thief. What the County Court judge actually said (see at p 51) was that the decorator failed to take reasonable care "to guard against the very thing that happened" and the decorator's counsel argued (unsuccessfully) that his job was to decorate his client's house, and not to look after its security. But the phrase has come to be used as a convenient label for the principle that if there is a duty (in contract or tort) to prevent harm caused by a third party, the person under that duty may be liable for the loss, and cannot excuse himself by saying that it was caused by the third party (though the third party will normally be concurrently liable). *Reeves v Commissioner of Police of the Metropolis* [1999] QB 169, [2000] 1 AC 360 and *Corr v IBC Vehicles Ltd* [2008] AC 884 (both concerned with suicide, though in a context of different duties of care) are extreme illustrations of this principle, where the (self-) harm was caused not by a third party but by the person to whom the duty was owed.

178. The principle is therefore a principle of causation. Mr Brindle accepts that, but submits that it is also a wider principle (he calls it a principle of logic) capable of excluding the public policy defence in a case where fraud on the part of a company is the very thing that it is the auditors' duty to detect (and so prevent for the future). He submits that a point made by Lord Hoffmann in *Reeves* (at p 372) applies to all defences, and not just causation defences:

> "[W]hatever views one may have about suicide in general, a 100 per cent apportionment of liability to Mr Lynch gives no weight at all to the policy of the law in imposing a duty of care upon the police. It is another different way

> of saying that the police should not have owed Mr Lynch a duty of care."

In *Reeves* illegality was run as a defence in the Court of Appeal, but not in this House. On the other hand *volenti non fit injuria* was run in this House, and was rejected. Mr Brindle submits (on the strength of *Smith v Baker & Sons* [1891] AC 325, 360) that that is not a principle of causation. The *volenti* principle is far from precise and it may sometimes operate not as a principle of causation, but to negative any duty (or any breach). But in this context it operates as an element in causation. As Lord Hoffmann said in *Reeves* [2000] 1 AC 360, 367:

> "In the present case, volenti non fit injuria can only mean that Mr Lynch voluntarily caused his own death to the exclusion of any causal effect on the part of what was done by the police. So I think it all comes to the same thing: was the breach of duty by the police a cause of the death?"

179. Checking for fraud is part of an auditor's task, but it is not his sole or primary task (for a reputable auditor to discover that the client company's business is wholly fraudulent and criminal must be quite unusual). But suppose for the sake of argument that a trader engages an accountant for the primary and express purpose of preparing financial statements that comply with all the requirements of company law and tax law, so that the lawfulness of the financial statements is the very thing that the accountant undertakes to do; and suppose that the accountant negligently fails to perform this task, and the trader is in consequence liable to some penalty or criminal sanction. Could the accountant meet a claim for professional negligence by pleading the *ex turpi causa* defence? It is obviously impossible to answer that question without knowing more about the facts. If the trader had honestly supplied information which he believed to be correct and complete, and the accountant had negligently failed to notice that the information could not be correct and complete, it seems unlikely that such a regulatory breach, not involving dishonesty, would bring the *ex turpi causa* principle into play.

180. That seems to have been the principle of the decision of the Court of Appeal of Singapore in *United Project Consultants Pte Ltd v Leong Kwok Onn* [2005] SLR 214 (paras 55 to 57), where the claimant trading company had been fined for incorrect tax returns prepared by the defendant. The court went on (paras 58 to 62) to express the view

that the “very thing” principle would have excluded the *ex turpi causa* defence even if the facts had been serious enough to be capable of attracting it (para 60):

> “The respondent, however, alleged that the commission by the appellant of a statutory offence constituted an illegal act that disentitled the latter from pursuing its claim in tort. This argument placed the proverbial cart before the horse. On a proper appreciation of the facts, the appellant’s running afoul of the Act could be attributed solely to the fact that the respondent had failed in his duty to warn. To allow the respondent to rely upon a consequence that was directly caused by his own failings and to absolve him from liability, would be to reward the wrongdoer and punish the innocent party.”

In my opinion that shows confusion of thought, since if the trader had been convicted of the more serious offence under section 96 of the Singapore Income Tax Act it would have been guilty of deliberate and dishonest tax evasion and could not have been described as an innocent party.

181. In that situation the law would not permit the trader to claim against the accountant, not because there was no fault on the part of the accountant, but because public policy requires the dishonest trader to be denied a remedy. It is not a matter of rewarding a wrongdoer. To repeat the words of Lord Mansfield CJ in *Holman v Johnson* (1775) 1 Cowp. 341, 343 “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.”

182. In *United Project Consultants* the Singapore Court of Appeal referred to the decision of the Court of Appeal in *Reeves* [1999] QB 169 as supporting their view on the “very thing” point. But as I read that case only Buxton LJ (at para 185) relied on that point as one of his reasons for rejecting *ex turpi causa.* Lord Bingham of Cornhill CJ and Morritt LJ relied on the simple ground that suicide is no longer a crime. As already note, illegality was not an issue when *Reeves* came on further appeal to this House.

183. Rimer LJ considered this point at length (paras 75 to 105) and rejected it (paras 106 to 110). In my opinion he was right to do so. His

reasoning was, I think, essentially the same as mine. The essential point is that a principle of causation cannot, as Rimer LJ put it, trump *ex turpi causa* where the latter principle applies, however short of merits the defendant may be.

The effect of liquidation

184. It was argued for the appellants that the public policy defence should not bar claims brought by a company in insolvent liquidation, where the creditors were innocent parties who had been defrauded by Mr Stojevic. If that were right, it would create a very large gap in the public policy defence, since most fraudsters (individual and corporate) become insolvent sooner or later and have liabilities to those whom they have defrauded. Mr Brindle conceded that if Mr Stojevic had carried out his frauds directly (and not through a one-man company) neither he nor his trustee in bankruptcy could have resisted the public policy defence. That conclusion was reached by Langley J. (para 65(2)) and is clearly correct (see Fry LJ in *Cleaver v Mutual Reserve Fund Life Association* [1892] 1 QB 147, 156). There is no good reason to apply a different rule to a company in liquidation. Apart from special statutory claims in respect of misfeasance, wrong trading and so on, it cannot assert any cause of action which it could not have asserted before the commencement of its liquidation, as Mr Brindle concedes. That is especially true in the context of the duties of an auditor, which are not owed to a company's creditors.

Contributory negligence

185. Mr Brindle put in the forefront of his case the general submission that *ex turpi causa* is a blunt instrument, and that a more satisfactory tool for doing justice would be the doctrine of contributory negligence. The *ex turpi causa* principle is indeed a blunt instrument. Rimer LJ referred to it, quoting Langley J at first instance, as "unforgiving and uncompromising." That is its nature. But I am far from convinced that (if the public policy defence were not available) contributory negligence would provide a more sensitive or effective tool, any more than it does in the suicide cases: see *Reeves*, especially Lord Hoffmann at pp 371-372. A company's fraud and its auditors' negligence are incommensurable in terms of blameworthiness and causal potency, just as lethal self-harm and negligent custody are incommensurable in those terms.

The opinions of the minority

186. My Lords, after trying to analyse the intricacies of a complex and difficult case it is often helpful to stand back, as we say, and try to identify the essentials. Had Mr Stojevic acted alone in his fraud (for instance, had S & R been a completely fictitious company, never properly incorporated) it is perfectly clear that he would have had no cause of action against Moore Stephens because of (among other reasons) the *ex turpi causa* rule. That would have been the case even if the action had been taken by his trustee in bankruptcy acting solely for the benefit of the defrauded bank and other innocent creditors. That was the clear view of Langley J (in his conclusions at para 65(2)) and it has not been challenged. The *ex turpi causa* rule is distinct from the general principle that a claimant should not obtain a personal profit from his own wrong, although the two often overlap.

187. The same results would follow if Mr Stojevic had an individual partner in crime (as Mr Alon may have been, although his participation has not formed part of the argument). Two highwaymen may be partners in crime but neither can sue the other for an account: *Everet v Williams* (1725), a case which was once thought to be apocryphal, but is verified by a note in (1893) 9 LQR 197 (see also Sir George Jessel MR in *Sykes v Beadon* (1877) 11 Ch D 170, 195-196). The bill in equity for a partnership account would also have been dismissed out of hand if it had been brought, not by Everet himself but by the administrator of his insolvent estate, after Everet had been hanged at Tyburn, even though the administrator might have been suing exclusively for the benefit of those whom the pair had robbed.

188. Why then does it make a difference that S & R, Mr Stojevic's partner in crime, was not an individual but a corporation? For present purposes there is an obvious parallel between an action by a company in insolvent liquidation, and an action by the trustee in bankruptcy of an individual, or the administrator of the estate of an individual who has died insolvent. In each case the action is being brought by or under the control of a fiduciary for the benefit of innocent creditors. But in each case the fiduciary can have no better cause of action than the insolvent company or individual, since the *ex turpi causa* rule is "unforgiving and uncompromising". I can see no reason why the corporate status of S & R should alter the analysis. Once it is accepted (first) that a company can have a guilty mind (*Tesco Supermarkets Ltd v Natrass; Royal Brunei Airlines v Tan*) and (second) that S & R was

directly (and not merely vicariously) liable for the frauds, then it seems to me to be in just the same position as one of the highwaymen.

189. My noble and learned friend Lord Scott of Foscote considers that the position is different because S & R was itself a victim. It had been turned, in his view, into a corporate automaton. That view contradicts not only the Court of Appeal but also the judge. Langley J observed (para 65(6)):

> "The primary victims of the fraud were KB and the other losers. The fraud undoubtedly exposed S & R to liabilities to KB and the other losers, which it could not meet once, as was intended, the moneys fraudulently obtained were paid away as they were to those responsible for the fraud. On the other hand S & R lost nothing to which it was ever entitled. S & R was in a real sense the perpetrator of the fraud on KB and the banks and the liability to which it was thereby exposed was not just the product of that fraud but the essence of it. In the particular circumstances of this case in my judgment it would be artificial not to fix S & R with the knowledge and wrongdoing of Mr Stojevic and also artificial to describe S & R even as a secondary victim of the fraud."

That puts the point very clearly. Lord Scott's view seems to me to treat the most obvious and extreme situation of a company which has a guilty mind (a one-man company engaged in wholly fraudulent activities) as amounting to a situation in which the company has no mind at all. That view, with great respect, seems to me to be inconsistent with *Royal Brunei Airlines v Tan* (which is generally regarded as a decision of high authority) and to put the clock back to *Abrath v North Eastern Railway Co.*

190. Some of the reasoning in Lord Scott's opinion proceeds on the basis that Moore Stephens, as auditors, were officers of S & R. There is long-standing authority that an auditor is an officer for the purpose of a misfeasance summons under what is now section 212 of the Insolvency Act 1986: *Re London and General Bank* [1895] 2 Ch 166, a decision of the Court of Appeal which was followed by another constitution of that Court (though with Lord Herschell expressly withholding his opinion) in *Re Kingston Mill Cotton Company* [1896] 1 Ch 6. In the leading case of *Re City Equitable Fire Insurance Co. Ltd* [1925] Ch 407 counsel for the auditors reserved this point (see at p

422) but the case did not reach this House. The law may now be taken as settled that for the purposes of a misfeasance summons under section 212—a procedural provision—an auditor is an officer of a company. But he is in a quite different position from a director or manager, as Bingham LJ pointed out in *Caparo* [1989] QB 653, 681, cited by Lord Bridge of Harwich in this House [1990] 2 AC 605, 625-626:

> "In carrying out his investigation and in forming his opinion the auditor necessarily works very closely with the directors and officers of the company. He receives his remuneration from the company. He naturally, and rightly, regards the company as his client. But he is employed by the company to exercise his professional skill and judgment for the purpose of giving the shareholders an independent report on the reliability of the company's accounts and thus on their investment. 'No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them': *In Re Kingston Cotton Mill Co* [1896] 1 Ch 6, 11, *per* Vaughan Williams J".

His part is, and must be, independent (section 27(1) of the Companies Act 1989 provides that a person is ineligible for appointment as company auditor of a company if he is an officer or employee of the company). In short, even if an auditor is for some purposes an officer of the company for which he acts, he is in a totally different position from that of the directors and managers who are running its business. In my respectful opinion it does not assist the task of analysis to equate them.

191. Someone who had been robbed by the highwaymen would have had a direct civil claim against both as joint tortfeasors, just as in this case KB had a claim (which it pursued to judgment) against S & R and Mr Stojevic. But KB had no possibility of a direct claim against Moore Stephens. That is clear from the judgment of Millett J in *Al Saudi Banque v Clarke Pixley* [1990] Ch 313 (decided after the decision of the Court of Appeal but before the decision of this House in *Caparo Industries plc v Dickman*) and by the decision of this House in the latter case, approving the decision in *Al Saudi Banque*. Much of the opinion of my noble and learned friend Lord Mance seems to me, with great respect, to be seeking to attenuate by indirect means the House's decision in *Caparo,* although we are not invited to depart from it.

192. Lord Mance is rightly concerned at the difficulty of pinning down the concept of a one-man company. What if there are innocent minority shareholders who have no say in the management of the company? What if majority shareholders, even, have been "hijacked" by a fraudulent but dominant managing director? These are difficult questions but what can be said with confidence is that cases of that sort would plainly not be suitable for a strike-out (compare the unreported case of *Marlwood Commercial Inc v Kozeny* [2006] EWHC 872 (Comm) mentioned in paras 48-51 of the judgment of Langley J). In a case of that sort the court would have to enquire closely into the facts in order to see (as Saville LJ put it in *Group Josi*) whether it would be contrary to justice and common sense to treat the company as complicit. But here it was the claimant's own case that the position was clear. As Rimer LJ said (to repeat para 9 of his judgment),

> "It is the essence of the company's claim that Mr Stojevic was its controlling mind and will. Nobody else was in a like position. In a real sense the company was his company. It was, for practical purposes, a 'one-man company'. It is a further part of the claim that the company was throughout used by Mr Stojevic as a vehicle for fraud, by extracting money from KB so that it could then be paid away to the fraudsters."

Some observations in Lord Scott's opinion appear to overlook this point.

193. I add a final comment on the "very thing" argument. It is nonsensical, the argument goes, to assert that there is a duty (for an auditor to detect fraud, or for the police to protect a man in custody from self-harm) but at the same time to empty that duty of content, either on grounds of causation or by applying the *ex turpi causa* rule. I see the force of that argument, but the analysis seems to me to rely on a good deal of hindsight. When the police hold a man in custody they owe him a variety of duties, including the duty to keep him safe from harm (whether from the police themselves, or from other detained persons, or from self-harm). The duty to take precautions against suicide is part of this duty. If a man in a good state of mental health deliberately kills himself while in police custody, his estate may be unable to recover damages, but that does not to my mind drain the police duty of care of all content. In *Reeves* only Buxton LJ seems to have been troubled by this point. Similarly with auditors. The detection of fraud is only a small part of the total statutory and common law duties owed by auditors, and the discovery that an apparently respectable and prosperous company is carrying on activities that are

wholly fraudulent must be a very rare occurrence. This case is, as Mr Sumption emphasised in his written and oral submissions, a rare and extreme case, so extreme that it is in my opinion appropriate for summary disposal.

Conclusion

194. For these reasons I would dismiss this appeal.

LORD BROWN OF EATON-UNDER-HEYWOOD

My Lords,

195. Suppose as a solicitor practising on my own account I engage an accountant to complete my annual tax return. I have earned fees of £200,000 but, with a view to defrauding the Revenue, I tell him that my fees were only £100,000 and provide him with my fee book for only six months of the year. He neglects to query this despite being provided with documents showing travelling expenses incurred over the full twelve month period. The Revenue are not so stupid and eventually my fraud is uncovered, I am charged the shortfall and heavily fined into the bargain. Can I sue my accountant in negligence or for breach of his contractual duty of care towards me? Plainly not. There could hardly be a more obvious application of the *ex turpi causa* principle to bar my claim. *Luscombe v Roberts* (1962) 106 SJ 373 illustrates the point. Suppose then I am bankrupted. Can my trustee in bankruptcy bring the claim for the benefit of my creditors? Equally plainly not. He enjoys no better claim than I had.

196. Suppose then essentially the same scenarios but this time I have incorporated my practice and carry it on as a one-man company. Would that bring about a different result? Would the accountant in those circumstances become liable for whatever losses the fraud ultimately occasioned the company? It would be odd were it so and in my opinion it is not so and could not be so ever since the rejection, over a century ago, of Lord Bramwell's view expressed in *Abrath v North Eastern Railway Co.* (1886) 11 App. Cas. 247, 251 that a company, as a fictitious person, is "incapable of malice or of motive". Once it is recognised that a company can itself be fraudulent there could be no

clearer instance of it than that suggested above, unless perhaps it is this very case.

197. The facts of this case are fully set out in the opinions of others of your Lordships and need not be repeated. Here, as my noble and learned friend Lord Walker of Gestingthorpe makes plain, not merely was Mr Stojevic "the directing mind and will of the corporation, the very ego and centre of the personality of the corporation" (Viscount Haldane LC in *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705, 713), but Stone & Rolls Ltd (S & R) was, even on the most exacting definition of the term, a one-man company. As Mr Sumption QC put it, uncontentiously, at the beginning of his printed case:

> "[Mr Stojevic] was as completely identified with the company as it is possible for a human agent to be. He had sole control over the company's every act. He was the company's sole beneficial owner. There were no independent or innocent directors whom Mr Stojevic had to deceive to make the fraud happen. There were no innocent shareholders relying upon the auditors to monitor the management. There were no employees."

198. How in these circumstances there is any room for the application of the *Hampshire Land* principle—see *In re Hampshire Land Company* [1896] 2 Ch 743—I cannot for the life of me see. That principle, otherwise described as the adverse interest rule, operates as an exception to the ordinary rule of attribution, itself a general principle of agency, that ordinarily one imputes to the company (the principal) the knowledge of a director (the agent) on the basis that the agent may be presumed to have discharged his duty to disclose all material facts to his principal. The *Hampshire Land* exception recognises that in reality agents will not disclose to their principals the fact that they are committing fraud, least of all when they are defrauding the principals themselves, and that it would be contrary to common sense and justice for the law to presume otherwise. Indeed, the *Hampshire Land* principle may well go wider than this and extend also to breaches of duty by the agent short of fraud—consider, for example, Vaughan Williams J's judgment in *Hampshire Land* itself and Rix J's judgment in *Arab Bank plc v Zurich Insurance Co.* [1999] 1 Lloyd's Rep 262—and to agents' frauds even if committed against others than their principals, and perhaps irrespective of whether the principal is to be regarded as "a secondary victim"—see again Rix J's judgment in *Arab Bank.* For the

purposes of the present appeal, however, it is quite unnecessary to explore, let alone decide, any of this.

199. In the present case Mr Stojevic and S & R were in effect one and the same person. It is absurd to describe Mr Stojevic as the agent and S & R as the principal for all the world as if, but for the *Hampshire Land* principle, the law would presume that Mr Stojevic had been disclosing to S & R his fraudulent conduct towards the Czech Bank. As Lord Reid said in *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153, 170:

> "He is not acting as a servant, representative, agent or delegate. He is an embodiment of the company or, one could say, he hears and speaks through the persona of the company, within his appropriate sphere, and his mind is the mind of the company. If it is a guilty mind then that guilt is the guilt of the company."

200. For this reason I find the concept of the "sole actor" exception to the adverse interest exception (the *Hampshire Land* principle) a somewhat puzzling one. Why is it necessary to except from an exception a category of case which cannot logically fall into the exception in the first place? Assuming, however, that there is scope for such an exception to the *Hampshire Land* principle, then the need for it seems to me compelling and as good a statement of it as any is to be found in *The Mediators Inc v Manney* 105 F 3d 822 (1997) already fully set out at para 163 of Lord Walker's opinion.

201. It is on this basis and this basis alone—the one-man company or sole actor basis—that I would uphold the Court of Appeal's judgment that S & R is in no different or better position than Mr Stojevic himself to resist the *ex turpi causa* defence (and the liquidator of S & R in no better position than either of them).

202. Lord Mance, as I understand his opinion, would find liability here in respect of all such losses as were occasioned by the fraud from the time when the auditors should have uncovered it. But what is this if not "liability in an indeterminate amount for an indeterminate time to an indeterminate class" of claimants—whoever came to be defrauded by the company in the trading period after the fraud should have been ended to whatever was the extent of their loss. (The quoted phrase comes, of course, from Cardozo CJ's judgment in *Ultramares*

Corporation v Touche (1931) 174 N.E. 441, adopted by Millett J in *Al Saudi Banque v Clarke Pixley* [1990] Ch 313, a judgment approved by the House in *Caparo Industries plc v Dickman* [1990] 2 AC 605.) The company, through its liquidator, would be suing to recover on behalf of all those whom it had defrauded. That, indeed, is precisely the nature of this claim. Such an approach seems to me to run diametrically counter to the principles established in *Caparo*. I also find it difficult to reconcile with Hobhouse J's decision in *Berg, Sons & Co Ltd v Mervyn Hampton Adams* [2002] Lloyd's Rep PN 41, an authority which Lord Mance prays in aid. Applying *Caparo* and rejecting a liquidator's claim against the company's former auditors, Hobhouse J said that the company "had based their case not upon any lack of information on the part of Mr Golechha [the company's directing mind] but rather upon the opportunity that the possession of the auditor's certificate is said to have given for the company to continue to carry on business and borrow money from third parties. Such matters do not fall within the scope of the duty of the statutory auditor". Here too, by the assumed negligence on the part of the auditors, the company was able to continue to carry on business, in this case stealing rather than borrowing money from third parties.

203. I recognise, of course, that confining the *ex turpi causa* defence, as I would, to one man company frauds means that, where any innocent shareholders are involved, a claim against the auditors may well lie (through the company) at their suit. This, however, would not be an open-ended claim, wholly indeterminate as to its potential scope and extent at the time of the audit, such as that presently brought. Quite how it would fall to be confined is no doubt open to argument. But on one view it might be limited to the innocent shareholders' own loss suffered through the continuing fraud from the time when, following a diligent audit, it should have been uncovered and brought to an end. A claim of that nature would seem to me to accord altogether more readily with the policies and principles generally understood to apply in this context.

204. With regard to the "very thing" argument, I agree entirely with what Lord Walker says and wish to add nothing on the point.

205. For these reasons, which really do no more than echo those of Lord Walker, I too would dismiss this appeal.

LORD MANCE

My Lords,

Introduction

206. The world has sufficient experience of Ponzi schemes operated by individuals owning "one man" companies for it to be questionable policy to relieve from all responsibility auditors negligently failing in their duty to check and report on such companies' activities. The speeches of my noble and learned friends in the majority have that effect. In my opinion, English law does not require it. I consider that the key to a proper resolution of this appeal is to bear firmly in mind: (a) the separate legal identities of a company and its shareholders; (b) the common law and contractual duties which it is common ground that auditors owe and which included in this case an express undertaking to comply with Auditing Standard SAS 110 on fraud and error of the Auditing Practices Board; (c) the rights that a company has as a result as against those who, whether as officer or auditor, commit wrongs against it; (d) the distinction between on the one hand a company's claim for its own net losses, for which it is entirely consistent with *Caparo Industries plc v. Dickman* [1990] 2 AC 605 that it should be able to sue auditors whose negligence led to such losses, and on the other hand its creditors' losses, for which under *Caparo* its creditors cannot sue negligent auditors; (e) the basic company law principle that the interests and powers of shareholders yield to those of creditors in a company which is actually or potentially insolvent. I differ from the majority speeches in this case because they fail in my respectful opinion to take these points duly into account.

207. Within the majority speeches, although their reasoning differs, there can be found (i) an inversion of the decision in *Caparo* - whereby the denial to creditors in that case of recovery against auditors because the company would have its own claim is deployed to deny the company's claim against auditors because this would indirectly benefit the company's creditors; (ii) a suggestion never pleaded or raised by the auditors that the auditors' contractual engagements might be unenforceable *ab initio*; (iii) a suggestion that the company did not suffer any loss at all - a surprising proposition, when its assets were over years steadily abstracted from it leaving it with a large deficit out of which it was unable to meet its liabilities to the banks; (iv) a suggestion that a company might be unable to recover against auditors,

if some or apparently even one of its shareholders were complicit in fraud committed by the company's directing mind and will causing the company to suffer loss - a suggestion which if good would have provided auditors with immunity in a large number of auditors' negligence claims. I will explain my disagreement with each of points (i) to (iv) in the course of this speech. However, it is points (d), (e) and (i) together which ultimately divide the House and are, or ought to be, central to this appeal. I address them in paras. 265 to 273 and 275 to 277 below.

208. The appeal - against an order of the Court of Appeal expressed to be "for summary judgment on, or to strike out, the whole" of a company's claim against its auditor - raises for the first time in this jurisdiction the issue whether the maxim *ex turpi causa non oritur actio* can apply to a claim in contract and/or tort by a company against its auditors for professional negligence. Moreover, the issue is raised in an acute form by the auditor's primary submission, that there are only three pre-conditions to the application of the maxim: (a) fraud should have been committed by a person counting as the company's directing mind and will; (b) it should have been committed by the company, not against it; and (c) the company should also have to rely on the fraud in order to plead its case against the auditor. Only in the alternative does the auditor submit that, if those conditions do not alone engage the maxim, then the fact that the fraud was committed by the sole beneficial owner of the company delivers the *coup de grace*. In response, the company submits, inter alia, that the auditor's submissions undermine the purpose of an audit, and that, at least in circumstances where the company was insolvent at the relevant audit date, the company's interests can no longer be equated with those of its shareholders and the company can recover for loss it sustained by a scheme of fraud, which would have been detected and stopped by a careful audit.

Facts

209. The essential facts to be assumed for the purposes of this appeal can be shortly stated. The appellant company, Stone & Rolls Ltd. ("S & R" – incorporated in England and Wales and in liquidation since November 2002), was at all material times under the complete control and effective ownership of a Mr Stojevic. (Mr Stojevic was not formally a director – the only such director was a resident of Sark - and the beneficial ownership which Mr Stojevic is admitted in the agreed statement of facts to have had of S & R's shares was indirect and covert, through an Isle of Man company the shares of which were held by a

trust.) The respondent acted as S & R's auditors for periods ending 31st December in the years 1996 to 1999, in each case under a separate contractual engagement. Mr Stojevic was throughout those years using S & R as a vehicle for fraud. The fraud involved the extraction from various banks, principally it appears Komercni Banka A.S (the former State Bank of Czechoslovakia), of increasingly large amounts under letters of credit providing for deferred payment at maturity dates as long as 180 or even 360 days. The banks believed they were financing bona fide commodity trades, but the documents presented were false and did not relate to actual goods. S & R obtained funds without waiting for the expiry of the deferred periods by assigning or forfeiting the letters of credit. The funds were then paid away to third parties under the influence or control of Mr Stojevic, and used, in part only, to reimburse the banks in respect of previous maturing letters of credit (and so secure the issue of further larger letters of credit). The sums outstanding under these circular transactions grew steadily until eventually reimbursement of the banks ceased, and the banks were left with unsecured and very substantial losses. In proceedings before Toulson J in 2002, Komercni Banka A.S. exposed the fraud and obtained judgment in deceit against S & R for US$94,470,382.28: [2002] EWHC 2263 (Comm); [2003] 1 Lloyd's Rep 383. S & R, having been stripped of its assets by Mr Stojevic and his associates, has nothing with which to meet this or any other liability or indebtedness, and is in liquidation.

210. S & R's claim against Moore Stephens is also capable of quite brief summary. It is agreed for present purposes that it is to be considered a claim in negligence only (though there is in relation to the 1998 audit a strongly denied and presently irrelevant allegation that Moore Stephens shut a Nelsonian eye to the fraud). The alleged negligence, put as a breach both of contract and of a duty of care, consists of failure on Moore Stephens's part to detect various aspects of the scheme of fraud. In this respect S & R accepts that no distinction can be drawn between the obtaining of monies under the letters of credit and their payment out. The two were integral parts of Mr Stojevic's scheme, and much of the negligence alleged against Moore Stephens consists of failure to react to clear signs that the goods purportedly being sold and represented by documents presented to the banks did not exist. The causation alleged is that, if Moore Stephens had discovered the fraud, they would have had to resign and report the matter to regulatory authorities. The loss claimed consists in the amounts paid out of S & R after the end of each of the audits upon which it is alleged the fraud should have been discovered.

The audit role

211. The proper starting point for consideration of this appeal is the nature of an audit and the duties which Moore Stephens as an auditor undertook each year. Both the statutory context and the terms of the particular engagement are important. But the existence of Moore Stephens's contractual engagement in each year is common ground, and it was neither pleaded (see Defence, paragraph 3) nor suggested in oral submissions that it was invalid or unenforceable as such; had any such point had any validity, one may be confident that those advising Moore Stephens would not have overlooked it, particularly bearing in mind the novelty and nature of some points which have been argued. The existence of a duty on the part of Moore Stephens to the company and its general scope are for present purposes also common ground. As the company's case puts it, Moore Stephens "owed the company a duty to take care to detect ….. the fraud; and …… breached that duty" or, as Moore Stephens' own case puts it, they "owed the company a duty to report whether its accounts showed a true and fair view of its financial affairs. One of the things that they had to do to perform that duty was take such steps as were reasonable in the circumstances to discover that the company's business was fraudulent". The audits were undertaken under the Companies Act 1985, and the cases of *Caparo Industries plc v. Dickman* [1990] 2 AC 605 and *Al Saudi Banque v. Clarke Pixley* [1990] Ch 313 (Millett J), approved in *Caparo*, therefore contain relevant further guidance as to Moore Stephens' role and duties. In so far as these are prescribed by statute, such role and duties are necessarily inflexible – they cannot be changed or waived by the company, its management or its shareholders.

212. An auditor's primary duty is to report to shareholders on the annual accounts and report to be prepared by the directors: ss.226(1), 227(1), 233(1) and (3) and 234(1) of the 1985 Act, as inserted by the Companies Act 1989. S.235, as so inserted, states the duty:

> "235(1) A company's auditors shall make a report *to the company's members* on all annual accounts of the company of which copies are to be laid *before the company in general meeting* during their tenure of office.
>
> (2) The auditors' report shall state whether in the auditors' opinion the annual accounts have been properly prepared in accordance with this Act, and in particular whether a true and fair view is given ….

> (3) The auditors shall consider whether the information given in the directors' report for the financial year ….. is consistent with those accounts; and if they are of opinion that it is not they shall state that fact in their report." (Emphasis added).

213. In *Caparo* at pp. 625D-616C Lord Bridge of Harwich approved the following summary by Bingham LJ [1989] QB 653, 680 of the position of auditors in relation to shareholders:

> "The members, or shareholders, of the company are its owners. But they are too numerous, and in most cases too unskilled, to undertake the day to day management of that which they own. So responsibility for day to day management of the company is delegated to directors. The shareholders, despite their overall powers of control, are in most companies for most of the time investors and little more. But it would of course be unsatisfactory and open to abuse if the shareholders received no report on the financial stewardship of their investment save from those to whom the stewardship had been entrusted. So provision is made for the company in general meeting to appoint an auditor (section 384 of the Companies Act 1985), whose duty is to investigate and form an opinion on the adequacy of the company's accounting records and returns and the correspondence between the company's accounting records and returns and its accounts: section 237. The auditor has then to report to the company's members (among other things) whether in his opinion the company's accounts give a true and fair view of the company's financial position: section 236 [sic]. In carrying out his investigation and in forming his opinion the auditor necessarily works very closely with the directors and officers of the company. He receives his remuneration from the company. He naturally, and rightly, regards the company as his client. But he is employed by the company to exercise his professional skill and judgment for the purpose of giving the shareholders an independent report on the reliability of the company's accounts and thus on their investment.

> ‘No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them:’ *In re Kingston Cotton Mill Co.* [1896] 1 Ch. 6, 11, *per* Vaughan Williams J.

> The auditor's report must be read before the company in general meeting and must be open to inspection by any member of the company: section 241. It is attached to and forms part of the company's accounts: sections 238(3) and 239. A copy of the company's accounts, including the auditor's report, must be sent to every member: section 240. Any member of the company, even if not entitled to have a copy of the accounts sent to him, is entitled to be furnished with a copy of the company's last accounts on demand and without charge: section 246.”

214. *Caparo* establishes that the auditor’s statutory duty is not to any individual shareholder as a purchaser or potential shareholder of shares in the company, but to the shareholders collectively, and that their remedy for any breach lies through the company. As Lord Bridge put it at p.626D-E:

> “….. in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders, e.g. by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders.”

Consistently with this, Lord Oliver of Aylmerton at p.630F-G described the auditor’s function as being

> “to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company’s affairs and to exercise their collective powers

> to reward or control or remove those to whom that conduct has been confided.”

At p.653H, he quoted with approval the statement by O’Connor LJ in the Court of Appeal (at p.714) to the effect that loss by “fraudulent abstraction of assets by directors or servants …..is recoverable by the company”.

215. In addition to the auditor’s primary responsibility to the shareholders as a whole, the legislation recognises certain obligations in respect of others. At p.631D-F Lord Oliver noted that:

> “…… the history of the legislation is one of an increasing availability of information regarding the financial affairs of the company to those having an interest in its progress and stability. It cannot fairly be said that the purpose of making such information available is solely to assist those interested in attending general meetings of the company to an informed supervision and appraisal of the stewardship of the company's directors, for the requirement to supply audited accounts to, for instance, preference shareholders having no right to vote at general meetings and to debenture holders cannot easily be attributed to any such purpose.”

Further, s.394 provides that:

> “394(1) Where an auditor ceases for any reason to hold office, he shall deposit at the company’s registered office a statement of any circumstances connected with his ceasing to hold office which he considers should be brought to the attention of *the members or creditors* of the company or, if he considers that there are no such circumstances, a statement that there are none.” (Emphasis added)

S.394(3) provides that the company must either send a copy of any statement identifying any such circumstances to every member, debenture-holder and person entitled to notice of general meetings or apply to the court.

216. Moore Stephens's statutory duties were reinforced by the contractual terms of their engagement letter dated 19 December 1996 and signed by Mr Stojevic for S & R on 14 January 1997. This letter acknowledged their statutory duties and identified their "professional responsibility to report if the financial statements do not comply in any material respect with applicable accounting standards, unless in our opinion the non-compliance is justified in the circumstances". The audit was to be "conducted in accordance with the Auditing Standards issued by the Auditing Practices Board", and the letter stated that

> "(11) The responsibility for safeguarding the assets of the company and for the prevention and detection of fraud, error and non-compliance with law or regulations rests with yourselves. However, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the financial statements or accounting records (including those resulting from fraud, error or non-compliance with law or regulations) but our examination should not be relied upon to disclose all such material misstatements or frauds, errors or instances of non-compliance as may exist ….."

217. Auditing Standard SAS 110 (issued January 1995) deals with fraud and error. It contains statements of auditing standards (SAS) and explanatory text in numbered paragraphs. SAS 110.1 states: "Auditors should plan and perform their audit procedures and evaluate and report the results thereof, recognising that fraud or error may materially affect the financial statements". SAS 110.10 (para. 50) states that, on becoming aware of a suspected or actual instance of fraud, auditors

> "should (a) consider whether the matter may be one that ought to be reported to a proper authority in the public interest; and where this is the case (b) except in the circumstances covered in SAS 110.12, discuss the matter with the board of directors, including any audit committee".

SAS 110.12 (para. 52) provides that

> "When a suspected or actual instance of fraud casts doubt on the integrity of the directors auditors should make a report direct to a proper authority in the public interest

> without delay and without informing the directors in advance."

The text at paragraph 56 explains that matters to be taken into account when considering whether disclosure is justified in the public interest may include "the extent to which the suspected or actual fraud is likely to affect members of the public". Plainly, one situation in which members of the public would be affected is where the fraud conceals or risks bringing about the company's insolvency. The viability of a company as a going concern is always a matter of audit importance.

218. The relationship of company and auditor is not therefore a simple two-party relationship. The company cannot in the audit context be equated with its board of directors or management. The company's shareholders are – at least while the company is solvent - the main focus of an auditor's activity and duties. The auditor, in undertaking the statutory role and contractual and tortious duties, is "acting antagonistically to the directors" (see para. 213 above).

Analysis

219. Moore Stephens's case, accepted by the Court of Appeal, is that the company, S & R, in order to show negligence on the part of Moore Stephens, has to plead and so rely on a scheme, to which it was through Mr Stojevic party and one aspect of which was fraud on S & R's banks; Mr Stojevic was S & R's directing mind; and the claim therefore falls within the core principle in *Tinsley v Milligan* [1994] 1 AC 340, which, it is submitted, precludes a party from pursuing a contractual or tortious claim if, in order to do so, it has to plead and rely on its own iniquity. Mr Sumption accepts that whether there is iniquity sufficient to trigger the maxim may sometimes require careful examination of the facts: see e.g. *Burrows v. Rhodes* [1899] 1 QB 816; *United Project Consultants Pte Ltd v. Leong Kwok Onn* [2005] SGCA 38; [2005] 4 SLR 214, but Mr Stojevic's iniquity is not here in doubt. The Court of Appeal accepted Moore Stephens' analysis, without drawing any distinction between cases where the directing mind of a company was and was not sole shareholder. S & R in resisting it draws on the nature and purpose of an audit (summarised above) as well as on two general principles of law: the first, that fraud *on* a company by even its most senior officer(s) constituting its directing mind is not to be attributed to the company: *In re Hampshire Land Company* [1896] 2 Ch 743, *Belmont Finance Corp. Ltd. v Williams Furniture Ltd.* [1979] Ch 250 and *Attorney General's Reference (No 2 of 1982*) [1984] QB 624; and the second, that a person

should not be entitled to deny liability for a breach of contract or duty consisting in failure to do the "very thing" (here, it is said, to check for and detect fraud) which it was his duty to do, reliance in this connection being placed on *Reeves v Commissioner of Police of the Metropolis* [2000] 1 AC 360.

220. A company, once legally incorporated, "must be treated like any other independent person with its rights and liabilities appropriate to itself": *Salomon v. Salomon & Co Ltd* [1897] AC 22, 30 per Lord Halsbury LC. But a company "has no mind of its own any more than it has a body of its own": *Lennard's Carrying Co. Ltd. v. Asiatic Petroleum Co. Ltd.* [1915] AC 705, 713. For some purposes it is necessary to attribute or impute to a company the mind, knowledge or intentions of one or more human beings. In a criminal law context, where the company stands accused, the law is likely to look at the acts and state of mind of a person who can be regarded as the embodiment of the company - its alter ego or directing mind - rather than at those of a person acting merely as servant, agent or delegate, for whom the company might in a civil law context be vicariously liable: *Tesco Supermarkets Ltd. v Nattrass* [1972] AC 153, 170E-G per Lord Reid. When and how far a company will be attributed with the state of mind of individuals who have acted for it depends on the circumstances and context. My noble and learned friend Lord Brown of Eaton-under-Heywood refers to the rejection of Lord Bramwell's view in *Abrath v. North Eastern Railway Co.* (1886) 11 App. Cas. 247, 251 that a company, as a fictitious person, is "incapable of malice or of motive". But the corollary of that rejection is not that the company is always to be attributed with the malice or motive of anyone acting for it or even of its top management (or indeed that it is always necessary to attribute to a company itself any state of mind at all).

221. The *locus classicus* in this area is now the advice of the Privy Council given by Lord Hoffmann in *Meridian Global Funds Management Asia Ltd. v Securities Commission* [1995] 2 AC 500. Lord Hoffmann identified the provisions of a company's constitution as its primary rules of attribution. He instanced provisions making decisions of the majority of its board decisions of the company and the common law rule that the unanimous decision of all the shareholders in a *solvent* company about anything which the company under its memorandum of association has power to do are also decisions of the company. He cited in the latter connection *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd.* [1983] Ch 258. A company's primary rules of attribution are supplemented by general principles of agency and vicarious liability.

222. At p.507B, Lord Hoffmann went on to say that these together "are usually sufficient to enable one to determine its rights and obligations. In exceptional cases, however, they will not provide an answer. This will be the case when a rule of law, either expressly or by implication, excludes attribution on the basis of the general principles of agency or vicarious liability". He gave as examples situations where the law requires some act or state of mind of a person "himself" as opposed to his servants or agents, and the rule of the criminal law "which ordinarily imposes liability only for the actus reus and mens rea of the defendant himself". The court might then find that the rule of law was not intended to apply to companies at all, or that it could apply only on the basis of the company's primary rules of attribution or that neither of these solutions was satisfactory. In that case:

> "the court must fashion a special rule of attribution for the particular substantive rule. This is always a matter of interpretation: given that it was intended to apply to a company, how was it intended to apply? Whose act (or knowledge, or state of mind) was *for this purpose* intended to count as the act etc. of the company? One finds the answer to this question by applying the usual canons of interpretation, taking into account the language of the rule (if it is a statute) and its content and policy." (p.507D-F)

223. Although Lord Hoffmann in these passages focused on situations in which the primary rules of attribution might not alone suffice, he was not excluding the possibility of cases in which not even the primary rules of attribution should apply; and Mr Sumption QC for Moore Stephens rightly did not suggest that he was, though submitting that such cases would be "very rare indeed". One issue before your Lordships is whether the audit context may be such a case.

Mr Stojevic's position as the company's directing mind

224. I start with the company's position vis-à-vis Mr Stojevic. Moore Stephens's case has changed at each instance. But before the House Mr Sumption submitted was that S & R could only claim against Mr Stojevic on a narrow basis for abstraction of its monies (a proprietary claim like that mentioned by O'Connor LJ in *Caparo*: see paragraph 214 above); and that any claim against him for damages for breach of duty as an officer would be barred by the maxim *ex turpi causa* because it would involve pleading S & R's fraud on the banks. I do not accept this

submission. It would mean that, if one element of Mr Stojevic's fraud on the banks had involved persuading the banks to pay the funds direct into an account represented as being S & R's but in fact Mr Stojevic's, S & R could not sue Mr Stojevic. Mr Stojevic's common law duty as a director to S & R was to conduct its affairs honestly and properly. S.172(1) of the Companies Act 2006 now states the duty, in terms expressly based on common law rules and equitable principles (see s.170(3)), as being to "act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole" - a duty made expressly "subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company" (see s.172(3)). S.212 of the Insolvency Act 1986 provides a summary remedy available in the course of winding up against anyone who is or has been an officer of the company in respect of, inter alia, "any misfeasance or breach of any fiduciary or other duty in relation to the company". (This is in addition to the specific remedies that apply in circumstances of fraudulent or wrongful trading under ss.213 and 214.)

225. As between S & R and Mr Stojevic, Mr Stojevic's fraud on the banks was and is just as objectionable as the later abstraction of monies to which it was designed to lead. In holding a director responsible in such a case, a company is as a separate legal entity enforcing duties owed to it by the director. It is not acting inconsistently, or asking the court to act inconsistently, with the law. It is a remarkable proposition, that the directing mind of a company can commit the company to a scheme of fraud and then avoid liability in damages if the company would have to plead and rely on this scheme to establish such liability. It is even more remarkable, indeed paradoxical, when it is, I conceive, clear beyond doubt that the company has a remedy against its auditor for negligent failure to detect and report fraud by a company's directing mind where (at the very least) the company has innocent shareholders: see paragraphs 241 to 245 below.

Ex turpi causa as between S & R and Mr Stojevic

226. It follows that one would not expect the maxim *ex turpi causa*, however mechanistic it may be, to have any operation in a context such as the present. Mr Sumption stressed that "the true rationale for the defence of illegality associated with the maxim *ex turpi causa non oritur actio*," is "the preservation of the integrity of the justice system" – meaning the need to avoid permitting a claimant "to indirectly profit from his or her crime, in the sense of obtaining remuneration for it" or in the sense of evading "a penalty prescribed by criminal law", to avoid

putting "the courts in the position of saying that the same conduct is both legal, in the sense of being capable of rectification by the court, and illegal": *Hall v. Hebert* (1993) 101 DLR (4th) 129, 160-165, 167 and 168 per McLachlin J (as she was). In *Hall v. Hebert* two drunken men had set off home by car. The defendant initially drove but stalled the car and lost the ignition key, and both then decided to try to push-start the car, with the plaintiff now as driver. The car turned over injuring the plaintiff. The defence of *ex turpi causa* failed, because the plaintiff was not seeking to make a profit from his wrongful act, but merely to claim damages for personal injury. The integrity of the legal system was not affected. No more do I think that it is here. On the contrary, S & R would be enforcing, and not seeking to profit from but to obtain compensation for, breach of the duties which Mr Stojevic owed to it. The law must enable that.

The Hampshire Land principle

227. Though not essential to my reasoning, I also consider that the principle established in *In re Hampshire Land Company*, *Belmont Finance* and *Attorney General's Reference (No 2 of 1982)* points towards the same result It prevents a company being treated as party to a fraud committed by its officers "on" or "against" the company, at least in the context of claims by the company for redress for offences committed *against* the company: *Belmont Finance*, 261D-H, per Buckley LJ, and 271F-G, per Goff LJ, and *Attorney General's Reference (No 2 of 1982)*, p.640A-B, per Kerr LJ; and see *Edwards Karwacki Smith & Co. Pty. Ltd. v Jacka Nominees Pty. Ltd.* (1994) 15 ACSR 502, 515-517. Thus, in *Belmont Finance* the company's directors were party to an illegal conspiracy, "part and parcel" of which was that the company bought shares at an inflated price (p.264A), but their knowledge of this illegality was not imputed to the company and did not bar the company suing them for the conspiracy. The principle has also been applied in the context of a claim or allegation of estoppel against a company, seeking to hold the company responsible for a transaction in fraud of the company, by attributing to it knowledge of the fraud possessed by directors or agents who did not represent or act for the company in the transaction but had knowledge of it which they withheld from the company: *J C Houghton and Co. v. Nothard, Lowe and Wills Ltd.* [1928] AC 1; *Kwei Tek Chao v. British Traders and Shippers Ld.* [1954] 2 QB 459, 471- 472.

228. Mr Sumption submits that the principle has no present relevance for two reasons. The first is based on its original rationale: that, since an

agent deceiving a company will not disclose his own fraud to the company, the company cannot be imputed with knowledge of or treated as party to the fraud. This rationale, Mr Sumption submits, postulates a company with an "innocent constituency" (other officers and/or shareholders) to whom Mr Stojevic could have disclosed, but from whom he would and did actually conceal, his misdeeds. If the suggestion is that the *Hampshire Land* principle or the thinking behind it can only apply where a company alleges loss through being deceived, I see no reason why it should be so confined. Whether knowledge should be attributed to a company is irrelevant in contexts like the present, where S & R's claim is not that there were others within the company who relied on misleading statements by Mr Stojevic, but rather that Mr Stojevic's actions were in breach of his duties to S & R and that, had Moore Stephens detected them, no further breaches of duty would have been possible.

229. Neither in *Belmont Finance* nor in *Attorney General's Reference (No 2 of 1982)* is there any suggestion that the application of the principle in *Hampshire Land* depends upon there being some innocent constituency within the company to whom knowledge could have been communicated. Moreover, *Attorney General's Reference (No 2 of 1982)* is direct authority to the contrary. The two defendants were charged with theft, consisting of the abstraction of the assets of companies, of which they were "the sole shareholders and directors" and "the sole will and directing mind" (pp.635D-F and 638F-G). They contended that the companies were bound by and had consented to the abstractions precisely because they were its sole shareholders, directors and directing mind and will (pp. 634E-F and 638F-H). The Court of Appeal acknowledged the rule of attribution attributing to a solvent company the unanimous decision of all its shareholders (p.640A-D), but roundly rejected its application to circumstances where the sole shareholders, directors and directing minds were acting illegally or dishonestly in relation to the company. The court cited *Belmont Finance* as "directly contradict[ing] the basis of the defendants' argument" (p. 641B-C). The defendants' acts and knowledge were thus not to be attributed to the companies - although there was no other innocent constituency within the companies. Another justification for this conclusion may be that the effect of the limitations recognised by Lord Hoffmann in *Meridian* (paragraph 221 above) is that in such situations there *is* another innocent constituency with interests in S & R, since it is not open even to a directing mind owning all a company's shares to run riot with the company's assets and affairs in a way which renders or would render a company insolvent to the detriment of its creditors.

230. The second reason advanced by Mr Sumption is that, if the *Hampshire Land* principle could otherwise apply, the fraud here was committed on the banks, not on S & R. The Court of Appeal agreed with this submission. The company's exposure when it was left "holding the baby" was merely a "secondary exposure" which was not enough to engage the principle: see paras. 72-73. In so reasoning, Rimer LJ was influenced by the fact that Mr Stojevic's fraud would be (and was by Toulson J) attributed to S & R itself in the context of any claims by the banks against S & R. This distinction between personal and vicarious liability towards third parties could have been relevant if, for example, S & R had been prosecuted for fraud (see e.g. *Attorney General's Reference (No 2 of 1982)* at p.640A-B) or if (more fancifully) there had been a general banking facility between Komercni Banka and S & R under which the latter's liability depended upon whether it was personally as opposed to vicariously liable for the deception of Komercni Banka. But it is irrelevant in the present context where S & R is seeking recourse from persons who, whatever their status vis-à-vis the company in the eyes of the outside world, owe duties and have committed wrongs towards S & R. The truth behind the *Hampshire Land* principle as explained in *Belmont Finance* and *Attorney General's Reference (No 2 of 1982)* is that such situations are different. They compel by their nature a separation of the interests and states of mind of the company and those owing it duties.

231. In the present case, the focus is on the separate interests of S & R on the one hand and Mr Stojevic (and the auditors, though I consider their position more fully later) on the other. In this context, there is no difficulty about characterising the whole scheme as one of fraud on the company. The scheme treated the company as a mere tool or conduit and left it at the end with a large deficit, in complete disregard of Mr Stojevic's duty to respect its separate identity and property. This is in no way to suggest that S & R did not incur liability to the banks. On the contrary, it is because Mr Stojevic quite wrongly involved it in a scheme of fraud of which this was one aspect that S & R is entitled to claim against him. (In fact of course, the liability which S & R incurred to its banks in deceit did not lead to S & R incurring the loss, or anything like the loss, it claims against Mr Stojevic - Mr Stojevic's abstraction of the monies from S & R did that. I note that, in a passage (para. 5) with a biblical echo (I Timothy 6, 7), my noble and learned friend, Lord Phillips of Worth Matravers suggests that S & R started life with nothing, never legitimately acquired anything and cannot realistically be said to have suffered any loss. This either ignores the abstraction of S & R's assets or wrongly assumes that a deficit rendering a company insolvent is not a loss.

232. The same conclusion is indicated by authorities concerning schemes of fraud directly parallel to the present - that is, first, the defrauding of third parties and then the stripping from the company of its resulting assets for the benefit of its directing minds and beneficial owners: see *RBG Resources plc v Rastogi*, *Brink's- Mat Ltd. v. Noye* and, from Ontario, *Oger v. Chiefscope Inc. et al.* (1996) 29 OR (3d) 215; upheld (1998) 113 OAC 373. In *RBG Resources plc v Rastogi* Laddie J held, in trenchant terms, that the company had an arguable claim against directors for trial in a claim involving a parallel scheme of fraud to the present (raising funds from financiers in respect of bogus trades and paying them over to fraudulent counter-parties): and, when the case went to trial before Hart J, the directors in question did not pursue any defence to the contrary and judgment was given against them: [2004] EWHC 1089 (Ch). The case was moreover similar to the present in that one of the fraudulent directors was regarded as the sole ultimate controlling shareholder: see [2002] EWHC 2782 (Ch), paras. 3 and 51. In support of his conclusion, Laddie J referred both to *Belmont* and *Attorney General's Reference (No. 2 of 1982)* and to the company's "fall-back position" (to which I return below) that "in the case of an insolvent company, the directors are not at liberty to ignore the interests of the creditors": *Kinsela v. Russell Kinsela Pty Ltd. (In Liquidation)* (1986) 4 NSWL 722, per Street CJ, cited with approval in *West Mercia Safetywear Ltd. (in liq) v Dodd* [1988] BCLC 250, 4 BCC 30 (CA). The fall-back position to which Laddie J referred is likely to have been made with particular reference to the fraudulent director's position as sole controlling shareholder, to which I shall return.

233. The fraud in *Oger* involved procuring the owners of a Mercedes car to hand over the car to the company on terms that the company would within 90 days either sell it or purchase it for $55,000, whereas the company's principals and owners always intended to and did decamp with it or its proceeds (as well as it appears other cars or their proceeds). At first instance, Molloy J said bluntly that:

> "…. the fraudulent actions of Barry and Vithoulkas [the principals] were for their own financial gain. The corporation was merely a tool or vehicle which they implemented as an instrument of their fraud and to give the scheme a veneer of respectability. There was no benefit to the company from their actions. Rather, they stripped from the company all of its assets, both in terms of cash and consigned vehicles, and then absconded with them, leaving the corporation an empty shell with nothing

> but liabilities. In my view, it cannot be said that Barry and Vithoulkas have in these circumstances acted as the ego of the company itself and for the benefit of the company so as to bring the identification principles into play."

On appeal, the Court of Appeal dealt summarily with a submission that it could not be said that the actions constituted a fraud on the company, when, it was submitted, the corporation was set up for the very purpose of effecting their fraudulent scheme. The court said:

> "There was no admissible evidence before the trial judge which would allow her to conclude that the corporation was set up with a view to perpetrating the frauds. Further, we do not read these comments of the trial judge as meaning anything other than Vithoulkas and Barry perpetrated a fraud on the corporation as a means of achieving personal gain. It does not detract from the main thrust of the judge's finding that Barry and Vithoulkas were acting for their own benefit only."

I agree with the last two sentences, and add that it cannot sensibly make any difference whether or not the corporation there or S & R here was originally incorporated with a view to perpetrating the relevant fraud. Whatever the motives with which it was incorporated, it was not a sham. Once incorporated as a separate legal entity, it was entitled to be respected as such – even (indeed especially) by those who created and became its directing minds, wills and beneficial owners – and was not to be treated as their puppet.

234. In *Arab Bank plc v. Zurich Insurance Co.* [1999] 1 Lloyd's Rep 262, 282-3 Rix LJ, and in *Brink's-Mat Ltd. v. Noye* [1991] 1 Bank L R 68 (a case involving a scheme of fraud with analogies to the present) the Court of Appeal, considered that a company exposed to third party liability by fraud could be regarded as a victim of the fraud for the purposes of a claim against other persons allegedly in breach of duty to it. In distinguishing between primary and secondary victims, the Court of Appeal in the present case was, however, influenced by reasoning in *McNicholas Construction Co. Ltd. v Customs and Excise Comrs* [2000] STC 553 (Dyson J) and in *Bank of India v. Morris* [2005] 2 BCLC 328 (Court of Appeal). Both those cases were (as Rimer LJ noted) concerned with claims *against* the company by injured third parties, rather than claims by the company against others in breach of duty to it. So it is not clear why the *Hampshire Land* issue arose at all, and in my view the

statements in them are of no assistance in resolving any issue of attribution in the present context.

Directing minds and will who are also sole shareholders

235. Does it make any difference to the result if the company's directing mind(s) also own all its shares? Here it is necessary to return to the common law rule of attribution to which Lord Hoffmann referred in *Meridian*, that the unanimous decision of all the shareholders in a solvent company about anything that the company has power to do under its memorandum of association counts as a decision of the company. Lord Hoffmann cited Dillon LJ's statement in *Multinational Gas*, p.288G-H, that "so long as the company is solvent the shareholders are in substance the company". In consequence, Kerr LJ said in *Attorney General's Reference (No 2 of 1982)*, p.640C-E, "the decisions alleged to have been taken negligently and breach of duty [in *Multinational Gas*] were the decisions of the company itself and – the transactions being intra vires the company's memorandum - there was no basis for any claim by the liquidator".

236. However, the limitations mentioned by Lord Hoffmann are important. The transactions must be within the company's power under its memorandum of association; and it is only the unanimous decision of all the shareholders in a *solvent* company that can authorise or ratify an act that would otherwise constitute a breach of duty to the company, and make it the company's. No argument was addressed to the House on the former limitation, which in the present context probably overlaps with the latter. Transactions entered into by directors amounting in substance to no more than the fraudulent abstraction of increasingly large sums from an increasingly insolvent company with no other assets are unlikely to be within the scope of the company's powers; and the breach of duty involved in entering into such transactions cannot be answered by pointing to the directing mind's ownership of all the company's shares. This, as I have noted (para. 229 above), is what was decided by the Court of Appeal in *Attorney General's Reference (No 2 of 1982)*, a decision which was clearly right. In summary, at latest once directors know that a company is or would be insolvent, a disposition of the company's assets in disregard of the general creditors of the insolvent company will be actionable by the company, whatever the shareholders may wish or approve: see also per Dillon LJ in *West Mercia Safetywear Ltd. (in liq) v Dodd* [1988] BCLC 250, 252, distinguishing the situation in *Multinational Gas* as one where the company was "amply solvent, and what the directors had done at the bidding of the shareholders had

merely been to make a business decision in good faith, and act on that decision"; and also per Kerr LJ in *Attorney General's Reference (No 2 of 1982)*, p.640D-641C distinguishing *Multinational Gas* as not "concerned with allegations that the shareholders and directors had acted illegally or dishonestly in relation to the company".

237. The current edition (2007) of Palmer's Company Law Annotated Guide to the Companies Act 2006 states the position, at p 169:

> "The scope of the common law duty requiring directors to consider the interests of creditors is more controversial. Cases support a variety of propositions, but the better accepted view is that a duty is owed by directors to the company (and not to the creditors themselves: *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd.* [1991] 1 AC 187 at 217 PC; *Yukong Line Ltd. v. Rendsburg Investments Corp (No 2)* [1998] 1 WLR 294 [Toulson J]), and this duty requires directors of insolvent or borderline insolvent companies to have regard to the interests of the company's creditors (*West Mercia Safetywear Ltd. v Dodd* [1988] BCLC 250 CA)."

238. I agree with this analysis. The Court of Appeal was therefore also correct in *West Mercia* to hold that directors who know the company to be insolvent owe to the company an enforceable duty to have regard to the interests of the company's creditors. In *Yukong Line* Toulson J was likewise right to consider that that would be so (p.314F-G). There, as in *West Mercia*, the directing mind and owner of a company which had incurred a large liability sought to put the company's assets out of the reach of its creditor by transferring them to another of his companies. A claim by the creditor against the director failed on the basis that the director owed no direct fiduciary or other duty towards creditors. His liability was, as in *West Mercia*, to the company for disregard of the interests of its creditors. Far from undermining the integrity of the common law if such a liability were recognised and enforced, it would undermine the concept of separate corporate identity and the protection for creditors in insolvent situations at which company law aims, if a company were not entitled to claim against its directing mind and sole controlling shareholder in such a situation. The English cases of *RBG Resources plc v Rastogi and others* and *Brink's- Mat Ltd. v. Noye* and the Canadian case of *Oger v. Chiefscope Inc. et al.* (cited above), in all of which the directing minds of the relevant companies were the only shareholders, reach the same conclusion.

239. In *In re The Mediators, Inc.* 105 F.3d 822 (USAC, 2nd Cir. 1997), the Court held inadmissible a claim by a creditors' committee standing in the company's shoes brought against the company's sole shareholder, chief executive officer and chairman together with its bankers, lawyers and accountants for deliberately devising a scheme, which stripped the company of its assets in order to shield them from liquidation and from the company's creditors, while rendering the company liable for the cost of so doing. The reasoning was that, in a case of a sole shareholder and decision maker, "whatever decisions he made were, by definition, authorised by, and made on behalf of, the corporation" (p.827) and that the company had "no standing to assert aiding-and-abetting claims against third parties for cooperating in the very misconduct that it had initiated" (p.826). This is not English law. But an important element to understanding this rule is that in American law "Where third parties aid and abet a fiduciary's breach of duty to creditors – as is claimed here – the creditors may bring an action in their own right against such parties." (p.825).

240. In summary, it is no answer in English law to a claim by S & R against Mr Stojevic that Mr Stojevic had, as S & R's sole directing mind and sole shareholder, authorised the scheme of fraud which to his knowledge made the company increasingly insolvent to the detriment of its existing and future creditors. For present purposes it is to be assumed (and in fact it seems clear) that Mr Stojevic must have known that, as a result of his scheme of fraud, S & R was (increasingly) insolvent at each audit date.

The auditors' liability where the company's directing mind is fraudulent

241. I turn against this background to the auditor's position. Leaving aside situations in which the directing mind(s) is or are the sole beneficial shareholder(s), it is obvious – although the Court of Appeal's judgment is surprisingly silent on the point – that an auditor cannot, by reference to the maxim *ex turpi causa*, defeat a claim for breach of duty in failing to detect managerial fraud at the company's highest level by attributing to the company the very fraud which the auditor should have detected. It would lame the very concept of an audit - a check on management for the benefit of shareholders - if the higher the level of managerial fraud, the lower the auditor's responsibility. When Lord Bridge noted in *Caparo* that shareholders' remedy in the case of negligent failure by an auditor to discover and expose misappropriation of funds by a director consisted in a claim against the auditors in the name of the company (p.626E), he cannot conceivably have had in mind

that it would make all the difference to the availability of such a claim whether the director was or was not the company's directing mind. The fact that a "very thing" that an auditor undertakes is the exercise of reasonable care in relation to the possibility of financial impropriety at the highest level makes it impossible for the auditor to treat the company itself as personally involved in such fraud, or to invoke the maxim *ex turpi causa* in such a case. Context is once again all, as Kerr LJ recognised in *Attorney General's Reference (No. 2 of 1982)* at pp.640D-642H (see especially at p.642D). (I interpose that I do not read the discussion starting there at p.641E as proceeding on a basis inconsistent with that preceding it – I understand Kerr LJ there to have been addressing the factual question whether a jury would be bound to conclude that there was no dishonesty, which would arise if he were wrong in his legal analysis at pp.640A-641E.) Deception of auditors is the necessary stock-in-trade of fraudulent top management, as auditors and those responsible for auditing standards are and have long been very well aware. Lord Phillips's statement (para.5) that "common sense" might suggest that S & R's claim should fail because Moore Stephens were victims of deceitfully prepared company accounts must be categorically rejected. It would emasculate audit responsibility and the auditor's well-recognised duty to approach their audit role if not as bloodhounds, then certainly as watchdogs - planning and performing their audit with the "attitude of professional scepticism" required by paragraphs 27 and 28 of Auditing Standard SAS 110 in relation to the possibility of fraud as well as of error in management representations and company records and documents.

242. Auditing standards and procedures have changed significantly over the years. But the potential responsibility of auditors for negligent failure to detect accounting deficiencies or managerial fraud - leading the company to sustain further loss connected with such deficiencies or the continuation of such fraud - dates back to the early days of auditing: see e.g. *In re London and General Bank (No 2)* [1895] 2 Ch 673 (CA) (liability for a dividend voted by shareholders on the basis of misleading accounts on which the auditors failed adequately to report) and *In re Thomas Gerrard & Son Ltd.* [1968] Ch 455 (liability for dividends voted and tax liabilities incurred on the basis of accounts containing fraudulent inflation of the company's profits by Mr Croston, its managing director and holder of 18,000 of its shares, which the auditors negligently failed to discover and report on). In the latter case, the auditors argued (somewhat faintly), that Mr Croston knew and was not misled about the true position and that the payment of the dividends and tax flowed from his or the directors' actions (pp.469D-E and 471C-D). Pennycuick J gave short shrift to the argument (pp.477G-478G)

243. In *Galoo Ltd. v. Bright Grahame Murray* [1994] 1 WLR 1360 auditors were allegedly negligent in failing to detect fraudulent overvaluation of Galoo Ltd.'s stock by Mr Sanders, who was clearly the directing mind of Galoo Ltd. and its 100% parent. The claim was that, but for such negligence, both companies would have been wound up in 1986 instead of in 1993 and would have avoided losses made in subsequent adverse trading in that eight year period. The claim was rejected on grounds of causation (the losses were caused by the subsequent adverse trading, and the "but for" link to the auditors' negligence was insufficient). There was no suggestion that Mr Sanders' knowledge of or involvement in the fraud could defeat it.

244. More recently, in *Sasea Finance Ltd (in liquidation) v KPMG (formerly KPMG Peat Marwick McLintock* [2000] 1 All ER 676, the auditors were alleged to have failed to report promptly during the audit evidence of impropriety by two dominant figures in the group (neither however then a director). The auditors argued that it would have been no use to report to senior management consisting of the two dominant figures. In response, the Court of Appeal noted that there were six directors of whom no criticism was made and, in any event, that the Auditing Guidelines of the Institute of Chartered Accountants (Feb 1990 ed.)

> "acknowledge that there may be occasions when it is necessary for an auditor to report directly to a third party without the knowledge or consent of the management. Such would be the case if the auditor suspects that management may be involved in, or is condoning, fraud or other irregularities and such would be occasions when the duty to report overrides the duty of confidentiality".

The Court of Appeal cannot have thought such a duty in shareholders' interests would only exist if senior management *below* the level of the company's directing mind or board were complicit in the fraud.

245. It is in principle therefore no answer to an auditor who has failed to discover fraud to point to involvement or knowledge on the part of the company's directing mind. This conclusion is justified on grounds paralleling those applicable between the company and its directing mind (see paras. 224-232 above). That is not surprising, since both senior management and auditors owe duties to the company intended to protect shareholders' interests, and such duties must be enforceable. The two sets of relationship are essentially complementary, although the duty is

in one case primary and in the other confirmatory. However the present scheme of fraud is categorised, it cannot in the context of the audit engagement be attributed to the company itself, so as to relieve the auditors from their duty or prevent the company complaining of its breach. Again, this is so as a matter of general principle having regard to the nature of the roles and duties undertaken. Again, however, it can be supported by reference to the *Hampshire Land* principle, which, in this context also, means that the interests and activities of S & R and of Mr Stojevic must be distinguished, precisely because it was among Moore Stephens's functions as auditor to ensure to the former a degree of protection against the latter.

246. In view of some observations made by my noble and learned friend, Lord Brown of Eaton-under-Heywood (in paras. 202-203) I add a word on the nature of an auditor's potential liability for negligent failure to detect, report and so stop a continuing course of management fraud. This was one of a number of topics on which the House did not hear argument, and some authorities relevant to it were not therefore cited. But in principle, the auditor is potentially liable for further frauds committed in the same course of management fraud. An auditor may argue that loss suffered by a continuing scheme of fraud which the auditor ought to have detected was outside the scope of the auditor's duty or too remote or that there was a break in the chain of causation, but success in such an argument may be unlikely in circumstances where, ex hypothesi, the auditor was negligent in failing to detect the same continuing scheme. The relevant considerations were canvassed by Evans-Lombe J in *Barings Plc v Coopers & Lybrand* [2003] EWHC 1319 (Ch) at paragraphs 816-838. Hobhouse J's comments in *Berg* (discussed below) and the case of *Galoo* (paragraph 243 above) have nothing to do with this question. In both those cases, the losses and insolvency were caused by subsequent adverse trading decisions unconnected with the fraud. (*Galoo* is no doubt the case to which Lord Hoffmann referred extra-judicially on this point in his Chancery Bar lecture *Common Sense and Causing Loss* of 15 June 1999.)

247. Examples of cases where auditors have been held liable for further losses in a continuing scheme of fraud include *Pacific Acceptance Corpn. Ltd. v Forsyth* (1970) 92 WN (NSW) 29 (see at p.41E-F – quantum was ultimately compromised: see p.133D-E), *Dairy Containers Ltd. v NZI Bank Ltd. and Auditor-General* [1995] 2 NZLR 30 (see at pp.52 lines 15-20 and 73 lines 23-29) and *Barings Plc v Coopers & Lybrand* itself (subject in that case to a finding of a break in the chain of causation occurring some 18 months after the negligent audit as a result of the fault of management not involved in the fraud

(paras. 839-878). The position in such cases parallels that where auditors failed to detect a continuing negligent course of foreign exchange dealings: *Daniels (formerly practising as Deloitte Haskins and Sells) v Anderson* (1995) 16 ACSR 607 (see at pp. 703 line 48 to 705 line 3, 717 line 27 to 718 line 3 and 720 lines 34-43). It is auditors' exposure in such respects which has led them over the years to press for some mitigation of liability over and above any offered under s.727 of the Companies Act 1985, now s.1157 of the Companies Act 2006. One suggestion was that their liability should be made proportionate. This suggestion was rejected by the Law Commission in a Feasibility Investigation of Joint and Several Liability for the Department of Trade and Industry (1996). More recently, auditors have however obtained a statutory right to limit their liability contractually under ss.534-536 of the 2006 Act.

Overseas authority on attribution

248. The House was shown a range of common law authority, particularly from Canada, Australia and the United States. It amply illustrates the variety of ideas and solutions current in this field. Ultimately, I derive no more than an increasing reluctance in recent case-law to hold that top management fraud provides a defence to a negligent auditor. While this corresponds with my own conclusion as to the right direction in principle for English law, I have relegated detailed examination of the overseas authorities to an annex.

The auditor's position where some of the shareholders have engaged in fraud

249. Fraud of the company's directing mind is as such, therefore, no bar to a claim by the company against its auditor for loss sustained by the company due to negligent failure to detect such fraud (paras 241 to 247 above). It cannot in principle make any difference if (as will very commonly be the case) the same person owns some shares in the company. As a matter of basic company law, the company's separate legal personality entitles it to claim, and the situation mentioned by Lord Hoffmann in *Meridian* (paras 221 to 235 above) in which it is legitimate to look behind the veil at the shareholders, applies only when *all* the shareholders in a solvent company concur in committing the company to some decision within its memorandum of association.

250. Lord Phillips expresses the view (para. 61) that the position "becomes unclear … if some of the shareholders were complicit in the directing mind and will's misconduct" because of the possibility of "the fraudulent …. shareholders profiting from their dishonesty". Self-evidently this focuses only on the presently irrelevant situation of a solvent company. But even in a situation of solvency, I consider that the doubt expressed by Lord Phillips about the company's right of recovery conflicts with the principle precluding the lifting of the corporate veil. In reality, it would, if accepted, transform the law regarding auditors' responsibility, since in many cases fraudulent management own some shares.

251. The concern behind the doubt is that auditors might be liable to the company in amounts which would then enure to the benefit of guilty shareholders. This is however an insubstantial spectre, whether or not the company is insolvent. In cases of insolvency (such as *In re London and General Bank* and *In re Thomas Gerrard* and the present), there is commonly no conceivable prospect of any shareholder benefiting by any recovery, however large, made against a negligent auditor. A claim against auditors will not in practice reimburse the company for all its loss, because the very basis of the claim will be that future loss was caused by failure on one or more audits to detect a continuing scheme of fraud which will *already* have caused past loss. This is quite apart from the fact that auditors' negligence cases are commonly compromised before trial. Further, if a guilty shareholder is identifiable and has current assets, the company will often look first to them and any recovery from the auditor will be reduced accordingly (as apparently happened in *In re Thomas Gerrard*). And, if this does not happen, auditors commonly join fraudulent directors and others as third party defendants, and take steps to freeze any assets that they may have.

252. Nevertheless, it is appropriate to give some further consideration to the position of a solvent company (or a company which would be rendered solvent if it recovered damages from its auditors), on the remote hypothesis that, if it were to recover in full, then shareholders who had already benefited by or were involved in the wrongdoing might benefit by an increase in value of the company. A similar spectre of double recovery may be summoned in respect of the recovery from negligent auditors of dividends which a company has wrongly paid out to shareholders on the faith of fraudulent accounts. In that situation, the shareholders may either be entirely innocent or may include shareholders aware of the accounts' falsity. The spectre of double recovery was thus raised, briefly and unsuccessfully, as an objection to the recovery of damages against negligent auditors in *In re Thomas*

Gerrard. Counsel submitted that it would be "monstrous for the shareholders to receive again what they had already received in excess dividends" (p.469F). Pennycuick J's response was simply that the auditors were "of course entitled to credit for the account [sic] recovered from Mr Croston" (p.478G). As stated above, Mr Croston was not only the managing director, but also a significant shareholder. However, the company was in liquidation, so that the factual basis for counsel's submission that the shareholders might "receive again what they had already received in excess dividends" is also unclear.

253. The whole topic was however comprehensively revisited by Giles J in the Supreme Court of New South Wales in *Segenhoe v Atkins* (1990) 1 ACSR 697 where he held that it did not matter whether the company paying the dividend was solvent rather than insolvent. In either case the company as a separate entity was out of pocket to the extent of the money paid away. To prevent recovery by the company because the money was paid to shareholders rather than to a third party "would negate the company's status as a legal entity separate from its shareholders" and in any event, even if the shareholders remained the same, they would not necessarily be paid twice over. Giles J's full reasoning at pp.701-702 repays reading. The only contrary suggestion in any authority appears to consist of a single dictum of Cotton LJ in *In re Exchange Banking Co (Flitcroft's case)* (1882) 21 Ch D 519. This was another case where dividends were over a period of years wrongly paid out of capital on the basis of accounts showing false profits prepared by directors who as shareholders received some of such dividends. The company, by now in liquidation, sued the directors for the totality of the dividends wrongly paid out. Sir George Jessel MR and Brett LJ held unequivocally that the dividends were recoverable in full, and would have been even had the company remained solvent. However Cotton LJ drew a distinction, saying, at p 536:

> "The corporation is not the mere aggregate of shareholders. If the corporation were suing for the purpose of paying over again to the shareholders what the shareholders had already received the Court would not allow it. But that is not the case here, the company is insolvent, and there is no objection to allowing it to get back its funds for the purpose of paying debts. The case of the liquidator is stronger, for in some respects he, as *a quasi* trustee for creditors as well as shareholders, stands in a different position from the company. But I rely on this, that the money was not paid to the corporation, but was paid improperly to individuals, and the corporation can sue the directors to get it back that it may be applied in payment of the debts of the corporation."

As Giles J observed in *Segenhoe v Atkins,* Cotton LJ's "reference to 'the shareholders' was probably to the particular shareholders who had received the dividends, rather than to the shareholders as a fluctuating body", and later case-law has tended to explain Cotton LJ's dictum as a reference to the court's power to give directions in a liquidation as to the proceedings which a liquidator may pursue. However, the dictum is on any view irrelevant in the present case where the company is irredeemably insolvent. If a case ever arose of a solvent company, the English courts would have the opportunity, as Giles J did, of reconsidering the dictum, and of either taking the same view as Giles J or fashioning the dictum into a rule preventing any possible double recovery (perhaps building on the *VGM* principle: see below).

254. I turn now to situations where the loss consists not of dividends paid out to shareholders, but of other payments fraudulently extracted from the company. In these situations, by definition, the only shareholders, who might conceivably benefit twice over if a company were able to recover such losses from wrongdoers such as its directors or auditor, would be shareholders participating in the fraud. Again, the issue would only arise in a case where (unlike the present) the company was solvent or (improbably) would be made so by recovery from its directors or auditor. In my view, English law would find, as some American courts have found, a way of addressing this issue, even though it may be a different way. First, if the point ever arose where a company, which had still not received full compensation for injury done to it by management fraud, were due to make a distribution to a manager shareholder, the company could impound the defaulting manager/shareholder's share of the distribution under the principle identified in *In re VGM Holdings Ltd.* [1942] Ch 235 and *Selangor United Rubber Estates Ltd. v. Cradock (No 4)* [1969] 1 WLR 1773. That principle not only enables the impounding, as in *VGM*, of a defaulting director's entitlement to satisfy his own liability, but also enables the impounding of the amounts due to a defaulting director in his capacity as shareholder to satisfy the liability of other defaulting directors liable jointly and severally with him. In *Brink's-Mat Ltd. v Noye and others* [1991] 1 Bank LR 68, 72 Nicholls LJ suggested and Mustill LJ in his judgment accepted that this "or some other process designed to achieve the ends of justice" would "without doubt" prevent the fraudulent shareholders from profiting by their dishonesty. I also believe that would be so. The common law is not so barren as to be unable to achieve in this area what Lord Goff of Chieveley once described in another context as "practical justice".

255. One approach that could not, with respect, be adopted is that suggested by my noble and learned friend, Lord Brown, in his judgment at para. 203. That paragraph ignores separate corporate personality when it refers to "a claim against the auditors [which] may well lie (through the company) at their [i.e. innocent shareholders'] suit". A company (all the more so when in insolvent liquidation) sues in its own right, not for or at the suit of its shareholders. I am also aware of no "policies and principles", generally understood or not, which might limit a company's recovery for a wrong done to it by reference to whatever loss its innocent shareholders might, if the corporate veil were lifted, be said themselves to have suffered. The suggestion that this could be the measure of a company's recovery again ignores the company's separate legal identity and interests. Suppose senior management own 50% of the shares, and are operating a scheme of fraud which the auditor should have detected at the end of year 1, and that the fraud costs the company £1m in year 2. Why should it matter whether, but for the £1m abstraction in year 2, shareholders' equity would or would not have increased in value? What if the £1m abstraction imperils the company or renders it insolvent? The company has suffered a loss of £1m., and is entitled to recover this for its own purposes including payment of its debts. The only qualification on full recovery that might, theoretically, exist in a solvent situation (other than those inherent in conventional contractual and tortious principles of causation and remoteness) is one tailored to ensuring that no guilty shareholder actually benefits, and this could be achieved, if it were ever to be a real concern, under or by development of the *VGM* principle in a manner respecting corporate identity (see para. 254 above)**.** Further, as Cotton LJ recognised in *In re Exchange Banking Co (Flitcroft's case)*, whatever view one may take about the position where a company is solvent, "there can be no objection to allowing it to get back its funds for the purpose of paying debts". In an insolvent situation like the present, Lord Brown's suggestion is also in conflict with the decision in *In re Thomas Gerrard*, where Mr Croston's shareholding and its value were, rightly, treated as irrelevant to the company's recovery against its negligent auditors.

The auditor's position where all the shareholders have engaged in fraud

256. The issue which is, or should be, critical to this appeal arises where the person(s) responsible for the scheme of fraud own *all* the company's shares. The auditor is there to check on management and report to shareholders. But the shareholders know the true position. In a situation of solvency, the straightforward analysis is that there is nothing to report, no-one to complain and no loss. It might also be questioned whether there is any breach of duty, at least in tort and perhaps also in

contract, in failing to report to persons who already know; however, this may overlook the fact that the negligent auditor will by definition not know that the shareholders do know, and it also needs to be considered in the light of the auditor's statutory role and the duties, here largely express, which an auditor undertakes. More pertinently, "so long as the company is solvent, the shareholders are in substance the company" (para. 235), and the company cannot therefore say that it was ignorant or misled or suffered loss.

257. Two cases illustrate the application of this straightforward analysis to companies solvent at the audit date. In *Pendleburys Ltd. v. Ellis Green and Co.* (1936) 181 LT 410, a company claimed against its auditor loss caused by its cashier's defalcations. It sought to attribute such loss to the auditor's failure, when reporting on the accounts, to disclose weaknesses in the company's book-keeping systems arising from the absence of certain books and internal checks. The company's only three directors were its sole shareholders and debenture-holders, and the auditor had reported the weaknesses to them from time to time. Swift J in dismissing the claim observed that the defendants had made their reports to the three men who had "every pecuniary interest in the company", and that, "although they, as auditors, were there to protect the shareholders it could not seriously be said that the shareholders did not receive the information and protection which the law desired should be secured to them" (p 411). The reference to the directors as having "every pecuniary interest in the company" and the absence in the report of any contrary suggestion indicate that the company remained solvent at all times.

258. The second case is Hobhouse J's decision in *Berg*. Berg & Co. was solvent at the date of the relevant 1982 audit. (It became insolvent some years later by reason of a trading debt incurred in 1984.) The negligence it alleged against its former auditors related to a receivable of £2.39m shown in the 1982 accounts as due from a company called Gimco, in respect of which the auditors had simply accepted the uncorroborated and unsupported assurances of Gimco and Mr Golechha, Berg & Co's sole active director and ultimate beneficial owner. At p.44 Hobhouse J pointed out that, although Berg & Co was a separate and distinct legal entity, Mr Golechha was its directing mind, his knowledge was the company's and "There was never any general body of shareholders nor any minority shareholders. In addressing their certificate to 'the Members' of Berg, [the auditors] were for all practical purposes addressing it to Mr Golechha alone". Applying *Caparo* he said (p.53) that

> "the purpose of the statutory audit is to provide a mechanism to enable those having a proprietary interest in the company or being concerned with its management or control to have access to accurate financial information about the company. Provided that those persons have that information, the statutory purpose is exhausted. What those persons do with that information is a matter for them and falls outside the scope of the statutory purpose. In the present case the first plaintiffs [the company] have based their case not upon any lack of information on the part of Mr Golechha but rather upon the opportunity that the possession of the auditor's certificate is said to have given for the company to continue to carry on business and to borrow money from third parties. Such matters do not fall within the scope of the duty of the statutory auditor."

259. In this passage, Hobhouse J was identifying a situation analogous to that applying where a person (A) undertakes to report to a professional body on the affairs of a third person (B) to enable B to continue to engage in professional practice. If B procures A to issue the relevant certificate by deceiving A about matters which A, had he been careful, should anyway have observed, B cannot then turn round and blame A: *Luscombe v. Roberts and Pascho* (1962) 106 SJ 373. But the professional body, if it incurs loss through allowing B to continue in practice, can in such a situation claim against A: *Law Society v. KPMG Peat Marwick* [2000] 1 All ER 515; [2000] 1 WLR 1921(CA). In a case like *Berg*, once it is established that all relevant persons within a company know the true position, the company falls to be treated as a single person (B) in relation to its auditor (A).

260. The company argued in *Berg* that the *Hampshire Land* principle precluded the attribution to it of Mr Golechha's knowledge. The argument failed *in limine* (because it was not shown that Mr Golechha was guilty of any fraud on the audit or towards the company), but Hobhouse J (at p.54) also addressed the position as it would have been had there been any fraud:

> "However one identifies the company, whether it is the head management, or the company in general meeting, it was not misled and no fraud was practised upon it. This is a simple and unsurprising consequence of the fact that every physical manifestation of the company Berg was Mr

> Golechha himself. Any company must in the last resort, if it is to allege that it was fraudulently misled, be able to point to some natural person who was misled by the fraud. That the Plaintiffs cannot do."

In the result, the company was entitled only to nominal damages for the technical breach of contract involved in the failure to qualify the audit report. Hobhouse J's words must be taken in context. The company was solvent at the relevant dates. There was no-one but Mr Golechha to think or act for or be interested in it.

261. American case-law supports a conclusion barring recovery from a auditor who has negligently failed to detect that the company's sole shareholder and controller (a "sole actor") has been engaging in fraud, e.g. by falsifying the company's accounts and conducting its business fraudulently to his own benefit and the injury of depositors and creditors (*Federal Deposit Insurance Corpn. v. Ernst & Young* 967 F.2d 166 (1992)) or by operating a Ponzi scheme leading the company into ever deeper insolvency (*Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.* 267 F.3d 340 (3rd Cir. 2001)). In the former case (decided under Texas law), the court left open the possibility that the creditors or the liquidator on their behalf might have a cause of action against the auditors. In the latter case, decided under Pennsylvania law, the court said that the nature of the claim (for the company's loss through "deepening insolvency" – a problematic head of loss in English law in any event) made it one which could only be pursued by the company, and that s.541 of the US Bankruptcy Code meant that the liquidator in pursuing it could be in no better position than the company had been before its liquidation.

262. Moore Stephens argue, and I understand the majority of your Lordships to consider, that this appeal is covered by the same analysis. In short, Mr Stojevic was S & R's sole directing mind and its sole beneficial owner; and the company cannot in consequence complain that it succeeded in deceiving Moore Stephens and was in consequence not stopped by others (regulatory or investigating authorities) from pursuing its scheme of fraud. Such a conclusion could be explained in various ways: the auditor's duty did not extend to supplying information which all persons who can represent the company already have; or whistle-blowing on S & R was and is outside the statutory purpose of the audit as between the company and the auditor; or the principle *ex turpi causa* applies. Which way was adopted would be presently immaterial.

263. In my opinion, Moore Stephens's argument and the majority conclusion overlook a critical distinction between a company which is solvent and a company which is insolvent at the audit date. Let me, however, first consider two other reasons suggested by S & R for rejecting Moore Stephens's argument. They are: (a) the "very thing" principle and (b) the fact that S & R is currently insolvent and in liquidation. The first, that the maxim *ex turpi causa* is incapable of defeating a claim against Moore Stephens for failure to discover and report the very continuing fraud which is the basis of the claim to rely on the maxim, makes no sense if and so long as S & R and its directing mind and sole shareholder are to be identified with each other. An auditor or reporting accountant (A) cannot be in breach of duty, to a person (B) committing a fraud, by failing to report to a third person (C) B's own fraud about which B well knows (and which B could perfectly well have reported himself, had that not been the opposite of what he wished). This is so, even if such a report would have led to B being unable to continue the fraud. These points are demonstrated by both *Luscombe* and *Berg*. The case of *Reeves v Commissioner of Police of the Metropolis* [1999] QB 169 has in my opinion no real relevance. It stands for a principle of causation which does not sensibly extend to situations of fraud and could not override the maxim *ex turpi causa* if otherwise applicable.

264. The second reason, that S & R's current insolvency and liquidation should make a difference since any recoveries will be held on the statutory trust for creditors, is touched on in the American case-law considered in the annex to this speech. Mr Brindle accepts that S & R cannot in liquidation have a claim which it did not have pre-liquidation. But he submits that the defence *ex turpi causa* may cease to apply to a one-man company which goes into liquidation, because in liquidation its assets are held and will be distributed under the statutory scheme for the benefit of creditors. I cannot however accept the argument. Under English law, the company in liquidation cannot in this respect be in a better position than it was pre-liquidation, merely by virtue of the fact that it has become insolvent and gone into liquidation: see also *Berg* (para. 258 to 260 above).

The significance of insolvency at the audit date

265. The fact that S & R was insolvent at each audit date is, in contrast, in my opinion critical. The powers of directors and shareholders in circumstances of insolvency or potential insolvency are qualified (as described in paras 235 to 240 above). The issue as between

the company and its auditors is whether the auditors' duty to the company extends, like the directors', beyond the protection of the interests of shareholders in a situation where the auditors ought to have detected that the company was (in fact, as a result of the fraud which the auditors ought to have discovered) insolvent. Despite the immense and highly skilled attention that the appeal has had generally, both prior to and during its presentation before the House, I fear that the centrality of this point may have been a little obscured by the spread of argument over other issues. Hobhouse J touched on it in *Berg* (at pp.54 to 55). But in *Berg* the problem did not arise because the insolvency arose *after* the 1982 audit certificate from Berg's subsequent unconnected trading misfortune and also because the auditor could not be said to have been "implicated in a breach of the company's duties to its creditors" in any way paralleling the way in which the directors in *West Mercia* were (*Berg*, p.55). On the latter possibility, Hobhouse J added (*Berg*, p.55):

> "The *West Mercia* case was a clear case of a director abusing his position for his own advantage but the same principle applies wherever it can be shown that those in charge of the affairs of a company or in control of it are acting contrary to the principles governing insolvency. It is only in this sense that it can be said that once a company is insolvent the interests of the company become those of its creditors. The duty of the company and its directors is then to preserve the assets of the company. The present case does not involve any such situation at any material time. The company may have been trading imprudently; but there is no evidence that in 1982 it was trading in fraud of its creditors. There is no allegation that Dearden Farrow were a party to any breach by Mr Golechha of any of his fiduciary duties."

This passage shows that the earlier passage in Hobhouse J's judgment (at p.54) quoted in para 260 above must be read in context. It does not mean that a company's only claim against its officers (including in this term its auditor) lies in deceit. It does not mean that a company is always to be equated with its directing mind. It does not address the context of insolvency.

266. None of the previous cases, *Pendleburys*, *Galoo* and *Berg*, deals with the position of a company insolvent at the date of the audit due to past fraud, where the loss claimed consists in the continuation of the scheme of fraud to the further detriment of the company and its creditors, existing or future. In *West Mercia* and *Yukong* the directors

knew of the company's potential insolvency and their actions constituted breaches of fiduciary duty designed to defeat creditor rights in insolvency. A director may now also incur responsibility to the company for wrongful trading under the Insolvency Act 1986, s.214; and the common law duty discussed in paragraphs 235 to 240 above covers some of the same ground. Here, however, there is no doubt that Mr Stojevic was in deliberate breach of fiduciary duty. If Moore Stephens had known about or shut a Nelsonian eye to Mr Stojevic's breach of duty, there could be little doubt about their liability (see Hobhouse J's dicta in *Berg*, p.55 (quoted in para 265 above). But the present appeal proceeds on the basis that they negligently failed to detect the scheme of fraud and the company's insolvency and so allowed the scheme to continue to the company's further detriment.

267. The decisions in *Caparo* and *Al Saudi Banque* establish that auditors' duties are normally limited to the protection of the company's interests for the benefit of its shareholders. There was no question of any insolvency on the facts of *Caparo*. The facts in *Al Saudi Banque* were closer, and the scheme of fraud remarkably similar, to the present. But the claimants were the banks, and their claim was dismissed on the basis that the auditors had not been appointed by them and "were under no statutory obligation to report to them" (p.336E). In both *Caparo* and *Al Saudi Banque*, the concern was about the uncertain and unknown exposure in respect of third party investment or lending which would follow from permitting third party claims.

268. Other than in special situations, therefore, auditors owe no direct duties towards third parties. But none of the above cases addresses the present situation of a claim by the *company* against its auditors for failure to pick up a fraudulent scheme rendering it increasingly insolvent. But in *Caparo*, both Lord Bridge and Lord Oliver recognised the company's standing to bring claims for loss which it has suffered by its officers' fraud (see para 214 above); and, further, Lord Oliver described an auditor's duty as being, first of all, "to protect the company itself from the consequences of undetected errors, or, possibly, wrongdoing", before identifying a second duty "to provide shareholders with reliable intelligence" (para 214 above).

269. In my opinion it is in no way inconsistent with *Caparo* or *Clarke Pixley* to hold auditors responsible to the company they audit in the present circumstances. I underline four points in this connection. First, the concern about indefinite exposure to third parties does not exist in the context of a claim by the company. S & R's claim is to recover its

own (not its creditors') loss by reason of the continuing scheme of fraud. Loss to the company is not the same as loss to its creditors, although there may or may not be an overlap. An insolvent company may by fraud raise £1m from bank A which it uses in a Ponzi type scheme to pay off a borrowing from bank B. Bank A is £1m worse off, and bank B £1m better off. But the company itself is no worse off from the continuing fraud. It is liable to pay bank A £1m, but it has benefited by £1m by paying off bank B using bank A's £1m. Of course if (as here) it raises £1m by fraud and pays only £500,000 to bank B and if its directing mind makes off with the other £500,000, then the company is £500,000 worse off due to the continuation of the fraud, but that is and remains its own loss. Secondly, S & R's claim is for precisely the same loss as a company with some shareholders innocent of involvement in top management's fraud would be entitled to claim from negligent auditors who had failed to detect and report the fraud (paras 249 to 255 above). Thirdly, it cannot be suggested that the care to be expected of Moore Stephens as auditors varied according to whether all of S & R's shares happened to be owned and/or controlled by Mr Stojevic. Their express contractual duty was under Auditing Standard SAS 110.10 and 110.12 to report to a proper authority without delay where suspected or actual fraud cast doubt on the integrity of directors. This duty in fact exists under SAS 110 irrespective of whether there are or are not independent shareholders of integrity. Auditors would not in any event necessarily have any idea whether any such shareholders exist.

270. Fourthly, quite apart from the express provisions of Auditing Standard SAS 110, a situation of insolvency introduces new considerations for reasons previously explained. The identity of interest which normally exists between a company and its shareholders ceases, and the duties of auditors, like those of directors, must recognise this. The company as a legal personality continues and the auditors' duty continues to be, in Lord Oliver's words in *Caparo*, "to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing". If, in Hobhouse J's words in *Berg*, "those in charge of the affairs of a company or in control of it are acting contrary to the principles governing insolvency", then the auditors can no longer treat them as representing the company, and must take other action - according to SAS 110 "without informing the directors in advance". In reality, a public report to shareholders (however many of them were involved in the fraud) would itself bring matters to an end. Resignation – and it is part of S & R's pleaded case that Moore Stephens should, after detecting the fraud, have resigned as well as reported it to the authorities - would by statute have involved an express duty on the part of Moore Stephens to report to creditors: s.394(1) of the Companies Act (para 215 above). I believe that it would in any event probably be

auditors' professional and common law duty to report suspicions of fraud to the proper authorities. But Auditing Standard SAS 110 puts this beyond doubt. Even if Moore Stephens had been aware that directors known or suspected to be acting fraudulently were the beneficial owners of all the company's shares, they would under SAS 110 still have been obliged to report the circumstances to regulators or other authorities, without informing management in advance, in order to protect the interests of the company. In fact, as I have said, auditors may often not know whether or not all such directors own all the shares. It would be a strange policy and law that exempts auditors from all responsibility to the company, according to the chance that the directors on whose integrity they undertake to report prove to be the sole "beneficial owners" of all the company's shares.

271. It follows that in my opinion Moore Stephens cannot invoke the maxim *ex turpi causa* or deny causation by reference to the knowledge of and involvement in the fraud of Mr Stojevic, if Moore Stephens ought with proper skill and care to have detected that S & R was subject to a continuing scheme of fraud in circumstances in which S & R was insolvent and being rendered increasingly so. Under English law, S & R is thus in my opinion entitled to pursue its present claim against Moore Stephens.

272. American cases appear to have taken a different view on this particular point under Texan and Pennsylvanian state law: *Federal Deposit Insurance Corpn. v. Ernst & Young* and *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.* 267 F.3d 340 (3rd Cir. 2001): see para 261 above. They come from a different legal background, one where creditors may at least in some States have direct remedies, and their reasoning does not answer the considerations which lead me to a different conclusion. For the reasons I have given, I do not consider that they represent English law.

Contributory fault

273. The last matter on which I wish to comment – though not to reach any conclusions - is the question of contributory fault. Mr Brindle opened his oral submissions by accepting that it would be open to the court to apportion fault between the company and its auditor if recovery against the auditor were permitted in respect of fraud by the company's directing mind. It suited Mr Brindle's case to present Moore Stephens' defence of *ex turpi causa* as an extreme and novel response to the

present situation, and to proffer at the outset the more balanced discretionary possibility of a reduction of the claim on account of the company's contributory fault. However, I regret that, as part of the whole picture, the House has not heard full argument on this aspect. (Indeed, I consider that the House's resulting inability on this appeal to review the complete picture is a further reason for not determining the whole claim against Moore Stephens at this stage. If contributory negligence is available as a defence, it would cater for or assuage concerns about the general appropriateness of allowing recovery expressed in some of the majority judgments.) The starting point would be to consider the extent to which contributory fault is available in respect of non-fraudulent management failings, either the very failings which the auditors ought with care to have identified or different management failings which nonetheless contributed to the same loss as that which the auditor's negligence allowed to occur. The House's decision in *Reeves* makes clear that, in a simple two-party situation, it is possible for recovery, for breach of a duty to prevent the very thing complained of happening, to be reduced on a broad brush basis on account of the claimant's conduct in bringing about the thing. In *Professional Negligence* by Jackson & Powell (6th Ed. 2007), chap 17, a number of authorities are cited in which contributory fault has also been recognised as a ground for reduction of liability in auditor's negligence claims.

274. However, the obvious conundrum, if the fraud of top management is not attributed to the company for the purpose of the maxim *ex turpi causa*, is why it should be attributed to the company for the purpose of contributory fault under the Law Reform (Contributory Negligence) Act 1945. Mr Brindle's justification for doing this is that, when considering the allocation of fault to the company under the Act, the court is in effect considering a claim against the company. But, even if a "fault" is in this way equated with a claim, the question arises in the context of an audit of a solvent company, how management fraud may be balanced against an auditor's negligence, when an auditor's primary responsibility is in respect of innocent shareholders, whose conduct will not usually be susceptible to criticism. And a similar difficulty arises about weighing the significance of fraud by a directing mind who is also sole beneficial shareholder, if, as I consider, the auditor may be answerable to the company for negligent failure to detect and report on such a fraud. Despite such problems, contributory fault, including Leeson's fraud which the judge had held (rightly or wrongly, I need not consider) to be attributable to the company, was recognised as a ground for a substantial reduction in recovery against the auditors in *Barings Plc v. Coopers & Lybrand* [2003] EWHC 1319 (Ch). The subject was also discussed by the Full Court of South Australia in *Duke Group Ltd. v*

Pilmer 73 SASR 180 (1999) (reversed in part on a different point at [2001] BCLC 773). The court there concluded that, while the company's directors' knowledge of their own fraud on the company would not be attributed to the company, the company could and would nonetheless be liable vicariously for such directors' misconduct and treated as at fault on the same basis, for the purposes of enabling negligent auditors to reduce their liability in tort. (This was a Pyrrhic victory, since at the time contributory negligence was not available in Australia in relation to the concurrent contractual claim against the auditors.) The Full Court's reasoning was avowedly pragmatic and it relied as it said on its "view that this is the fairer and more appropriate outcome". There is obvious attraction in such pragmatism in the present context. Not having heard argument on any such aspects, I say no more.

Conclusion

275. For the reasons I have given, I consider that this appeal should be allowed on the ground that Moore Stephens's duty was to the company, that it is not sufficient for Moore Stephens to argue that every relevant emanation of the company consisted of Mr Stojevic as its directing mind and sole shareholder, if Moore Stephens failed in breach of duty to the company to detect the continuing scheme of fraud being pursued by Mr Stojevic and to detect that the company was (in fact, due to such scheme of fraud) insolvent or potentially so. In that context, Moore Stephens cannot attribute to the company itself, for the purpose of invoking against it the maxim ex turpi causa, the knowledge of and involvement in the fraud of Mr Stojevic which (it is for present purposes to be assumed) they ought to have detected and reported to regulators or other proper authorities in the company's interests. What would have happened upon such detection and report is simply a matter of causation.

276. The company's ability to recover its own loss in such circumstances is in my view not only also right in principle, but also desirable. It means that recovery does not depend on the happenstance of whether or not all the company's shareholders were involved in the fraud. Whether a company is a one-person company or not may itself also be unclear, until one has penetrated a web of nominee or trust shareholdings. The result I reach reflects the various categories of person interested in the company, with whom in mind the auditors ought to plan and conduct their work. The contrary result espoused by the majority of your Lordships will weaken the value of an audit and diminish auditors' exposure in relation to precisely those companies most vulnerable to management fraud. The (too topical) lesson for

creditors or depositors might be said to be that they should not expose themselves to one-person companies, at least without extensive due diligence. That is neither attractive nor realistic as an answer, when one-person companies can be large financial enterprises offering banking facilities to or inviting deposits or investments from many ordinary members of the public. It is in relation to exactly such companies that auditors ought to be encouraged to exercise the skill and care anyway due, rather than to feel that the risks of incurring liability to the company for a negligent audit are reduced. For completeness and not because it in any way influences my conclusion, I note that auditors are now also able to enter into fair and reasonable liability limitation agreements under ss.534-538 of the Companies Act 2006, though how far this is proving acceptable to their client companies or others I am unaware.

277. I would therefore allow this appeal, and restore the judge's order dated 11 September 2007 dismissing Moore Stephens's application for summary judgment on, or to strike out, the claim against them and giving directions for the further conduct of the proceedings.. The critical issue dividing the House is ultimately whether auditors, who should, in the performance of their contractual and tortious duties towards a company, have detected and (under the express terms of their engagement) then have reported to the appropriate authorities a scheme of fraud by top management rendering the company as a separate legal person increasingly insolvent, owe any enforceable duty towards the company to do this, so avoiding further loss to the company. In my opinion, they do.

Annex
Overseas authority on attribution
(para 248)

i. *Canadian Dredge & Dock Co. Ltd. v The Queen* (1985) 19 DLR (4th) 314 was decided by the Canadian Supreme Court, after reference to English case-law including *Tesco Supermarkets Ltd. v Nattrass*. It concerned a criminal prosecution. Not surprisingly in this context, the Supreme Court took a limited view of the circumstances in which the company could disclaim the acts and state of mind of its directing mind. Estey J described these as being "when the directing mind ceases completely to act, in fact or in substance, in the interests of the corporation", or "where all of the activities of the directing mind are directed against the interests of the corporation with a view to damaging that corporation, whether or not the result is beneficial economically to the directing mind". Only then, might there "be said to be fraud on the corporation" or an act "totally in fraud of the corporate employer" (p.351). Two comments may be made. First, the language of fraud on a company was being used in the unfamiliar context of a charge *against* the company. In such a context, as I have said, the hurdle for disclaimer of responsibility was, not surprisingly, set high. Second, the phraseology developed in the judgment and used in subsequent Canadian cases (and some other common law cases: see e.g. *In re The Mediators, Inc.,* paras. 6-7, discussed in paragraph 239 above, and *Duke Group Ltd. v Pilmer* 73 SASR 180 (1999), para.632. indicates a test which is both more rigid and more extreme than that which English law would adopt, particularly since the Privy Council's decision in *Meridian*.

ii. Despite the first point, the reasoning in *Canadian Dredge* has been transposed in Canada to the context of an auditor's negligence claim in a first instance decision. *Hart Building Supplies Ltd. v. Deloitte & Touche* [2004] BCSC 55 was a case where Mr Larson, a director and the directing mind and a 15% shareholder, had falsified Hart's inventory records and inflated its profits by false invoices "to try to help Hart's business", and so misled the auditors. The company's claim was brought at the instance of its innocent 85% shareholder against the auditors for negligence. The judge in applying "the law as set out in *Canadian Dredge*" took principles which may be appropriate when determining a company's liability to the third party and applied them, without question, to the different situation of a company seeking redress from a third party on the face of it in breach of duty to the company. For reasons I have given, this does not represent English law, and it has also been subjected to trenchant Canadian critique: *Emaciating the statutory audit – a comment on Hart Building Supplies Ltd. v. Deloitte & Touche* by Ass. Prof. Darcy MacPherson, University of Manitoba: (2005) 41 Can Bus LJ 471.

iii. Australian authority has adopted a more sceptical attitude to the scope and appropriateness of application of *Canadian Dredge* in the audit context: *Edwards Karwacki Smith & Co. Pty. Ltd. v Jacka Nominees Pty. Ltd.* (1994) 15 ACSR 502, where the Supreme Court of West Australia, after reviewing inter alia *Canadian Dredge*, refused summary disposal of a claim against auditors for negligently failing to discover that the directing mind of a "one-man company" had been fraudulently concealing the true state of the business and so fraudulently inducing investors in it.

iv. American authority is copious and less easy to digest (as well appears from the May 2008 continuing legal education study paper of the American Law Institute and Bar Association which the House was shown). Various broad approaches emerge. One takes the general law's theory of attribution or "imputation" and subjects it to an "adverse interest" exception (itself stated in differing terms, some resembling the *Canadian Dredge* test, others considerably more nuanced), which is then in turn subject to a "sole actor" exception. Another suggests that, in the context of a professional duty to check upon and report fraud such as the audit duty, either the general theory of imputation or the *ex turpi causa* doctrine (known in the United States as the *in pari delicto defense*) itself requires modification.

v. The early case of *Cenco Inc. v. Seidman & Seidman* 686 F 2d 449 (1982) (USCA, 7th Circ.) concerned a claim by a still solvent company to recover damages from auditors who had failed to discover a fraud at top management and board level, consisting of inflating the value of inventory, and so of stock which was used to buy up other companies. Speaking for the court and applying the common law of Illinois, Judge Posner upheld the trial judge's directions to a jury which had led the jury to dismiss Cenco's claim. He differentiated fraud by top management involving theft from the company from the actual fraud which involved "turning the company into an engine of theft against outsiders". The case is therefore distinguishable from the present, which I would, for reasons indicated in paras 230 to 234, place in the former category for the purposes of the company's claim against Mr Stojevic or its auditors. Judge Posner went on to say that, even in deciding how to treat the latter category, the Illinois courts would be guided by "the underlying objectives of tort liability". Holding that these justified the judge's directions, he adopted a two-pronged "cost-benefit" analysis. To allow recovery would, first, benefit stockholders without differentiating between innocent and guilty stockholders and, second, shift the loss to all stockholders (who the court said were "slipshod in their oversight [of their chosen board] and so share responsibility for the fraud"), thus, in the court's view, reducing the incentive for stockholders to hire and monitor honest stockholders (pp.455-456).

vi. In *Schacht v. Brown* 711 F 2d 1343 (1983) (also USCA, 7th Circ.), top management had fraudulently continued an insurance company in business past its point of insolvency and systematically looted it of its most profitable and least risky business and income, aggravating its insolvency. *Cenco* was distinguished on various grounds: first, as decided under Illinois law, whereas the issue in *Schacht* arose under federal law and the court could say that "we therefore write on a clean slate and may bring to bear federal policies in deciding the estoppel question"; second, on the ground that the fraud in *Schacht*, including the "Pyrrhic 'benefit'" of its artificially prolonged life, was not sufficient to engage the *Cenco* analysis of a company operating as the engine of fraud on others; and, third, on the ground that the two-pronged analysis adopted in *Cenco* led in *Schacht* to a different answer, because in *Schacht* the company was insolvent, there was no indication that the fraudulent top management would benefit from any recovery and "no evidence here of the existence of large corporate shareholders capable of conducting an independent audit, as in *Cenco*, and whose lack of investigatory zeal would be rewarded by a decision favourable to the [liquidator]" (p.1349).

vii. Similar thinking appears in (a) *In re Jack Greenberg Inc. (Larry Waslow, Trustee v. Grant Thornton LLP)* (U.S. Bankruptcy Court, E.D. Penn., Phil. Div.) 240 BR 486 (1999), where the court emphasised that "while the imputation doctrine may be applied in auditor liability cases, the doctrine was not crafted with that purpose in mind" and should be allowed "to be invoked only where the objectives of tort liability dictate" (p.508); (b) *NCP Litigation Trust v. KPMG LLP* 901 A.2d 871 (N.J. 2006), where the Supreme Court of New Jersey differentiated between shareholders engaged in a fraud involving inflation of profits and other innocent shareholders, holding that imputation could only be asserted to preclude recovery by the former, disagreed with the suggestion in *Cenco* that "imputation must be applied to shareholder suits to deter future such wrongdoing", noted differences between Illinois and New Jersey law, and, referring to *Schacht*, also concluded that the management's fraud "inflating a corporation's revenues and enabling a corporation to continue in business 'past the point of insolvency' cannot be considered a benefit to the corporation", but that, even if it could, "any benefit would not be a complete bar to liability, but only a factor in apportioning damages" (p.888); and (c) *In re Sunpoint Securities, Inc.* (U.S. Bankruptcy Court, E.D. Texas, Tyler Div.) (377 BR 513 (2007).

viii. One, though by no means the only, strand of the reasoning in *Schacht* and *Jack Greenberg*, involves a possible distinction between situations of solvency and insolvency. This is controversial in American law, particularly in the light of s.541 of the Federal Bankruptcy Code (according to which the bankruptcy estate "is comprised of ….. all legal or equitable interests of the debtor in property as of the commencement of the case"), and there is authority rejecting such a distinction in cases covered by s.541: *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.* 267 F.3d 340 (3rd Cir. 2001). Earlier authorities had rejected the defence of *in pari delicto* as an answer to claims by *receivers* against negligent auditors: *Federal Deposit Insurance Corpn v. O'Melveny & Myers* 61 F.3d 17, 19, (1995) and *Scholes v. Lehmann* 56 F. 3d 750, 754, (1995). The court in *Lafferty* distinguished these authorities on the ground that receivers are not within s.541 (*Lafferty*, p.358). However, in a still more recent decision, *Knauer v. Jonathon Roberts Financial Group, Inc.* 348 F.3d 230, (2003) the Court of Appeals for the Seventh Circuit has taken the view that receivers do stand in the shoes of the company in relation to entities deriving no benefit from the fraud, as opposed to direct beneficiaries of the fraud.

ix. The "cost-benefit" analysis and other techniques deployed in American case-law do not find any easy match in English law. Case-law in some states permitting direct claims against auditors by injured third parties (including creditors) also complicates any appreciation of the practical significance of American authority: see e.g. *Bily v. Arthur Young & Co.* 3 Cal.4th 370 (1992). However, the general message in the recent case-law that I have examined is one of increasing reluctance to hold that top management fraud provides a defence to a negligent auditor, and this at least corresponds with my conclusions as to the right approach in principle in English law.