

Accountancy Update

In this issue

Using the Illegality Defence.....	1	Casenotes.....	3	Stop Press.....	4
		• Facing indemnity costs			
		• Lehman: the High Court upholds the administrators' decisions			
		• Revisiting pre-action disclosure			

Using the Illegality Defence: a shot in the dark?

It seems almost certain that the economic downturn will lead to an increase in claims against accountants and auditors involving frauds committed during the recent boom. In this article Ross Goodrich considers the Law Commission's new consultation on the status of the Illegality Defence and how this may affect its availability to auditors and accountants.



Ross Goodrich
+44(0)20 3060 6244
ross.goodrich@rpc.co.uk

Who can forget the case of *Revell v Newbery*¹, in which the court refused to apply the doctrine of illegality. The result was that the 76-year-old Mr Newbery was forced to pay compensation to Mr Revell, whom he had shot while Mr Revell was attempting to break-in to Mr Newbery's allotment shed. Mr Revell had by then spent the night breaking into two portakabins, setting fire to one portakabin, and stealing two cars with keys stolen from the other. He was presumably looking for a quiet spot to rest his head.

Cases like *Revell v Newbery* may cause an uproar in the popular press and be used as examples of absurdities in the law. However, a case such as this can be relevant when

considering the possible use of the illegality defence, where, for example, former clients who bring negligence claims may have been involved in illegal conduct, such as tax fraud. These cases can also have an important bearing on the position of auditors facing negligence claims involving sophisticated frauds perpetrated by individual claimants and companies to which fraudulent conduct can be attributed. An example of the latter is the much publicised case of *Moore Stephens v Stone & Rolls*², in which the House of Lords' decision is now pending. The Law Commission's recently launched consultation on the illegality defence is therefore timely and may help to set a path for the development of this sometimes confusing area of the law.

The consultation, which is open until April 2009, considers the question of how far a claimant's illegal conduct should go before it prevents recovery from a wrongdoer. In approaching this question the Law Commission has considered five overlapping bases for the principle.

These are:

- disallowing a claim may further the purpose of the rule that has been infringed
- the law should be internally consistent
- the law should prevent a claimant from profiting from his own wrongdoing
- the law should deter illegal conduct
- the law may be needed to maintain public confidence.

The manner in which the illegality defence operates in tort is difficult to predict with certainty and so is its deployment. The number of factors to be taken into account and the varying significance placed on the conceptual justifications for the defence mean that there have been inconsistent approaches in the reasoning on cases involving the illegality defence. The Law Commission identifies a number of approaches the courts have adopted to illustrate this.

The courts have refused a claimant's case where he or she has been required to rely on his or her own illegal conduct to bring a claim. This was the basis on which the Court found for Moore Stephens in *Stone & Rolls*, where Rimer LJ noted a claim would be barred if it was necessary for the claimant to rely on the illegality.

There are also instances where courts will apply a proximity based test, which allows a flexible and pragmatic approach such that the courts will look to determine if there is an *inextricable link* between the facts giving rise to the claim and the illegality. This test is demonstrated by the case of *Hall v Woolston Hall Leisure Limited*³. An employee sued for sexual discrimination, but was faced with a defence of illegality arising from her acquiescence in the employer's underpayment of income tax. Here the court found that the claim would not be barred since it was not inextricably linked with the illegal conduct. Another recent example is *Gray v Thames Trains Limited*⁴ where the Court of Appeal found that where the depression the claimant suffered as a result of the defendant's negligence caused him to kill, he could still recover loss of earnings if his claim was not inextricably linked with his crime. The matter is shortly to go before the House of Lords.

The courts have also considered the seriousness of the alleged illegal conduct on the part of the claimant. For example, even if

the unlawful act is inextricably linked to the claim a court may, in some instances, allow it to proceed if the criminal conduct is not sufficiently grave. In the *Woolston* case the court also noted that acquiescence in the PAYE fraud should not bar a claim on illegality grounds. There will also be instances where the courts will be unlikely to allow technical breaches of minor statutes to bar claims on such grounds.

There are other approaches. One is weighing up the claimant's conduct against the

incremental reform by case law, so that the courts should continue to consider in each case whether an illegality defence can be justified on the policy grounds outlined above. It suggests that the courts should balance the strength of these policies against the objective of achieving a just result taking into account the relative merits of the parties' case and the proportionality of denying the claim.

So what does this all mean? The starting point may well be the *Stone & Rolls* and *Gray* cases. There is a strong chance that

“the conceptual basis on which judges often make their decisions is unclear”

seriousness of the harm which may be suffered if relief is denied, although such an approach has largely been discredited. Another is determining whether the statutory context prohibits the recovery of damages in tort (this approach was used in *Revell v Newbury*). There are also cases in which a court has made a finding against a claimant on the grounds that to do otherwise would appear to condone the illegal conduct and would offend the “public conscience”. However, such an approach was rejected by the Court of Appeal in the *Stone & Rolls* decision.

The Law Commission does not criticise the outcomes of the matters they examined, which they suggest demonstrate that the courts will adopt a fairly pragmatic and flexible approach. However, they point out that the conceptual basis on which judges often make their decisions is unclear. The effect of this is that the Law Commission is in favour of reforming the law. Significantly though, the Law Commission has shied away from legislative reform, principally because it recognises that a one-size fits all approach would not work in the range of situations in which the courts are required to consider the defence. Rather, the Law Commission has recommended

the House of Lords will take account of the Law Commission's comments and make pronouncements on this area of the law. However, it seems likely that the House of Lords will adopt an approach in keeping with the law thus far. In other words it is likely to adopt a pragmatic and flexible approach taking account of the underlying merits of the claim, without seeking to stifle or overly encourage the use of the defence. This may well mean that the grounds for the defence will be made clearer, such that it will be on a sturdier footing going forward. However, since the courts will be likely to continue to adopt a case by case approach, it will continue to be difficult to determine whether a defence is worth running in a given case. This is something that will require careful consideration rather than an unfocused shot in the dark.

1. [1996] QB 567
2. [2008] EWCA Civ 644
3. [2001] 1 WLR 225
4. [2008] EWCA Civ 713

The Illegality Principle

Ex turpi causa non oritur actio - No cause of action may be founded upon an immoral or illegal act



Casenotes

Facing indemnity costs

Rachael Healey
+44(0)20 3060 6029
rachael.healey@rpc.co.uk

In *JP Morgan Chase Bank v Springwell Navigation Corporation (Springwell)*¹, the court has awarded 65% of JP Morgan's costs on an indemnity basis.

In the underlying proceedings² Springwell sued JP Morgan, their investment advisers, for negligence and breach of contract and fiduciary duty.

JP Morgan's defence relied, in part, on contractual disclaimers, by which Springwell acknowledged that it had not

relied on JP Morgan's advice and that JP Morgan would not be liable for any losses caused by Springwell's investment decisions. The court agreed that JP Morgan did not owe a duty of care to provide general investment advice. Springwell was a sophisticated investor, and the disclaimers were held to be effective in preventing a general duty to advise from arising.

The decision to award indemnity costs against Springwell was based on numerous factors: the overly extensive range and

scope of Springwell's allegations; failure to realistically assess its own contributory negligence; withdrawing allegations close to trial; and wide divergence between witness statement evidence and oral evidence. These factors took the case "outside the norm" justifying an award of indemnity costs and serve as a reminder to all litigants to watch their conduct during proceedings.

1. [2008] EWHC 2848
2. [2008] EWHC 1186

Lehman: the High Court upholds the administrators' decisions

The High Court recently dismissed an application for further information from four investors against the administrators of Lehman Brothers International (Europe) (LBIE)³.

The investors had entered into agreements with LBIE and Lehman Brothers Inc (LBI) under which the investors lodged securities with LBI. LBI transferred the securities to LBIE, which made loans and provided services to the investors, using the securities as collateral. LBIE utilised the securities for its own and others' benefit, eg by pledging the securities.

The investors argued that by Friday 12 September 2008 they had agreed with LBI to transfer the securities to a third party bank, which would service

outstanding loans owed to the Lehman Group. However, on 15 September the ultimate parent in the Lehman Group filed for Chapter 11 bankruptcy protection and the transaction appeared to be incomplete.

The investors received information from the administrators of LBIE regarding their securities, but applied for further information in order to fulfil obligations to their own investors.

The High Court dismissed the application. The court recognised the plight of the investors; two investors argued that without the information they would have to wind down their funds. However, the administrators had acted fairly and within their statutory powers by declining to provide the information, particularly as

they had followed the directions agreed at the creditors' meeting.

The case follows a similar decision by the High Court in which RAB Capital applied for its proprietary claim to the assets held in LBIE to be expedited⁴. 95% of its fund was held by LBIE. The High Court dismissed the application, upholding the statutory moratorium period, which prevents proceedings being brought against a company in administration during the moratorium period.

These decisions illustrate the court's reluctance to interfere in an administrator's day-to-day management of a company.

3. *Re Lehman Brothers* [2008] EWHC Civ 2869
4. *RAB Capital plc v LBIE* [2008] EWHC 2335

Revisiting pre-action disclosure

BNP Paribas (BNPP) brought an application for pre-action disclosure of documents, information and provision of an affidavit from the respondents⁵.

Richard Sheldon QC set out a useful reminder of the principles for pre-action disclosure: (i) a

wrong had been carried out, or arguably carried out, by an ultimate wrongdoer; (ii) an order was needed to enable an action to be brought against the ultimate wrongdoer; and (iii) the person against whom the order was sought was caught up in some form of wrongdoing and in the

circumstances it was right to make the order.

5. *BNP Paribas ("BNPP") v (1) TH Global Limited (2) Spinaker Limited (3) Kvaerner 2004 (No.2) Limited* [2009] EWHC 37 (Ch).



Stop Press

Andrew Williamson
+44(0)20 3060 6286
andrew.williamson@rpc.co.uk

APB guidance on going concern issues and auditing complex financial instruments

The Auditing Practices Board (APB) has recognised that the current economic climate leads to uncertainty regarding the availability of finance, the impact of the recession on a company's own business and the impact of the recession on customers and suppliers. A consequence of these uncertainties is that there is expected to be an increase in the number of disclosures in annual reports and accounts about going concern and liquidity risks. To help auditors to respond the APB has published a bulletin entitled "Growing concern issues during the current economic conditions".

The APB has also issued a Consultation Draft providing guidance for auditors on "Auditing Complex Financial Instruments". The aim of this guidance is to widen the scope of Practice Note 23 to cover not only derivatives but other complex financial instruments. This is due to the current turbulence of the financial markets as well as recent changes to the financial reporting frameworks used by entities in the UK and Ireland to account for these complex financial instruments.

FRC Alert on corporate reporting challenges in current economic conditions

The Financial Reporting Council (FRC) has recognised that the current economic problems experienced by the global economy increase the challenges for directors in preparing corporate reports.

More time may need to be spent by directors and audit committees planning year-end activities, reviewing the key assumptions and reviewing the sufficient accounting and disclosure judgements.

The FRC has published an analysis of some of the challenges for audit committees and an update for directors of listed companies on reporting ongoing concerns and liquidity risks. The FRC highlights challenges for all the parties involved and concludes that auditors will need to ensure that they fully consider going concern assessments and only refer to going concern in their audit reports when appropriate.

GC100 issues note on auditor liability limitation agreements (LLAs)

The GC100 (an association of senior legal officers of more than 85 FTSE 100 companies) has published a note on LLAs pursuant to the Companies Act 2006. It is thought that few public companies have obtained shareholder approval to enter into such an agreement despite such agreements being permitted since 6 April 2008.

The note sets out the issues for directors to consider before entering into an LLA and emphasises the fact that there is no obligation to enter into one. It also notes that when the client is a complex group of companies spread over various jurisdictions, it would be reasonable to expect the audit firm to bear the costs of the research on how such agreements might work.

Madoff claims

The large audit firms are amongst the targets in the numerous actions already launched in the US courts arising out of Bernard Madoff's fraudulent activities. KPMG, Ernst & Young, PricewaterhouseCoopers and BDO Seidman are all on the receiving end of claims as a result of their roles as auditors to the feeder funds which invested with Madoff. The claims include allegations that the auditors failed to spot the obvious warning signs of the underlying fraud.

RPC news

Our next Breakfast Briefing is on Wednesday, 29 April 2009. Jane Howard, Ross Goodrich and Catherine Elford will be discussing liability issues facing global networks. For more information please email us at seminars@rpc.co.uk.

The Professional Risks Group is delighted to welcome Ollie Hincks and Chris Wakem into the department. Ollie trained at RPC and spent six months as a trainee in the Professional Risks Group and six months on secondment at BDO Stoy Hayward LLP. Chris Wakem joins us as an employed barrister and has experience of dealing with fraudulent transactions involving professionals.

Editors

Jane Howard
+44(0)20 3060 6888
jane.howard@rpc.co.uk

Maria Oats
+44(0)20 3060 6862
maria.oats@rpc.co.uk



Tower Bridge House
St Katharine's Way
London E1W 1AA
+44(0)20 3060 6000

Accountancy Update is a summary of recent developments. It should not be regarded as a substitute for advice on how to act in any particular case. For further information please contact one of the editors.

© Reynolds Porter Chamberlain LLP www.rpc.co.uk