grounds (commission of a serious criminal offence, *cf*. the claimant's suicide in *Corr*). Similarly, Lord Rodger, at [76], "happily" found it unnecessary "to review the merits of *Baker* v. *Willoughby*".

The House of Lords' decision in *Gray* seems plainly correct. The Court of Appeal had questioned the "traditional harsh view of public policy" when "it is far from clear to us why the ends of justice are not sufficiently served by the principles of foreseeability, causation and contributory negligence": [2008] EWCA Civ 713, at [49]. None of this seemed to find favour in the House of Lords, although their Lordships did not engage directly with such arguments. Perhaps they felt, quite understandably, that radical judicial reform of the *ex turpi causa* defence would be out of place while the Law Commission's marathon examination of the issue still grinds on: see, for the latest instalment, *The Illegality Defence: A Consultative Report* CP No. 189 (January 2009).

JONATHAN MORGAN

AUDITORS' LIABILITY: NO NEED TO DETECT FRAUD?

CAN a fraudster sue his auditors for failing to detect his fraud? If the fraudster is an individual, seeking damages for his own benefit, plainly not: *ex turpi causa non oritur actio*. But what if the claimant is an insolvent company? In the case of a "one-man" company, a bare majority of the House of Lords has decided that the illegality defence still applies: *Moore Stephens (a firm)* v. *Stone & Rolls Ltd. (in liquidation)* [2009] UKHL 39.

Mr Stojevic was the sole directing mind and will, and the beneficial owner, of Stone & Rolls Limited ("S&R"). He used S&R in order to defraud banks through fictitious letters of credit. His major victim successfully sued him and S&R for deceit (*Komercni Banka A.S.* v. *Stone & Rolls Ltd.* [2002] EWHC 2263 (Comm), [2003] 1 Lloyd's Rep 383). S&R was consequently put into liquidation. The liquidators, in an attempt to recover some of the money owed to S&R's creditors, sued Moore Stephens for negligently carrying out its audit of S&R. For the purposes of the strike out application, Moore Stephens accepted that it breached its contractual and tortious duties of care by failing to detect and report the fraud, but raised the novel defence of *ex turpi causa*: S&R could not rely on its own illegal acts to found its claim. The House of Lords agreed.

Ultimately, the decisive point was that of attribution: could the illegal acts of Stojevic be attributed to S&R? Since Stojevic was the company's directing mind and will, ordinarily his fraud would be attributed to the company. However, *Re Hampshire Land Company*

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[1896] 2 Ch. 743 held that the knowledge of an agent should not be attributed to his principal where such knowledge relates to the agent's own breach of duty to his principal. The liquidators therefore argued that Stojevic's fraud should not be attributed to S&R. The majority of the Law Lords (Lords Phillips, Walker and Brown) disagreed: in the case of a "one-man" company, the fraud of the individual will also be the fraud of the company. The minority (Lords Scott and Mance) considered this to be an inappropriate lifting of the corporate veil, but it is submitted that the majority was right to emphasise that "common sense and justice" dictated that S&R be treated as the perpetrator, not the victim, of the fraudulent scheme. *Hampshire Land* provides only a very limited exception to the ordinary rules of attribution in circumstances where it would be unfair for innocent directors and shareholders of a company to be affixed with a wrongdoing director's fraudulent intention. Where there are no innocent members this exception is clearly redundant.

Since Stojevic's fraud was attributed to S&R, S&R was forced to rely upon its own illegal acts in order to succeed. Lord Walker (with whom Lord Brown agreed) held that the illegality defence therefore necessarily barred the claim (*Tinsley* v. *Milligan* [1994] 1 A.C. 340). However, this test of "reliance" upon an illegal act is too rigid and should be discarded. The illegality defence is one of public policy (*Holman* v. *Johnson* (1775) 1 Cowp. 341). In any given circumstance, the reasons justifying the defence should be coherently identified; as Lord Scott, in the minority, emphasised, "[t]he wielding of a rule of public policy in circumstances where public policy is not engaged constitutes … bad jurisprudence", at [122]. Lord Phillips, in the majority, also recognised this, but concluded that *ex turpi causa* must apply; otherwise, S&R would be able to recover a benefit from its own wrongdoing. That it would, in reality, be S&R's creditors rather than S&R itself who would benefit did not alter his Lordship's analysis: the auditors owed no duty of care to the creditors (*Caparo Industries plc.* v. *Dickman* [1990] 2 A.C. 605).

The application of the illegality defence was very generous to the auditors. This is highlighted by the fact that the same result would have been reached if Moore Stephens had actually been aware of, and played a part in, the fraudulent activity: S&R would still not have been allowed to benefit from its own wrong. Such a result is surely unacceptable. Lord Scott was strongly of the view that the liquidators' claim should not be struck out because of the illegality defence; the creditors were entirely innocent, so there was no public interest in barring the claim. Although this approach may be criticised, since S&R would be more likely to recover damages as an insolvent company rather than a solvent one, it is suggested that this might nevertheless be tolerated.

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After all, S&R did still have a claim even when solvent; the issue is simply whether the auditors can rely on a procedural defence.

Lord Walker acknowledged that the Law Commission has provisionally recommended a wider, more flexible test for the application of the illegality defence: *The Illegality Defence: A Consultative Report* CP No. 189 (2009). This would undoubtedly be an improvement on the current law. However, Lord Walker also stated that such proposals would only be effective "if enacted by Parliament", at [130]. The Law Commission suggested that legislative reform in the tortious sphere is not necessary; but it is to be hoped that the final report will recognise the need for a statutory discretion. It may also be incumbent upon the Law Commission to re-examine the issue of whether the illegality defence should provide an absolute bar to a claim. Their Lordships were not persuaded by the argument that contributory negligence should be used to adjust the burden of loss between the parties, but Lord Mance was attracted by the possibility of a more balanced, discretionary defence. It is submitted that the courts should be able to apportion damages after applying the illegality defence; its current all-or-nothing nature renders it very much a "blunt instrument".

Moore Stephens will no doubt come as a great relief to auditors, but the scope of the decision is very narrow and limited to "one-man" companies (or arguably situations in which all the directors and shareholders are complicit in the fraud). It does not universally absolve auditors of a duty to detect fraud. This would be highly undesirable; indeed, even the result in *Moore Stephens* may be considered troublesome. "The world has had 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", *per* Lord Mance at [206].

PAUL S. DAVIES

NEGLIGENCE, NEIGHBOURLINESS, AND THE WELFARE STATE

WHEN Lord Atkin enunciated the neighbour principle (in *Donoghue* v. *Stevenson* [1932] A.C. 562, 580), he struck a blow for simplicity in negligence law. For he declared that defendants – all defendants – could be held liable for carelessly inflicting harm on others while closely and directly interacting with them. However, Lord Atkin's colleagues made it plain nine years later, that they were not prepared to apply this approach to public bodies (*East Suffolk Rivers Catchment Board* v. *Kent* [1941] A.C. 74). Since then, judges have worked assiduously to

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