Company v director: who pays for wrongdoing?

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When the directors of a company involve it in a fraudulent transaction, is the company barred by the doctrine of illegality from suing them and their accessories for losses caused by their breach of fiduciary duty?

This question was considered by the Supreme Court, in *Bilta*, in refusing to strike out a claim by a company's innocent liquidator and creditors (through the legal personality of a liquidated company guilty of carousel or acquisition fraud) against accessories of the directors. This article considers the illegality defence, but not the attribution or territorial jurisdiction points.

The ex turpi causa rule

The illegality defence is shorthand for a rule of public policy – *ex turpi causa non oritur actio* – derived from a judgment of Lord Mansfield in 1775, which prevents a person founding a cause of action on an immoral or illegal act. The principle has been applied more consistently in relation to fines and penalties for criminal law wrongs than in civil claims. It is sometimes referred to as 'the Beresford principle', following the eponymous House of Lords decision which concerned a claim on policies of life insurance where the deceased made clear in letters that he committed the crime of suicide with the intention that his policies would pay off his debts.

It is of importance to directors and their employing companies, as it has provided a shield to directors when companies have tried to recover fines or other sums from them, and when the company blames the director for making the company incur the sum in question. It also presents an obstacle to companies by constraining their ability to reassure their directors in an uncertain legal landscape by purchasing D&O insurance, or providing direct contractual indemnities, as a bulwark against potentially devastating personal liability. Both insurers and employers have relied on the *ex turpi causa* maxim to avoid claims by directors and employees in the past.

The barrier to indemnification is now also based in statute for various matters (s.232 CA 2006). Directors also owe statutory duties to the members of the company as a whole, and, in certain circumstances, to the company's creditors (s.172 CA 2006).

The modern application of the *ex turpi causa* maxim in civil actions derives from *Tinsley*; a case concerning ownership of a house which had been bought in the name of one of two co-habiting women so that the non-owner could fraudulently claim to be a lodger and obtain housing benefit. On the purchase of the property the intention had been that both would be beneficial owners. After they fell out, the legal owner claimed to be the sole owner. In that case both women were wrong 'wrongdoers' in different ways, but the House of Lords allowed the equitable co-owner to pursue her claim (ie she was not barred by *ex turpi causa*) as her claim was not pleaded or reliant on the illegality.

Stone & Rolls

The House of Lords first applied the *ex turpi causa* maxim to prevent a civil cause of action being brought by a company for a loss arising from its own wrongdoing in *Stone & Rolls*. There, a one-man company had been created solely for the purpose of defrauding banks and then (in an action brought by the liquidators but through the company) attempted to sue its own auditors for failing to detect the fraud perpetrated by that company. Lord Sumption (who appeared in that case as QC) suggested in *Bilta* that *Stone & Rolls* establishes a general and context un-specific distinction between personal and vicarious liability as central to the application of the illegality defence (paras 79-81, page 33). The other Lords in *Bilta* disagreed; Lords Phillips and Walker explicitly regarding the case of a one-man company as different, in principle, to one in which there were other, innocent, directors and shareholders. Lord Neuberger said that *Stone & Rolls* should be 'put on one side and marked "not to be looked at again"' (adopting Lord Denning's graphic terminology, para 30, page 9).

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Twigger

The ability of a company to seek to recover its own losses from its own culpable directors was considered by the Court of Appeal in *Twigger*. There Safeway sought indemnity from directors, including Mr Twigger, for a fine, anticipated at the time of the litigation to be for over £10 million plus legal costs. The fine had been imposed for breach of s.2(1) CA 1998. Safeway had reached an agreement with the Competition Commission, which included making certain admissions and not appealing the fine imposed. The fine was for coordinated initiatives to increase the retail price of milk (in order to allow for higher payments to the milk producers) amounting to unlawful price-fixing.

As in *Bilta*, the defendants sought summary judgment on the basis that Safeway's claim was precluded by the maxim *ex turpi causa*. The admission by the company resulted in it receiving a penalty which shared the characteristics of a criminal fine (being motivated by policy reasons of punishment and deterrence) and could only be imposed for intentional or negligent infringement of the law. The claimants had been fined for conduct which had 'been committed intentionally or negligently by the undertaking'. Safeway had argued that the defendants, not the company, were morally culpable for the breaches of the CA 1998. However, the leading judgment in the Court of Appeal held that the statute made the company personally liable. The *ex turpi causa* maxim would apply to a company where the company was 'personally at fault', following *Stone & Rolls*, so the claim against the culpable directors failed.

In *Bilta* the judgment of Lords Toulson and Hodge preferred the approach of Pill LJ in *Twigger*. Pill LJ considered that the policy of the CA 1998 would be undermined if undertakings were able to pass on their liability to their employees. Lords Toulson and Hodge accepted that there may be circumstances where the nature of a statutory code, and the need to ensure its effectiveness, may provide a policy reason for not permitting a company to pursue a claim of the kind brought in *Twigger* (para162, page 63).

They also observed that if the reasoning on the illegality defence in *Twigger* was taken to its logical conclusion, that would mean that the company could not lawfully dismiss errant employees or directors, because to rely on their misconduct would be to rely on the company's own misconduct (para 161, page 63).

Bilta

Bilta (UK) Ltd is a company which was compulsorily wound up pursuant to a petition presented by HMRC, following its involvement in an alleged fraud on the HMRC through a series of transactions relating to European Emissions Trading Scheme Allowances which left Bilta owing VAT in excess of £38m. The claim was brought by the liquidators, and alleged that the four defendants facilitated that fraud, with Messrs Nazir & Chopra breaching their fiduciary duties as the former directors of Bilta (and Mr Chopra also being the sole shareholder).

The claims were (i) through the company for (a) damages in tort and (b) compensation based on constructive trust, and (ii) directly against each defendant for a contribution under s.213 IA. The appeal was in relation to a strike-out application by Jetivia SA and its Chief Executive, Mr Brunschweiler, who were alleged co-conspirators.

Although the court (sitting as seven judges) gave three separate judgments, Lord Neuberger concluded that all three reached the same conclusion on attribution of the wrongdoing. He stated that conclusion as: 'Where a company has been the victim of wrongdoing by its directors, or of which its directors had notice, then the wrongdoing or knowledge, of the directors cannot be attributed to the company as a defence to a claim brought against the directors by the company's liquidator, in the name of the company and/or on behalf of its creditors, for the loss suffered by the company as a result of the wrongdoing, even where the directors were the only directors and shareholders of the company, and even though the wrongdoing or knowledge of the directors may be attributed to the company in many other types of proceedings' (para 7, page 3).

In other words, wrongdoing directors cannot escape personal liability to innocent third parties by relying on the *ex turpi causa* maxim.

The *Stone & Rolls* approach was to be treated as decided on its own facts, or at its broadest where there are no innocent shareholders or directors (para 26, page 8 and para 30, page 9). The approach of the majority in *Twigger* was doubted; Pill LJ's approach generally being preferred, subject to a decision following full argument.

The future of the illegality defence

The judgments differed in their interpretations of both *Stone & Rolls*, and *Twigger*, and, *obiter*, on the correct approach to

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the illegality defence more generally. Lord Sumption relied on *Les Labratoires Servier* as authority that the court is required to act on the illegality defence in every case, and denied that the court could apply a public conscience test (para 62, page 22), albeit he distinguished the people-trafficking case of *Hounga*, saying that it turned on its own context of 'a competing public policy [which] required that damage should be available even to a person who was privy to her own trafficking' (para 102, page 44). Lord Neuberger called for the proper approach to the defence of illegality to be considered by the Supreme Court as soon as appropriately possible (para 15, page 5).

Conclusion

It appears likely that, at its next opportunity, the Supreme Court will narrow the illegality defence, either by adopting an approach prioritising clarity and certainty, as advocated by Lord Sumption, or following the majority in *Bilta*, by a more fact-sensitive approach, but with some increase in the ability of companies to hold their own directors to financial account for their actions.

The sums potentially at stake in the context of fines and penalties have been significantly increased, so as to provide an effective deterrent (under RESA and LASPO ss.85 & 86).

It is to be hoped that the new approach will be nuanced to recognise (i) that the personal liability of companies in the regulatory context has succeeded in increasing company motivation for compliance and (ii) the different moral context of the relatively powerless wrongdoer, such as in *Hounga*.

The observations of Lords Toulson and Hodge also suggest the potential for new arguments in unfair dismissal cases where the employer is also a wrongdoer by virtue of the action of the dismissed employee and/or by his/her co-conspirators; however, the implied disapproval of that approach suggests that in the context of employment law the impact of *Bilta* will be on civil claims for damages/ contributions and will not make a material difference to the development of the law on unfair dismissal.

KEY:

Bilta	*Jetivia SA & anor (Appellants) v Bilta (UK) Ltd (in liquidation) & ors* [2015] UKSC 23
1775	*Holman v Johnson* (1775) I Cop 341 at 343
Beresford	*Beresford v Royal Insurance Co Ltd* [1938] 2 ALL ER 602
CA 2006	Companies Act 2006
Tinsley	*Tinsley v Milligan* [1994] 1 AC 340
Stone & Rolls	*Stone & Rolls Ltd v Moor Stephens* [2009] AC 1391
Twigger	*Safeway Stores Ltd v Twigger* [2011] 2 All ER 841
CA 1998	Competition Act 1998
IA	Insolvency Act 1986
Les Labratoires Servier	*Les Labratoires Servier v Apotex Inc* [2014] UKSC 55
Hounga	*Hounga v Allen* [2014] UKSC 47
RESA	Regulatory Enforcement and Sanctions Act 2008
LASPO	Legal Aid, Sentencing and Punishment of Offenders Act 2012