Auditors' Liability and Corporate Fraud in the UK: Does Corporate Size and Structure Matter?

Dr. Adolfo Paolini

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Auditors’ Liability and Corporate Fraud in the UK: Does Corporate Size and Structure Matter?

**Introduction**

The 2008 financial crisis badly hit worldwide economies and forced shareholders, creditors, and liquidators to seek legal redress. In many cases, aggrieved parties sought to pierce the “corporate veil” and hold company directors liable for their financial losses. In recent years, shareholder and creditor lawsuits have also targeted professional auditors.

In the United Kingdom, the House of Lords issued an important auditors’ liability decision in *Stone & Rolls Ltd. v. Moore Stephens*. A 3:2 majority declined to hold liable a one-man company’s auditors, where the auditors failed to discover that the company’s controlling director had perpetrated a fraud.

The main issue concerned the effective use of the *ex turpi causa* defense to defeat a claim brought by a company’s liquidator against its auditors. The objective was to...
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recover losses from professional insurance carriers. However, the knowledge and fraud of the company’s only director was attributed to the company, which could not claim against its auditors for their failure to discover the fraud that the company itself committed through its controlling mind. In this instance, the ex turpi causa defense provided its full benefits.

When corporate governance, especially in banks, focuses on implementing stricter controls and accountability, one must highlight that auditors play a crucial role in maintaining the financial equilibrium and/or capital ratio of corporate bodies. The public expects from auditors the highest degree of care, diligence, and professionalism. Yet such duty cannot encompass that of finding a director’s own fraud, where the director not only commits the fraud, but also provides financial information to accounting professionals.

This Article assesses the extent to which company auditors (and indeed any third parties) would escape professional liability in disputes tainted by fraud if they proved that a company and its controlling mind should be treated as one.

I. To Whom Do Auditors Owe Their Duties?

Certainly, auditors have been the center of attention and legal claims when they have audited companies whose financial situations reach the point of no return. However, auditors are not insurers in the sense that they do not contractually agree to indemnify a company should it become insolvent, nor do they “guarantee that the books do correctly shew the true position of the company’s affairs...” Rather, auditors guarantee that they will discharge their duties with the professional standard expected in their demanding role. They are not bound to discover the truth, especially in cases where company directors have cleverly...
designed and concealed the real financial situation of the corporate body.\footnote{13} Consequently, “[a]n auditor is not bound to be a detective, or . . . to approach his work with suspicion or with a foregone conclusion that there is something wrong.”\footnote{14} In more eloquent terms, an auditor is a “watch-dog, but not a bloodhound.”\footnote{15}

Having highlighted the fact that auditors could be targeted in cases of company insolvency, it is paramount to ascertain the potential claimants. At least two large groups exist: internal claimants (company, employees) and external claimants (third parties or company outsiders).\footnote{16}

The Companies Act of 2006 may not be as clear as one would like in the sense of clarifying whether auditors are company officers.\footnote{17} For example, Section 487(1) establishes that “[a]n auditor or auditors of a private company hold office in accordance with the terms of their appointment . . . .”\footnote{18} This phrasing gives the impression that auditors who hold office are company officers. However, Section 1121(2) complicates this issue, as it does not define auditors as officers.\footnote{19} Inconsistencies exist, especially in legal cases where the point is still open for debate.\footnote{20}

Arguably, auditors appointed to carry out the functions established in Companies Act Sections 495 to 497(a) are not company officers;\footnote{21} on the contrary, they enter into contractual agreements with the corporate body to provide their professional services. They do not enter into an employment relationship with the

\footnote{13}{Companies Act, 2006, c. 46, § 507(1) (U.K.) (“A person to whom this section applies commits an offence if he knowingly or recklessly causes a report under section 495 (auditor’s report on company’s annual accounts) to include any matter that is misleading, false or deceptive in a material particular.”).}

\footnote{14}{In re Kingston Cotton Mill Co., [1896] 2 Ch. 279 at 288 (Eng.) (concluding that auditors constituted company “officers” under the Companies (Winding-up) Act, 1890, 53 & 54 Vict., c. 63, § 10 (Eng.)).}

\footnote{15}{Id.}


\footnote{17}{See Companies Act, c. 46; infra notes 18–20 and accompanying text.}

\footnote{18}{C. 46, § 487(1) (emphasis added).}

\footnote{19}{C. 46, § 1121(2). For officer-liability purposes, “officer” means ”(a) any director, manager or secretary,” or ”(b) any person who is to be treated as an officer of the company for the purposes of the provision in question.” Id.}

\footnote{20}{See, e.g., R v. Shacter, [1960] 2 Q.B. 252 at 257–58 (Eng.) (holding that an auditor qualified as an “officer” under the Companies Act because a company had appointed him to “hold office”).}

\footnote{21}{See supra note 19 and accompanying text.}
company.\textsuperscript{22} This point is of major significance in identifying potential internal claimants who may have been victims of substandard professional services.

A company could also be a victim if an auditor, in breach of statutory provisions, presented a report to the company’s directors showing the insufficiency of the securities on which the company invested its capital, but presented to the shareholders a less detailed report which stated that the value of the assets was dependent on realization, so as to deceive the shareholders as to the actual financial situation of the company and lead them to pass a resolution authorizing the payments of dividends out of capital rather than profits.\textsuperscript{22} In a situation like this, auditors could be found guilty of misfeasance and held personally liable for the company’s payment of dividends out of capital.\textsuperscript{24}

The leading authority of *Caparo Industries v. Dickman*\textsuperscript{25} is clear that company auditors, in principle, owe their duties to the corporate body and not to outsiders.\textsuperscript{26} Hence, it is up to the company to claim against the auditors whose lack of care or diligence has caused losses to the corporate body.\textsuperscript{27} Typical claims involve losses accruing as a result of reliance on what happened to be negligently prepared, misleading, or inaccurate accounts.\textsuperscript{28} The action itself will be based on breach of contract or in negligent misstatements leading to a claim in tort (company vs. auditor).\textsuperscript{29}

On the other hand, outsiders find it more difficult to make claims against auditors who, as explained above, do not owe them the so-called duty of care.\textsuperscript{30} For a claim of this nature to succeed, the third party has the burden to prove that his/her situation is different in the sense that the auditor has assumed certain responsibility to him/her, as to the accuracy of the reports and/or accounts.\textsuperscript{31} *Hedley Byrne v. Heller Partners*\textsuperscript{32} is authority for pure economic loss claims in tort, based on

\begin{thebibliography}{9}
\bibitem{22} See George A. Locke, *Employer’s Retention of Control over Independent Contractor*, 5 AM. JUR. PROOF OF FACTS 2D 219, 223 (1974) (defining an independent contractor as a person who contracts to perform work “according to his own methods”).
\bibitem{23} See *In re London General Bank*, [1895] 2 Ch. 673 at 680–85 (Eng.).
\bibitem{24} *Id.* at 693–96.
\bibitem{25} *Caparo Indus. v. Dickman*, [1990] 2 A.C. 605 (H.L.) (appeal taken from Eng.).
\bibitem{26} See *id.* at 606 (finding “no reason in policy or principle why auditors should be deemed to have a special relationship with non-shareholders contemplating investment in [a] company in reliance on [its] published accounts”). \textit{But see Hedley Byrne & Co. v. Heller Partners}, [1964] 1 A.C. 465 (H.L.) 502–03 (appeal taken from Eng.) (“[I]f someone possessed of a special skill undertakes, quite irrespective of contract, to apply that skill for the assistance of another person who relies upon such skill, a duty of care will arise.”).
\bibitem{27} \textbf{Paul L. Davies \& Sarah Worthington}, *Principles of Modern Company Law* 835 (9th ed. 2012).
\bibitem{28} \textit{Id.} at 837.
\bibitem{29} \textit{Id.}
\bibitem{30} \textit{Id.} at 847.
\bibitem{31} See *id.*; see also infra text accompanying note 33.
\bibitem{32} [1964] 1 A.C. 465 (H.L.) (appeal taken from Eng.).
\end{thebibliography}
negligent misrepresentations. However, it will not be enough for the outside party to prove that an auditor negligently prepared the report or accounts on which he/she relied and caused losses, if the outsider fails to prove also that the auditor owed him/her a duty of care.\(^\text{33}\) At this moment, \textit{Caparo Industries} comes into play.\(^\text{34}\) The case concerned auditors’ liability to third parties.\(^\text{35}\) At the spine of this decision lies the fact that the auditor must have assumed personal responsibility to the third party as to the accuracy of the report or account to create the duty of care—the breach of which could give rise to a claim in tort.\(^\text{36}\) The general rule is that auditors owe their duties to the corporate body.\(^\text{37}\) On the other hand, they owe a duty to outsiders only when they assumed personal responsibility to third parties.\(^\text{38}\) The claim in \textit{Caparo Industries} failed because the third party, who relied on the accounts and suffered losses, did not prove the test of assumption of responsibility and consequent proximity.\(^\text{39}\) Therefore, the auditors escaped liability.

In \textit{James McNaughton Paper Group v. Hicks Anderson & Co.},\(^\text{40}\) it was held that the accountants of the target company, in a takeover scenario, did not owe a duty of care to those who wanted to take over the business.\(^\text{41}\) The draft accounts had been prepared for the target company, to which auditors owed their duties.\(^\text{42}\) Later, there were some inaccuracies in the draft accounts and the claimant (bidder) suffered losses and damages as a result.\(^\text{43}\) The Court of Appeal, reversing the decision of the High Court, allowed the appeal and decided that the claimant should not have relied on the draft accounts prepared by the defendant’s accountant without having them examined by its own accountants.\(^\text{44}\) The claimants failed to establish the proximity required under \textit{Caparo Industries}, as to create the duty of care between

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\(^{33}\) \textit{Id.} at 483, 496, 504.  
\(^{34}\) \textit{Caparo Indus. v. Dickman}, [1990] 2 A.C. 605 (H.L.) (appeal taken from Eng.).  
\(^{35}\) \textit{Id.} at 608–09.  
\(^{36}\) \textit{Id.} at 619, 621, 627.  
\(^{37}\) \textit{See id.} at 619 ("In advising the client who employs him the professional man owes a duty to exercise that standard of skill and care appropriate to his professional status and will be liable both in contract and in tort for all losses which his client may suffer by reason of any breach of that duty. But the possibility of any duty of care being owed to third parties with whom the professional man was in no contractual relationship was for long denied. . ."); \textit{see also id.} at 659.  
\(^{38}\) \textit{Id.} at 620–21.  
\(^{39}\) \textit{Id.} at 642–43.  
\(^{40}\) \textit{Id.} at 654, 663.  
\(^{41}\) [1991] 2 Q.B. 113 (Eng.).  
\(^{42}\) \textit{Id.} at 128.  
\(^{43}\) \textit{See id.} at 119, 127; \textit{supra} note 37 and accompanying text.  
\(^{44}\) \textit{James McNaughton}, [1991] 2 Q.B. at 117.  
\(^{45}\) \textit{Id.} at 128–29.
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the accountants of the target company and the bidder. Consequently, the claim for damages failed.

Additionally, Lord Justice Neill highlighted that even though the law regarding the duty of care for negligent misstatements was somewhat clear, it could be widened so as to encompass people whom a statement’s maker did not expect to rely on the statement.

Several more cases have followed Caparo Industries, including the important decision in Williams v. Natural Life Health Foods Ltd., where parties who purchased a franchise from a defendant company and incurred severe losses later claimed against the company. The claimants joined the company director as a defendant on the grounds that his personal lack of care in giving advice and negligently forecasting profits induced the claimants to enter into the agreement. The claim failed on the grounds that not enough proximity existed between the claimant and the defendant directors as to prove that the latter assumed personal responsibility to the former. Consequently, the claimants could not prove that the company director personally owed them a duty of care. It is necessary to emphasize, nevertheless, that the House of Lords slightly opened the possibility that company directors could incur liability to third parties. A claimant need only prove that the way in which directors carried out the transaction created enough proximity between them and the third party.

In Electra Private Equity Partners v. KPMG Peat Marwick, the UK Court of Appeal relied on Williams and confirmed that a clear assumption of responsibility is essential whenever it was sought to impose personal tortuous liability above and beyond that ordinarily assumed by a professional. Liability was nevertheless found in Morgan Crucible Co. v. Hill Samuel & Co., where the target company intended

46. Id. at 128.
47. Id. at 125–27. Lord Justice Neill considered six factors: (1) “The purpose for which the statement was made,” (2) “The purpose for which the statement was communicated,” (3) “The relationship between the adviser, the advisee and any relevant third party,” (4) “The state of knowledge of the adviser,” and (6) “Reliance by the advisee.” Id.
48. Id. at 126–27.
49. [1998] 1 W.L.R. 830 (H.L.) (appeal taken from Eng.).
50. Id. at 832.
51. Id. at 838.
52. Id. (“There were no exchanges or conduct crossing the line which could have conveyed to the plaintiffs that [the director] was willing to assume personal responsibility to them . . . [and] there was not even evidence that the plaintiffs believed that [the director] was undertaking personal responsibility to them.”).
53. Id. at 838–39.
54. Id. at 835.
56. Id.
57. [1991] Ch. 295 at 296 (Eng.).

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the bidder to rely on pre-bid financial statements and profit forecasts. Consequently, there was enough proximity as to create a duty of care.

When auditors’ liability is established, the viability of the ex turpi causa defense remains unclear, although auditors successfully pled the defense in Stone & Rolls Ltd. v. Moore Stephens. Generally, the answer to this point lies in two of the most important principles underpinning company law: the relationship between the directors and the company, and the rules of attribution.

II. The Relationship Between the Company and its Directors, and the Rules of Attribution

There are two leading theories which attempt to identify the complex nature of the relationship between companies and directors. Reality shows that directors manage a company’s assets and therefore establish a fiduciary relationship, which triggers a duty of good faith and loyalty. Additionally, a director can enter into a service contract with his company, giving rise to a number of contractual consequences and effects. Finally, directors are also a company’s agents, which imposes upon them a duty to act with skill, care, and diligence.

Arguably, finding the theory and/or principle upon which such complex relationships could be explained is far from easy. Nevertheless, two theories seem to have provided some answers: organic theory and agency theory.

Under the organic theory, which is usually associated with the alter ego doctrine, directors act as the company itself, rather than for it. The requirement of mandatorily having to appoint directors forces the amalgamation between the

58. Id. at 298–99.
59. Id. at 320.
62. See L.C.B. GOWER, GOWER’S PRINCIPLES OF MODERN COMPANY LAW 165, 193 (5th ed. 1992); infra text accompanying note 68.
64. See Companies Act, 2006, c. 46, § 227 (U.K.) (defining a director’s “service contract” as “a contract under which a director of the company undertakes personally to perform services (as director or otherwise) for the company”).
65. See id.
66. Id. § 174 (“A director of a company must exercise reasonable care, skill, and diligence.”).
67. GOWER, supra note 62, at 193.
68. See id. at 197. Under the organic theory, “the board of directors is not a mere agent of the company but [rather] an organic part of it so that third parties can treat acts of the board as acts of the company itself.” Id.
company and those who think and act for it. Directors are therefore seen as an organ of the company, without which it cannot function. Now, company decisions could be made by its primary decision-making body (directors, board of directors, or shareholders acting collectively), or by other persons who may act as company agents. When any of these decision-making bodies act on behalf of the company, it does so as the company itself, as an organ merged with the company. Individuals in these bodies cannot incur personal liability. Therefore, it is the company itself which enters, for example, into contractual relationships with third parties.

The agency theory, on the other hand, works slightly differently. Under this theory, directors and other officers, including managers, act as a company’s agents. The theory presumes that officers act for a company, so they are not amalgamated to it. When decisions are made by agents who represent the company, the general rules of attribution apply, or in other words, the rules applicable to any principal-agent relationship. Agency theory automatically triggers the rules of express, implied, and ostensible authority, to say nothing of the principles of vicarious liability. Although the distinction between agency and organic theory has been criticized as “unhelpful,” it still plays a crucial role in establishing individual or corporate liabilities. When the general rules of attribution apply, directors and/or company officers are more likely to incur personal liability to third parties.

69. See id. at 140 (“[T]he initial constitution of [a] company will provide for the appointment of a board of directors and expressly delegate all powers of management to it. . . . [The constitution] operates an appointment and delegation by the company.”).

70. See id. at 196.

71. DAVIES & WORTHINGTON, supra note 27, at 165.

72. Id. (“Where the board or the shareholders collectively act, they constitute the company, ie they act as the company. They are not its agents. Consequently, they will not be personally liable on any resulting contract . . . .”).

73. See infra notes 75–78 and accompanying text.

74. GOWER, supra note 62, at 140.

75. See id. at 139 (“[A] company is itself a legal person, with an existence independent of that of its members.”).

76. Id. at 139 n.1 (citing Ferguson v. Wilson, [1866] L.R. 2 Ch. App. 77, 89 (Eng.)).

77. See id. at 165 (summarizing agency law and attribution principles).

78. Peter Watts, Corrupt Company Controllers, Their Companies and Their Companies’ Creditors: Dealing with Pleas of Ex Turpi Causa, 2014 J. BUS. L. 161, 161 (U.K.) (“The first unhelpful idea is that, in relation to common law wrongs, companies are special in that they have two sorts of representative[s] for whose acts the company may be liable, those who are ‘the directing mind and will’ or the ‘alter ego’ of the company, and those who are only ‘agents.’”).

79. See GOWER, supra note 62, at 194.

80. See DAVIES & WORTHINGTON, supra note 27, at 226 (noting that lawsuits typically target company directors, who “are much more likely to be in a position to initiate such action on the company’s part than shareholders”); see also ADOLFO PAOLINI & DEEPAK NAMBIAN, DIRECTORS’ AND OFFICERS’ LIABILITY INSURANCE 125 (2008).
One might question why a piece of research, purportedly trying to cover auditors’ liability and their defenses, is touching on these quite philosophical ideas. The answer is that it is precisely here, in the rules of attribution, that auditors could rely on public policy grounds to escape liability.\textsuperscript{81}

In \textit{Lennard’s Carrying Co. v. Asiatic Petroleum Co.},\textsuperscript{82} a leading authority for the alter ego principle, the House of Lords attributed to a steamship company the knowledge that one of the directors and shareholders of a managing company had in regard to faulty boilers that made a vessel unseaworthy.\textsuperscript{83} The facts of the case were basically the following: according to the Merchant Shipping Act of 1894,\textsuperscript{84} a shipowner is not liable for any loss or damage caused without the shipowner's actual fault or privity, where the cargo on his ship is lost or damaged by fire.\textsuperscript{85} The ship’s defective boilers caused a fire that destroyed the cargo (benzine).\textsuperscript{86} The ship was owned by one company, but another company took the management of the vessel.\textsuperscript{87} The managing director of the managing company was also the registered director of the shipowner company.\textsuperscript{88} The managing director knew about the defective conditions of the boilers but he failed to properly instruct the captain and members of the crew as to the way in which the boilers should be supervised, and took no measures to prevent the vessel from being put to sea in such an unseaworthy condition.\textsuperscript{89} The issue to be resolved was whether the shipowner company could rely on the Merchant Shipping Act to escape liability, on the grounds that the fire which destroyed the cargo happened without the company’s fault or privity.\textsuperscript{90}

Lord Chancellor Viscount Haldane issued one of the most quoted and cited opinions in company law:

\begin{quote}
\textit{I think that it is impossible in the face of the findings of the learned judge, and of the evidence, to contend successfully that Mr. J. M. Lennard has shown that he did not know or can excuse himself for not having known of the defects which manifested themselves in the condition of the ship, amounting to unseaworthiness. Mr. Lennard is the person who is registered}\end{quote}

\textsuperscript{82} [1915] A.C. 705 (H.L.) (appeal taken from Eng.).
\textsuperscript{83} See id. at 706–07, 713.
\textsuperscript{84} Merchant Shipping Act, 1894, 57 & 58 Vict., c. 60, § 502 (U.K.).
\textsuperscript{85} See id.
\textsuperscript{86} Lennard’s, [1915] A.C. at 708.
\textsuperscript{87} Id. at 710, 712.
\textsuperscript{88} Id. at 712.
\textsuperscript{89} See id. at 707 ("[The director received a letter] complaining that there was something greatly wrong with [the ship’s] engines and boilers.").
\textsuperscript{90} Id. at 712; see Merchant Shipping Act, 1894, 57 & 58 Vict., c. 60, § 502 (U.K.).
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in the ship’s register and is designated as the person to whom the management of the vessel was entrusted. He appears to have been the active spirit in the joint stock company which managed this ship for the appellants; and under the circumstances the question is whether the company can invoke the protection of s. 502 of the Merchant Shipping Act to relieve it from the liability which the respondents seek to impose on it.

Now, my Lords, did what happened take place without the actual fault or privity of the owners of the ship who were the appellants? My Lords, a corporation is an abstraction. 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.

The close connection between the director and the controlled companies was such that the House of Lords attributed to the shipowner company the knowledge that the director had in regard to the vessel’s unseaworthiness. The court rejected the argument that the managing and shipowner companies were distinct entities; consequently, the shipowner company could not rely on the Merchant Shipping Act to escape liability. The alter ego doctrine was to some extent established; the director was not acting on behalf of the company, but rather acted as the company itself in regard to what he knew were faulty boilers.

One may think that the attribution of knowledge found in Lennard’s could happen only where the person whose knowledge is so attributed occupies a prominent position or controlling position in the company. However, the rules have gone as far as to cover company officers who are not, in principle, discharging managing positions. In Meridian Global Funds Management Asia Ltd v. Securities Commission, the Chief Investment Officer of an investment management company purchased substantial shares in a public issuer on behalf of the company.

92. Id. at 713.
93. See Lennard’s, [1915] A.C. at 714 (“[T]he inference to be drawn is that the officials of the two companies were very much the same and transacted very much the same business.”).
94. See id. at 713–14 (finding that the managing director’s actions were “action[s] of the [shipowner] company itself within the meaning of s. 502”).
95. See id. at 713; Gower, supra note 62, at 197.
96. See supra notes 92–94 and accompanying text.
98. Id.
99. Id. at 503.
According to New Zealand securities law, the company should have notified regulators of such a large purchase, but it failed to do so. In applying the rules of attribution, the Privy Council found that the company knew it was a substantial holder of shares in a public issue, and that it acquired such knowledge when the investment officer purchased the shares.

The Privy Council did not suggest that a low-hierarchy officer could be the controlling mind and will of the corporation, but it did find that the investment manager’s knowledge in regard to the purchase of shares was enough to make the company aware of the transaction with the resulting consequences. Lord Hoffman, in deciding the case and upholding the appeal, clearly explained the rules of attribution by classifying them into three groups: primary rules of attribution, general rules of attribution, and special rules of attribution. His explanation is worth quoting here:

The company’s primary rules of attribution will generally be found in its constitution, typically the articles of association, and will say things such as “for the purpose of appointing members of the board, a majority vote of the shareholders shall be a decision of the company” or “the decisions of the board in managing the company’s business shall be the decisions of the company.” There are also primary rules of attribution which are not expressly stated in the articles but implied by company law, such as “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 shall be the decision of the company[.]”

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

100. Securities Amendment Act 1988, § 20(3) (N.Z.) (requiring “[e]very person who . . . becomes a substantial security holder in a public issuer [to] give notice” to the public issuer and any stock exchange that lists the public issuer’s securities).
102. Id. at 511 (“The fact that [the investment manager] did the deal for a corrupt purpose and . . . did not want his employers to find out cannot in their Lordships’ view affect the attribution of knowledge and the consequent duty to notify.”).
103. Id.
104. Id. at 506–07.
rules of attribution, count as the acts of the company. And having done so, it will also make itself subject to the general rules by which liability for the acts of others can be attributed to natural persons, such as estoppel or ostensible authority in contract and vicarious liability in tort.

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 a 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 excludes 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.

Consequently, attributing to a company the knowledge or wrongful conduct of any of its directors or officers is more likely to happen in small corporate bodies,

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105. Id. (citations omitted).
where controlling the company and becoming the mind and will is not so difficult. Look for example to Lennard’s case, where the House of Lords found no difficulty in identifying the appellant company’s alter ego, and concluded that the alter ego had knowledge of the faulty boilers. This finding was possible because the structure of the corporate group was not too large or complex. The point is that the larger and more complex a company, the more difficult to find or identify its controlling mind. In very large corporations, like public limited companies, it is almost impossible to conceive that one individual or even a group could be the controlling mind for the purpose of attributing to the company their knowledge or wrongdoings.

III. Is the Company the Victim or the Agent of the Wrong?

The main purpose of this Article is to clarify in what circumstances company auditors could successfully rely on the ex turpi causa defense to escape liability to the company following a claim for breach of their professional duty of care. Cases concerning corporate fraud abound, and in most scenarios, stakeholders and shareholders have suffered substantial losses as a result. Very often, the targets of these claims are company directors, whose breach of duties are thought to be the cause of financial collapse. In the United Kingdom, third-party claims do not succeed very often when plaintiffs contend that directors owe their duty to the company, not outsiders. Not in vain, liquidators have attempted to go beyond the veil of incorporation and seek some redress from directors’ pockets, usually having professional indemnity insurers in mind. The Insolvency Act of 1986 opens the


108. Id. at 712–14; see supra text accompanying notes 92–96.

109. See Lennard’s, [1915] A.C. at 712 (emphasizing Mr. Lennard’s dominant role in the company); supra text accompanying note 89.


111. See John Clemency & LeGrande Smith, Corporate Fraud: Where Should the Buck Really Stop?, Am. BANKR. INST. J., Nov. 2002, at 20, 20 (“In the past, assigning personal liability for the frauds of the corporation has centered on (1) principals—corporate officers and directors who orchestrated, or at least had knowledge of, the fraud, and (2) employees of the corporation who breached a specific duty or duties owed to the corporation such as a breach of fiduciary duty, of the duty of good faith and fair dealing, of loyalty, trust, confidence and the like.”).

112. See Companies Act, 2006, c. 46, § 170(1) (U.K.) (providing that a company director owes duties “to the company”).

113. See Davies & Worthington, supra note 27, at 228; see also Paolini & Namisan, supra note 80, at 1.
doors for directors to incur liability for wrongful and fraudulent trading, but this resolves nothing in regard to whether auditors could somehow challenge that the connection between directors and the company is such that they are not only the controlling mind whose knowledge, act or omissions should be attributed to the latter, but also that the company itself has become the fraudster along with its directors. In a very eloquent way, the situation has been described as follows: “Courts around the Commonwealth continue to confront cases where company controllers, in the form of directors or shareholders or both, engage in illegal conduct, and the courts have to settle how the company itself stands in relation to that conduct,” either as victim or co-perpetrator of the illegal act.

Whether the company is considered one with its directors or is still separate from them is the point at which companies could be deemed agents or victims of wrongful acts. As we will see later, auditors can successfully invoke the *ex turpi causa* defense only in the former scenario.

In *In re Hampshire Land Co.*, a company’s articles of association allowed directors to borrow money on behalf of the company up to a certain limit, which could not exceed the company’s paid-up capital, unless duly authorized by the general meeting of shareholders. The general meeting gave such consent to the director, but the notices that announced the meeting did not specify, as the regulator required, that the meeting would deal with such authorization. The company borrowed the money from another company, which shared the same secretary. In short, the secretary worked for both the lender and the borrower. A resolution to wind-up the company was passed and the liquidators challenged the validity of the borrowing agreement. The point at issue was whether the shared secretary’s knowledge—that the general meeting of shareholders had not duly authorized the directors to borrow money in excess of the limit capped by the articles of association—was attributable to both companies. If so, the act was *ultra*

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114. Insolvency Act, 1986, c. 45, §§ 213–214 (U.K.) (instructing courts to hold liable “any persons who were knowingly parties” to fraudulent business activities).
115. Watts, supra note 78, at 161.
116. See infra notes 132–45 and accompanying text.
117. See infra notes 132–45 and accompanying text.
118. [1896] 2 Ch. 743 (Eng.).
119. Id. at 743 (quoting the articles of association).
120. See id. at 747 (“[N]o notice was given . . . [and] therefore the authority of the directors of the company to borrow this money was not perfected.”).
121. See id. at 745.
122. Id.
123. Id. at 744–45.
124. See id. at 747.
Furthermore, the two companies were closely connected and four directors held office in both companies. Justice Vaughan Williams decided that such knowledge could not be attributed to the company:

Where is the line to be drawn or what is the test to be applied in order to say whether or not in each case the knowledge of the common officer is the knowledge of each company employing him? It seems to me . . . that the knowledge which has been acquired by the officer of one company will not be imputed to the other company, unless the common officer had some duty imposed upon him to communicate that knowledge to the other company, and had some duty imposed on him by the company which is alleged to be affected by the notice to receive the notice.

It is necessary to emphasize that the company was not controlled and the directors were not the will and mind of the corporate body. Additionally, a number of shareholders authorized the company director to borrow the money, even though they were not directors and lacked managerial powers. This last point has proved very powerful as a defense to corporate fraud claims.

Principles underpinning the rules of attribution reached their summit in the eagerly awaited decision in Stone & Rolls Ltd. v. Moore Stephens. The House of Lords, by a 3:2 majority, was of the view that the auditors of a company controlled by its sole shareholder could successfully plead the ex turpi causa defense to stop any claim against them instigated by the company, when the company itself and its controlling mind were both found to be the co-perpetrators of fraud. In this case
the company’s sole shareholder entered, on behalf of the company, into a series of transactions (letters of credit) with a bank. The company initially complied with its contractual obligations, but the controlling directors started to gradually misappropriate the company’s money and deviate it beyond the reach of the company’s creditors. As a consequence, the company defaulted on its payments and the bank (creditor) was faced with the fact that the company was insolvent. During the period when the directors misappropriated money, Moore Stephens was the company’s auditing firm. A liquidator was appointed, and he tried to maximize recoveries to pay for the company’s debts. The director was not to be found, so the liquidator (on behalf of the company) sued the auditors who had failed to discover the fraud.

The auditors admitted that they breached the duty of care by failing to discover the fraud; nevertheless, they defended the claim on the grounds that, as a fully controlled company, the fraudulent act of the company’s controlling mind should be attributed to the company. The auditors argued that both the director and the company were fraudsters, such that the company could not bring claims against the auditors for failing to discover the fraud that the company itself had committed. The company could not rely upon its own misconduct to prevail against the auditing firm. The House of Lords accepted this argument and dismissed the claim.

The House of Lords distinguished Stone & Rolls from In re Hampshire Land Co. with a novel and controversial analysis. They found that when, in the company

133. Id. at 1398–99, 1507.
134. Id. at 1471, 1507.
135. Id. at 1480, 1507.
136. Id. at 1471.
137. Id.
138. Id. at 1472.
139. Id. at 1449.
140. Id. at 1449–50.
141. Id. at 1449.
142. Id. at 1451; see supra note 5 and accompanying text.
143. See Robert Merkin, Fraud and Insurance Agents: The Law After Moore Stephens, in 3 Modern Law of Marine Insurance 59, 65 (D. Rhidian Thomas ed., 2009) ("Mr. Stojcic perpetrated a proven fraud on third party banks in the name of his company. Under the ordinary rules of attribution laid down in the Meridian Global Funds decision, the fraud was attributed to the company. That meant that the company bore primary liability to the banks. Any claim by the company against its auditors for failing to prevent the illegality was doomed to failure on the basis of ex turpi causa. At no point was the imputation of knowledge, or the Re Hampshire Land Co exception to imputation of knowledge, of any significance to that outcome."). Lord Justice Mance, in his dissenting opinion, gave a very eloquent speech:

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
structure, there are shareholders who do not form part of the board and do not have managerial duties, and a fraud or tortious act has been committed by persons with managerial functions, the company will frequently be seen as the victim, not as the wrongdoer. 144 This last argument is paramount for the defense of illegality to proceed. 145

Whether a company is primarily or vicariously liable depends on a number of circumstances, one of which has been eloquently described in the following way:

Is the corporation to be perceived as a villain devising a Machiavellian plan to defraud a third party or to create a deliberate environmental catastrophe in its operations or to cause a death, injury or destruction to those who stand in its way? Or should the corporation be perceived as a victim whose soul has been ripped apart by the machinations of the very people who are the directing mind and will of the corporation, and who ostensibly clothe themselves under the guise of a corporate veil that cannot be pierced, while seemingly trying to protect the corporation's interest, but actually protect their own? 146

Safeway Stores Ltd. v. Twigger 147 was another important decision on this point. In this case, some employees and directors fixed the price of dairy products, which caused the company to incur a serious fine for breaching competition rules. 148 The

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 . . . 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.

144. Id. at 1462–63.
145. Id. at 1438.
148. Id. at 1632, 1634.
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issue was whether the company had incurred primary or vicarious liability. Should the company have incurred primary liability, it would be precluded from recovering its losses from the guilty managers on the grounds of public policy. However, should the company incur vicarious liability through the acts or omissions of any of its employees, the company would be liable to indemnify the victim or pay the fine but will also have a cause of action against the wrongdoers (either the company’s employees or their D&O insurance carrier). In Safeway Stores v. Twigger, the employees suggested that the company was prevented from claiming against them the money it paid for the fine on the grounds of public policy, because it was the company itself who breached competition rules. The Court of Appeal agreed with this, albeit on different grounds:

Once it is appreciated that the claimant companies are (personally and not vicariously) liable to pay the penalties exigible under the 1998 Act, those companies cannot invoke the Hampshire Land principle to say that they were not “truly” liable. The principle gives them no defense to the [Office of Fair Trading’s] claim for the penalties; they are personally liable to pay those penalties and it would be inconsistent with that liability for them to be able to recover those penalties in the civil courts from the defendants. The statutory scheme has attributed responsibility to the claimant companies and the Hampshire Land exception to the ordinary rule of attribution can have no import on the application of the ex turpi maxim.

However, in a company the size of Safeway, it was impossible to attribute to the company the acts or omissions of the so-called managers because it was impossible to prove that these managers were the “directing mind or will” of the corporation. Had the company been small and controlled by one shareholder, Stone & Rolls arguably would have applied (High Court position).

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149. Id. at 1635–36.
150. Id. at 1634–35, 1641.
153. Id. at 1639; see Competition Act, 1998, c. 41, § 36 (U.K.); In re Hampshire Land Co., [1896] 2 Ch. 743 at 749–50 (Eng.).
155. See id. at 1635–36 (“The difficulty and novelty of the present case is that the claimants are a corporation and can only act through their human agents. If it is those human agents who have acted intentionally or negligently and have thus caused the corporation to become liable by way of penalty to the OFT, does the maxim apply to preclude recovery of that penalty and its consequences from the very employees and directors whose conduct has created the corporation’s liability? The judge has held that it arguably does not
In *Bilha Ltd. v. Nazir*, 156 (also known as *Jetivia v. Bilta*) the defendants lost a suit brought by company liquidators on the grounds of conspiracy and dishonest assistance and fraudulent trading under Section 213 of the Insolvency Act 1986. 157 Bilta was a company registered in the UK and its main business was trading in European Emissions Trading Scheme Allowances—carbon credits for short. 158 It had two directors, one of whom was its sole shareholder. 159 It carried out most of its business with several sellers in Europe, especially a company named Jetivia Ltd, which happened to have the beneficiary of most of the sales proceeds Bilta earned in the UK. 156 Due to the fact that Bilta bought from suppliers outside the UK, its transactions were exempt of Value-Added Tax ("VAT"). 161 Nevertheless, all sales made by Bilta to UK buyers were subject to VAT, and as it happened in the present case, Bilta sold to UK purchasers for less than it had originally paid. 162 It is clear from the facts that the whole structure was devised to evade the VAT. 163 Selling carbon credits at a loss meant that Bilta was not liable to pay VAT in the UK, where its liabilities reached £38 million. 164

The liquidators claimed against two company directors, who had diverted funds to off-shore accounts controlled by Jetivia (a Swiss company) and THG (another foreign company). 160 The liquidators alleged that the directors had breached their fiduciary duties to Bilta and violated the rules of company capital maintenance to the detriment of creditors (the tax man). 165

In an attempt to avoid liability, the directors purported to rely on the *ex turpi causa* defense, 167 by arguing that the company should be attributed with their

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156. [2013] EWCA (Civ) 968, [2014] Ch. 52 (Eng.).
157. *Id.* at 59–60; see Insolvency Act, 1986, c. 45, § 213 (Eng.).
159. *Id.*
160. *Id.*
161. *Id.;* see VAT: How to Work Out Your Place of Supply of Services, Gov.UK (July 1, 2014), https://gov.uk/vat-how-to-work-out-your-place-of-supply-of-services ("If [a company is] in the UK and the place of supply of [the company's] service is in another EU country, [the company does not] pay UK VAT.").
163. *Id.* at 59–60, 82.
164. *Id.* at 80.
165. *Id.* at 59, 80–82.
166. *Id.* at 83–84.
167. *Id.* at 84.
In other words, the two directors claimed that the company co-conspired with them and, on the grounds of public policy, could not sue them. This was a clever attempt, but it did not succeed. Contrary to the decision in Stone & Rolls, where the defendant was an outsider (the auditor), in Bilta, the defendants were the company directors who inexorably owed duties to the company, of which the duty to promote the company’s success and consider its interests was essential. By diverting the company’s funds and rendering it financially unable to meet its debts, the directors breached their fiduciary duties. This entitled the company to sue the directors for the losses it sustained. The Court of Appeal was of the view that the company was the victim of a fraudulent act; the company was used by the two directors to evade taxes, consequently the company had the right to claim against the fraudsters. Furthermore, the company’s claim did not implicate its own misconduct, falling outside the exception that the House of Lords established in Tinsley v. Milligan. As a result, the defendants could not attribute their own wrongdoing to the company and could

168. Id. at 89 (“In order to engage the ex turpi causa rule in this case the defendants must establish that the law attributes to Bilta the unlawful conduct of its directors and sole shareholder so that its actions against them and the defendants falls to be treated as an action between co-conspirators. . . . Put very simply, his case is that Bilta’s claim . . . discloses that Bilta was used by its directors and their associates to carry out a carousel fraud, the only victim of which was HMRC. Since Bilta was a party to the fraud, it cannot claim against the other conspirators for losses which it suffered as a result of the fraud it carried out.”).

169. See id. at 84 (describing ex turpi causa as a “rule of public policy”).

170. See id. at 110 (“This court is, in my view, bound . . . to hold that a director even of a one-man company can be held liable to account for breaches of fiduciary duty which he commits against the company.”).


172. Bilta, [2014] Ch. at 86 (“[T]he sole director/shareholder owes to the company the fiduciary duties spelt out in section 172 of the Companies Act and cannot use his control of the company to ratify his fraudulent acts against the company particularly where the interests of creditors would be prejudiced.”); see Companies Act, 2006, c. 46, § 172(1) (Eng.) (“A director of a company must 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, and in doing so have regard (amongst other matters) to — (a) the likely consequences of any decision in the long term, (b) the interests of the company’s employees, (c) the need to foster the company’s business relationships with suppliers, customers and others, (d) the impact of the company’s operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.”).


174. Id. at 110 (identifying the company as “the victim”).

175. Id.

176. See supra notes 174–75 and accompanying text.

177. See [1994] 1 A.C. 340 (H.L.) (appeal taken from Eng.). Tinsley distinguished between (1) “reliance on the illegal act as the basis of the cause of action” and (2) “the enforcement of a property or other legal right which although historically the product of an illegal act or transaction, has an independent existence from it.” Bilta, [2014] Ch. at 85; see Tinsley, [1994] 1 A.C. at 376.
not use the *ex turpi causa* defense. Nevertheless, the court emphasized that auditors may rely upon the *ex turpi causa* defense when the wrongful acts of its controller are attributed to the company itself, which is seen as an instrument of fraud. It is the author’s view that such level of control and manipulation is only possible in small or medium size companies with a reduced number of shareholders and directors.

### IV. Conclusions

One does not know what to expect after embarking on a research mission; the deeper one digs, the more difficult and even more confusing it becomes. However, some conclusions can be drawn from the above paragraphs.

The reigning discussion in regard to the nature of directorship and the difficulty in clearly establishing when companies are agents or victims of a wrongful act reveals the uncertainty as to auditors’ real level of exposure when they breach or act below accepted professional standards. Arguably, the decision in *Stone & Rolls* opened the doors for courts looking well behind the veil of incorporation to identify wrongdoers and hold them personally accountable. Analysis of company size and structure is crucial if one wants to succeed in this identification process.

So, this is the list of what is needed for the *ex turpi causa* defense to succeed:

1. The company must be controlled by the wrongdoer director. Directors typically exert such control only in small and medium-size companies.

2. The primary rules of attribution—making body of the company (directors, board of directors, and shareholders acting collectively)—are the foundation stone for the defense to proceed. When the company and its directors are seen as one, one could conclude that both parties are primarily liable or should be attributed with the same wrongful act.

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184. *Id.*
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3. To be deemed a victim rather than a co-perpetrator, a company’s shareholders must not have participated in committing the wrongful act. 185

4. The defense, as decided in Bilta, cannot be invoked by the company directors themselves. 186 It is available only to outsiders. 187

Deciding Stone & Rolls otherwise would have led to the absurd situation of suits against company auditors for their failure to discover a fraud that the proper claimant committed. 188 In a more eloquent way, let us imagine a letter addressed to the auditors in the following terms: Dear Auditors: You failed to discover my own corporate fraud, so I will be suing you!

185. See supra notes 144–46 and accompanying text.
186. Bilta, [2014] Ch. at 84, 89, 110; see supra notes 168–72 and accompanying text.
187. See supra notes 132–45 and accompanying text.
188. See Stone & Rolls Ltd. v. Moore Stephens, [2009] UKHL 39, [2009] 1 A.C. 1391 (H.L.) 1436 (appeal taken from Eng.) (“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.”).