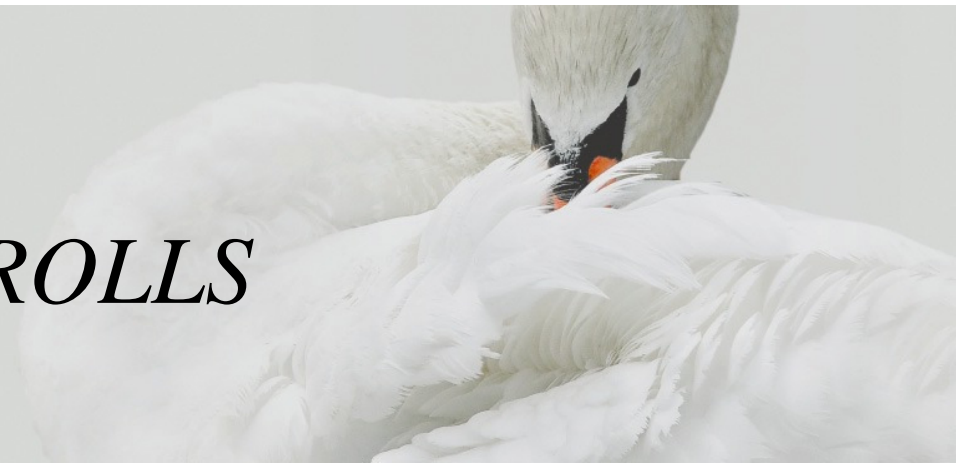
TRAVERS SMITH



STONE & ROLLS

Case note

On 18 June 2008, the Court of Appeal gave judgment in the case of *Stone & Rolls v Moore Stephens*. The case is interesting for a number of reasons: it contains a strong endorsement of the illegality doctrine laid down by the House of Lords in *Tinsley v Milligan*; it discusses the circumstances in which knowledge of individuals can be attributed to a company; it discusses the "very thing" doctrine and explains when it applies; and the case is a high profile example of third party funding.

Stone & Rolls (in liquidation) v Moore Stephens (a firm)

[2008] All ER (D) 225 (Jun)

The facts

Stone & Rolls was a one man company owned and controlled by Mister Stojevic. He used the company to carry out a series of letter of credit frauds whereby fraudulent documents were presented to banks which paid money to the company against the documents. The money was then paid away to the parties to the fraud. The frauds gave rise to liabilities by the company to the banks, including a Czech bank called Komercni Bank which obtained judgment against the company and Stojevic. The company was unable to satisfy the judgment and, following a petition by the bank, went into liquidation.

The liquidator brought the current claim against Moore Stephens, the company's auditors, alleging that they were negligent in failing to detect the frauds. Moore Stephens applied to strike out the case on the grounds that the company's claim arose out of the company's own fraudulent conduct and so was barred by public policy by reason of the illegality doctrine. Moore Stephens were unsuccessful at first instance but won in the Court of Appeal.

The illegality doctrine

The illegality doctrine is a rule of public policy expressed in the maxim *ex turpi causa non oritur actio* (of an illegal act there can be no lawsuit). In the 1980s the Courts sought to develop a flexible approach to the doctrine in tort cases recognising that the seriousness of the illegality may vary enormously, as may its connection to the claim – thus a public conscience test was developed: a claim involving some element of illegality would be allowed as long as that result would not shock the public conscience. In *Tinsley v Milligan* (1994) the House of Lords rejected the broad public conscience test and applied a test based on reliance: was it necessary for the claimant to plead or rely on their illegality to advance their claim? If so, the claim must fail and there is no scope for any judicial discretion. As *Tinsley v Milligan* was a property dispute it was not clear where the decision left tort cases and some later decisions showed a continued attempt to adopt a flexible approach. However in *Stone & Rolls* the Court of Appeal applied the reliance test laid down in *Tinsley v Milligan* and rejected any element of judicial discretion or flexibility.

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Rimer LJ, giving the leading judgment, said that whilst the reliance test laid down in *Tinsley* was expressed in the context of the facts of a property dispute it was one which he regarded as applying generally. His Lordship said that if, to advance the claim, it is necessary for the claimant to plead or rely on illegality, "*the axe falls indiscriminately and the claim is barred, however good it might otherwise be. There is no discretion to permit it to succeed*".

In *Tinsley v Milligan* the legal principles were discussed in the context of principles of equity. It does not necessarily follow that the same principles should apply in the context of a tort case such as *Stone & Rolls*. Indeed, in *Gray v Thames Trains*, another tort case decided in the same week as *Stone & Rolls*, a differently constituted Court of Appeal applied a different test.

In *Gray* the claimant was one of the victims of the Ladbroke rail crash. He suffered severe post traumatic stress disorder and some two years after the crash stabbed a stranger to death. He pleaded guilty to manslaughter on the grounds of diminished responsibility and was detained under the Mental Health Act. The claimant sought damages from the defendant train companies for negligence – including a claim for loss of earnings. The defendants accepted that in principle they were liable for such losses incurred before the date the claimant committed manslaughter but argued that the illegality doctrine precluded any award of damages for loss of earnings after that date. The Judge at first instance agreed but the decision was overturned by the Court of Appeal. In doing so they declined to follow *Tinsley v Milligan* holding that that it was "*too narrow to apply to a case in tort like the instant case*". Instead the Court of Appeal adopted a broader test, namely:

> *"whether the relevant loss is inextricably linked with the claimant's illegal act or…so closely connected or inextricably bound up with his criminal or illegal conduct that the court could not permit him to recover without appearing to condone that conduct".*

On the facts that was held not to be the case – the claimant's case was that as a result of the defendant's negligence he had suffered PTSD which had led to a loss of earnings both before and after the manslaughter. However, the Court did go on to say that principles of foreseeability, causation and contributory negligence were relevant to whether the claim could succeed and the case was remitted back to the Judge for further consideration.

These two cases show that the scope of the law of illegality in tort cases is somewhat uncertain at the moment. However, in *Stone & Rolls* it seems to have been accepted that it did not really matter which test was applied as the claim fell full square within the illegality doctrine. Thus, as an authority on the scope of the doctrine, the case should be viewed with some care. Certainly *Gray v Thames Trains* advocates a more flexible approach which, until there is clarification from the House of Lords, may find more favour with the courts.

Attribution of knowledge

The company argued that the illegality doctrine should not apply as the acts of Stojevic should not be attributed to the company as it was the victim of his fraud. This involved the Court examining the general principles of attribution and the circumstances in which knowledge is not attributed.

A company can be vicariously liable for the acts of its agents but can also be directly liable for a dishonest act by reason of the attribution to it of the knowledge of its directing mind and will. The difference in the two concepts lies in the degree to which the relevant agent is identified with the company. If a junior employee commits a fraud in the course of his employment, the company will be vicariously liable for the fraud, but the fraud will not automatically be imputed to the company itself. But if the board of directors resolves on the commission of a fraud by the company, their dishonesty will be attributed to it and the company will itself be directly and not just vicariously liable for the fraud. The cases use the phrase "directing mind and will" – the doctrine of attribution will attribute to the company the mind and will of the persons having management and control in relation to the act or omission in point.

In *Stone & Rolls,* Mr Stojevic had control of the company and ran its affairs – his was the company's directing mind and will and so his fraudulent acts should be attributed to the company. However, counsel for the company argued that the general application of the principle of attribution was excluded by the *Hampshire Land* principle, which was summarised by Rimer LJ as follows: "*a company will not have attributed to it knowledge of a fraud when that fraud is being practiced on the company itself. The law does not attribute knowledge of a deception to the person who is being deceived."*

"The guidance provided by the Court of Appeal on the Hampshire Land exception is helpful and clarifies the situations in which a company may claim against auditors and other third parties based on fraudulent acts by its own directors."

Counsel for Moore Stephens argued that, for *Hampshire Land* to apply, there had to be at least one other human being in the company to whom the relevant dishonest knowledge was capable of being communicated. The Court of Appeal rejected this submission - where the mind and will is fraudulent and he is for all intents and purposes the company, it is artificial to suggest that the company (which can only act through individuals) can have some other knowledge.

The Court of Appeal said, in applying the *Hampshire Land* exception, the real question was whether the Court should regard the company as the victim of the fraud. The Court held that the principle will only ordinarily apply in circumstances in which the agent intends to harm the company or it is the target of his acts – it is not enough to engage the principle that the agent's acts may result in harm to the company. The task is to identify who is the victim against whom the fraudulent acts are directed – in doing so, it is necessary to consider the purpose of the frauds themselves not their consequential effect on the company if they are eventually uncovered.

On the facts the sole directing mind and will of the company procured it to enter into fraudulent transactions with banks – the banks were the targets and victims of the fraud not the company. It made no difference that the frauds were likely, when and if found out, to result in the company itself incurring liabilities.

The guidance provided by the Court of Appeal on the *Hampshire Land* exception is helpful and clarifies the situations in which a company may claim against auditors and other third parties based on fraudulent acts by its own directors.

The "very thing" doctrine

The company also tried to escape the application of the illegality doctrine by arguing that it did not apply where the illegal act was the very thing that the defendant had a duty to prevent happening. Counsel argued that one of the very things that Moore Stephens' engagement as the company's auditors required it to do was to detect whether the company was engaged in fraud and that as a result, the illegality principle could not bar a claim.

The main authority relied on by the Company was the Court of Appeal decision in *Reeves v Commissioner of Police* (1990). In that case, Lynch committed suicide whilst in police custody. He was a known suicide risk and the Judge at first instance held that the police owed him a duty to take reasonable care to prevent him from committing suicide and that adequate steps were not taken, but that the claim failed by reason of *volenti* and contributory negligence.

The Court of Appeal allowed the appeal – in general terms, if the police had an obligation to take reasonable care to prevent the defendant from committing suicide, then how could they be excused liability when the defendant did the very act which they were under a duty to take reasonable steps to prevent? Thus, the Court of Appeal stated the "very thing" doctrine as an aspect of causation.

However, the judgments of the Court of Appeal in *Reeves* also made reference to the illegality doctrine, stating that, where there was a duty to take reasonable steps to prevent suicide, the conscience of the ordinary citizen would not be affronted by an award of damages to the estate of the deceased. It was this that led to counsel for the company in *Stone & Rolls* to argue that *Reeves* was authority for a "very thing" exception to the illegality doctrine.

However the Court of Appeal disagreed. Rimer LJ noted that the Court of Appeal in *Reeves* applied a broad public conscience approach to illegality and so their comments on "very thing" had to be viewed in that context. He held that the Court of Appeal in *Reeves* had been incorrect to apply such a test and should instead have applied the strict test laid down in *Tinsley v Milligan*. Had they done so and concluded that the claim was founded on an act attracting the illegality defence, they could not have held that the defence did not apply because of some "very thing" exception.

Thus *Reeves* did not assist the company in seeking to avoid the application of the illegality doctrine. The Court of Appeal had not applied the correct test in that case and it was not authority for the point the company was trying to argue. The Court of Appeal in *Stone & Rolls* held that the "very thing" concept was really all about causation and did not provide any exception to the illegality doctrine.

Third party funding

Finally, a headline in the Times the day after the Court of Appeal's judgment read "*Third-party lawsuit funding hit as case thrown out*". *Stone & Rolls* was one of the largest and most high profile claims to be brought to date with the aid of litigation funding. The decision is a salutary reminder of the risks involved in funding litigation and shows that it is not always possible to back winners.

A petition for leave to appeal has been lodged with the House of Lords and a decision on permission is expected later this year.

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