

LEGAL BRIEF

BARLOW LYDE & GILBERT



Ruling in *Stone & Rolls* offers a beacon of hope

THE UK House of Lords' decision in *Stone & Rolls* (in liquidation) *v* *Moore Stephens** has been heralded in the media as a beacon of hope for auditors (and their insurers) in the impending storm of professional indemnity claims.

The strike-out of *Stone & Rolls*' claim has also been called a blow to the fledgling third-party funding industry that has recently threatened an increase in claims. Will the judgment deliver on both counts?

The background

Stone & Rolls' controller and (indirectly) beneficial owner, Zvonko Stojevic, had used the company as a vehicle for fraud. When the fraud was eventually discovered, both Stojevic and the company were successfully sued by one of the defrauded banks for deceit.

The company then went into liquidation and the liquidators (in the company's name) claimed \$174m from its auditors, *Moore Stephens*, alleging they had negligently failed to uncover and report the fraud.

Moore Stephens applied to strike out the claim on the basis that the court will not assist a claimant with recovering compensation for the consequences of his own illegal act (the "illegality principle").

The issues

The key issue was whether the company was, in fact, relying on its own illegal act. In what circumstances are a person's knowledge and/or acts attributed to a company, particularly where, as here, that person is the sole embodiment of the company?

Another matter, which came to the fore in the House of Lords, in the context of public policy, was whether the scope of the auditors' duty of care extends to innocent parties, such as creditors, particularly when a company is insolvent.

The judgment

The House of Lords upheld the decision of the Court of Appeal to strike out the claim by a three-to-two majority. Even within the majority, the matters on which the Lords agreed were limited.

The majority held that in the case of a "one-man" company, where the directing mind and will of the company is also its owner, its fraudulent conduct is to be treated as the company's conduct and the illegality principle will defeat the company's claim against its auditors for failure to detect the fraud.

The application of this authority where there are innocent shareholders or directors is less clear. Although placing different weight on the issues of attribution and the auditors' duty of care, the majority confirmed that the auditors' duty is owed to the company alone, not to the creditors or other third parties.

Lord Mance in his minority judgment considered that where a company is insolvent at the time of the audit, the scope of the auditors' duty extends, like the directors', to protecting the interests of creditors. This would have created an innocent constituency to whom the auditors owed a duty to report Stojevic's fraud.

Practical consequences

While the decision does add to the defence arsenal, auditors, their insurers and their advisers should be circumspect about the effect of this judgment. The House of Lords' decision requires auditors to show they were dealing with a true "one-man" company with no innocent constituency. Any extension of the principle beyond that is yet to be tested.

It remains to be seen how this defeat will affect the litigation-funding industry. Undoubtedly it serves as a timely reminder of the risks of litigation but funders may be able to exploit this setback as justifying the significant costs of litigation funding.

**Barlow Lyde & Gilbert LLP* represented *Moore Stephens* in this case.

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