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September 2009

## Stone & Rolls: The House of Lords further defines auditors' obligations to corporate victims of fraud

In the recent case of *Stone & Rolls Ltd. (in Liquidation) v. Moore Stephens (a firm)*[1], the House of Lords has provided further guidance on auditors' duty of care. The case will be of particular importance to auditors sued for allegedly failing to uncover fraudulent activities in closely-held companies.

While Stone & Rolls will be of limited significance in England and Wales in the future, as statutory reform of the illegality defence is pending, the judgment will have significant impact in the offshore finance and banking communities where the common law principles considered in the case will continue to apply. Offshore professional service providers and liquidators should know what Stone & Rolls decides.

The outcome of Stone & Rolls is likely to allow more claims by clients of professional service providers than would have been permitted by the Court of Appeal, as the House of Lords has narrowed the occasions upon which a defendant can rely upon the defence of illegality. However the pay-off for this is that more claims by third parties, such as shareholders and creditors (already exceptional), will be barred as the corporate client will retain an underlying cause of action as long as the illegality defence does not apply to the corporate claim.

### Facts

Moore Stephens was a firm of auditors retained by a company, Stone & Rolls. Mr. Stojevic was the sole directing mind and will of Stone & Rolls. The majority of the House of Lords assumed he was also the sole beneficial owner. He was not a registered director of the company, although the corporate services directors had given Mr. Stojevic a broad power of attorney to manage the company.

Through Stone & Rolls, Mr. Stojevic managed a multi-million pound letter of credit fraud on various banks, most notably Komerčni Bank SA, a Czech bank. In an earlier trial, Komerčni Bank was successful in obtaining judgment against both Stone & Rolls and Mr. Stojevic. As typically happens with fraud, Stone & Rolls was unable to pay the judgment due to Stojevic's removal of the company's assets. Stone & Rolls went into liquidation, and the liquidator sued Moore Stephens for damages, alleging that the auditors had failed to uncover the fraud, and that this was precisely the type of irregularity they were meant to find (i.e. fraud by the principal) when conducting the audit.

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Moore Stephens applied to strike out the claim on the basis that Stone & Rolls' own fraudulent activities had created the loss, the claim was nothing more than an action brought by a fraudster seeking an indemnity for its own fraudulent acts, and accordingly the claim was barred by reason of the illegality defence, also referred to in the judgment as the *ex turpi causai* defence. For the purposes of its strike out application, Moore Stephens accepted that it owed a duty of care to Stone & Rolls and that it had breached that duty.

At first instance, Langley J., agreed with the Liquidator and refused to strike out the claim. The Court of Appeal allowed the Moore Stephens appeal and set down two important principles; first that a company could avoid attribution of knowledge of management fraud where it was the direct victim of the fraud (as opposed to an indirect or secondary victim), and second that even cases allowing recovery for illegal acts against persons who had assumed a duty to prevent those acts happening (the “very thing” principle) were cases considering causation issues and could not undermine the wider public policy underpinning the illegality defence.

In the House of Lords, their Lordships dismissed Stone & Rolls' further appeal by a 3:2 majority. In a nutshell, the majority overturned the wide principle of attribution set out by the Court of Appeal. The majority confirmed that in certain cases indirect victims of a fraud could still bring a claim despite the illegal conduct of management. The illegality defence would apply where the company was so involved in the fraud that it could be considered a “one man company”.

The new battlefield in this context will be the definition of a “one man company”. The term is misleading, since it was clear that at least two of their Lordships accepted that a “one man company” could have more than one fraudster involved with it. From the judgments, it appears safe to assume that a company where all the active management and all the beneficial shareholders are involved in a fraud will be considered a “one man company”. Where the doctrine applies beyond this is uncertain, although it seems from the judgments that outside clear examples, the doctrine may have limited application.

Several members of the House of Lords confirmed, in general terms, the principle established in *Caparo v. Dickman* that auditors owe an actionable duty of a care to their corporate clients alone, so that shareholders and creditors cannot generally assert a claim.

The decision is likely to be more relevant in ordinary offshore litigation than onshore disputes, as offshore jurisdictions tend to have more closely-held companies in the financial services sector. The case itself had an offshore element as Stone & Rolls was beneficially owned by an Isle of Man trust.

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[1] [2009] UKHL, 39; [2009] [WLR] D277, per Lord Philips of Worth Matravers, Lord Scott of Foscoat, Lord Walker of Gestingthorpe, Lord Brown of Eaton-under-Heyword, and Lord Manse, 30 July 2009.

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