



Client Alert

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The Risks of Failing to Detect Fraud

Those who place and underwrite insurance on behalf of accountants will be interested in the impact of a judgment handed down by the House of Lords on 30 July 2009 in *Moore Stephens (a firm) -v- Stone & Rolls Limited (in liquidation) [2009] UK HL 39* which considered whether a firm of auditors could be held liable for failing to detect a fraud committed by one of its clients. The judgment in the case has been eagerly awaited and received much media attention. This claim was described as being "...a rare and extreme case...". Indeed, the facts reveal a considerable degree of deception on the part of Mr Stojevic, the owner of the audited company. The case is one of the most significant recent disputes involving third party litigation funders. The judgment was also one of the Law Lords' last before their functions are transferred to the new UK Supreme Court in October. For those involved in assessing accountants' liability, the case has provided a degree of guidance for claims involving fraud, but the impact on the profession is, in parts, likely to be limited and fact specific.

Background

Stone & Rolls ("S&R") was effectively owned, run and controlled by one man, Mr Stojevic. He used S&R to commit fraud against banks using letters of credit. S&R would present false documentation to financiers to obtain funds that was then paid away, leading to a claim by a Czech bank for recovery of approximately \$174m of credit. Following an award of damages arising from the fraud S&R was placed into liquidation.

Proceedings

S&R's liquidators, funded by third party litigation funders commenced proceedings for breach of duty against the accountants Moore Stephens, alleging that, at audit, they had negligently failed to detect the fraud committed by Mr Stojevic which directly caused S&R's loss.

Accountants are under a contractual duty to exercise reasonable skill and care in completing an audit of a company's accounts (this duty must be interpreted in the light of relevant statutory provisions and auditing standards). Specifically, if auditors have reason to suspect that directors are acting fraudulently, auditing standards require them to draw this to the attention of shareholders and relevant authorities. Auditors owe a duty to the body of shareholders as a whole and not to individual members.

S&R claimed that the acts of Mr Stojevic could not be attributed to the company and that it was able to rely on the *Hampshire Land*¹ principal whereby dishonesty of an agent will not be attributed to its principal if the agent commits fraud against that principal. S&R insisted it had merely acted as a conduit and was therefore free to make a claim against Moore Stephens based on negligence.

In its defence, Moore Stephens applied to strike out the claim based on a principle of public policy preventing a party from claiming damages arising from its own fraudulent activities (a defence known as *ex turpi causa*). It did so by claiming that S&R should be deprived of its claim because the fraud could be directly attributed to it as Mr Stojevic controlled everything the company did. Langley J rejected the strike out application and Moore Stephens appealed.

The Court of Appeal overturned the first instance judgment applying the *ex turpi causa* principal and preventing S&R from recovering losses against Moore Stephens as they were based on its own fraudulent activity. The Court of Appeal also found that just because the fraud was "the very thing" that Moore Stephens had a duty to report and protect its client from, the auditors did not lose the right to rely on the public policy defence. S&R appealed to the House of Lords.

In their judgments the Law Lords came to a majority 3:2 decision in favour of Moore Stephens, but did so based not only on the Court of Appeal judgment but also on other grounds. Broadly, the House of Lords held that as Mr Stojevic was the sole will, mind and shareholder of the company, S&R was the perpetrator of the

fraud and a court cannot assist a party in the recovery of compensation for the consequences of its own illegal conduct.

Although the Court of Appeal had limited the application of the public policy defence to "one-man companies" the Lords' majority make it clear that it may apply in situations involving more than one director or shareholder if all are found to be fraudulent (including directors who, had they not recklessly failed to make enquiries, would have uncovered the fraud). However, if some directors and shareholders are found to be innocent of any wrongdoing, the *ex turpi causa* defence will not apply.

Impact on an auditors' duty of care

Of critical importance is Lord Phillips's judgment. He preferred to analyse the case based on the scope of an auditor's duty of care and the ability of the auditors to rely on the public policy defence of *ex turpi causa*. He stated that

"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".

Critically, Lord Phillips concluded that as the sole will, mind and beneficial owner was the same party to whom a duty of care was owed the illegal conduct by that party formed the basis of the company's claim and it was for this reason that Moore Stephens could rely on the public policy defence.

Ramifications

While this case is helpful to accountants (particularly smaller firms who regularly act for and audit small, one-man or family run companies), caution should be adopted in seeking to establish general propositions. Any wider application will depend on the degree to which it is established that those responsible for the perpetration of fraud effectively amount to the "sole directing mind and will of the company involved". While the judgment's effect is not limited to so called 'one man' or family run companies per se, accountants are unlikely to be able to rely on the principal of *ex turpi causa* where not all directors and/or shareholders are complicit in the fraud. Large accountancy firms, for example, may still find themselves faced with similar claims in the future arising from a breach of their duty as auditors where they will be unable to rely on the defences argued by Moore Stephens.

¹ In Re Hampshire Land Company [1896] 2 Ch 743

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