purchases of stock so that the amounts payable were **(p. 470)** made to appear just *after*, instead of just *before*, the half-yearly 'cut off' date; and (iii) (the converse of (ii)) by advancing *into* the half-yearly period sums due in respect of goods sold which were in fact invoiced *after* the 'cut-off' date. The auditors ('Kevans') had accepted the explanations given by Croston and his brother-in-law Heyes (now deceased) regarding the altered invoices. The court held that Kevans had been negligent in relation to (ii) and (without any finding in relation to (i) and (iii)) held them liable to the company's liquidator in respect of dividends which the company had wrongly paid on the strength of the false accounts.

> [PENNYCUICK J referred to *Re Kingston Cotton Mill Co (No 2)* **[8.02]** and continued:] This case appears, at any rate at first sight, to be conclusive in favour of Kevans as regards the falsification of the stock taken in isolation. Mr Walton, for the liquidator, pointed out that before 1900 there was no statutory provision corresponding to section 162 of the Companies Act 1948 [CA 2006 s 498]. That is so, but I am not clear that the quality of the auditor's duty has changed in any relevant respect since 1896. Basically that duty has always been to audit the company's accounts with reasonable care and skill. The real ground on which *Re Kingston Cotton Mill Co (No 2)* is, I think, capable of being distinguished is that the standards of reasonable care and skill are, upon the expert evidence, more exacting today than those which prevailed in 1896. I see considerable force in this contention. It must, I think, be open, even in this court, to make a finding that in all the particular circumstances the auditors have been in breach of their duty in relation to stock. On the other hand, if this breach of duty stood alone and the facts were more or less the same as those in *Re Kingston Cotton Mill Co (No 2)*, this court would, I think, be very chary indeed of reaching a conclusion different from that reached by the Court of Appeal in *Re Kingston Cotton Mill Co (No 2)* …
>
> I find it impossible to acquit Kevans of negligence as regards purchases of stock before the end of each current period of account and the attribution of the price to the succeeding period of account. I will assume in their favour that Mr Nightingale [a partner in Kevans] was entitled to rely on the assurances of Mr Heyes and Mr Croston until he first came upon the altered invoices, but once these were discovered he was clearly put upon inquiry and I do not think he was then entitled to rest content with the assurances of Mr Croston and Mr Heyes, however implicitly he may have trusted Mr Croston. I find the conclusion inescapable alike on the expert evidence and as a matter of business common sense that at this stage he ought to have taken steps on the lines indicated by Mr Macnamara [an expert witness], that is to say, he should have examined the suppliers' statements and where necessary have communicated with the suppliers. Having ascertained the precise facts so far as it was possible for him to do so, he should then have informed the board. It may be that the board would then have taken some action. But whatever the board did he should in each subsequent audit have made such checks and inquiries as would have ensured that any misattribution in the cut-off procedure was detected. He did not take any of these steps. I am bound to conclude that he failed in his duty.
>
> [His Lordship accordingly held the auditors liable for the amount of the dividends wrongly paid.]

The auditors of a company owe no duty of care either to members of the public who rely on the accounts in deciding whether to invest in the company's shares, or to existing members of the company who may also rely on the accounts for the purpose of decisions in relation to present or future investment in the company.

[8.04] Caparo Industries plc v Dickman [1990] 2 AC 605 (House of Lords)

Touche Ross & Co had audited the 1983–84 accounts of Fidelity plc, a listed company, which showed a pre-tax profit of £1.3 million. Both before and after the publication of these accounts, Caparo bought Fidelity shares in the market, and subsequently it made a takeover bid, as a result of which it acquired all the shares. In these proceedings Caparo alleged that it had paid too much for the shares because the trading figures should have shown a loss of £0.4 million **(p. 471)** instead of a profit, and claimed damages from the auditors on the ground that they had been negligent in certifying that the accounts showed a true and fair view of Fidelity's financial position. The House of Lords, reversing in part the judgment of the Court of Appeal, held that the auditors owed

Caparo no duty of care.

[LORD BRIDGE OF HARWICH referred to a number of well-known cases, including *Hedley Byrne & Co Ltd v Heller & Partners* [1964] AC 465, HL, and continued:] The salient feature of all these cases is that the defendant giving advice or information was fully aware of the nature of the transaction which the plaintiff had in contemplation, knew that the advice or information would be communicated to him directly or indirectly and knew that it was very likely that the plaintiff would rely on that advice or information in deciding whether or not to engage in the transaction in contemplation. In these circumstances the defendant could clearly be expected, subject always to the effect of any disclaimer of responsibility, specifically to anticipate that the plaintiff would rely on the advice or information given by the defendant for the very purpose for which he did in the event rely on it. So also the plaintiff, subject again to the effect of any disclaimer, would in that situation reasonably suppose that he was entitled to rely on the advice or information communicated to him for the very purpose for which he required it. The situation is entirely different where a statement is put into more or less general circulation and may foreseeably be relied on by strangers to the maker of the statement for any one of a variety of different purposes which the maker of the statement has no specific reason to anticipate. To hold the maker of the statement to be under a duty of care in respect of the accuracy of the statement to all and sundry for any purpose for which they may choose to rely on it is not only to subject him, in the classic words of Cardozo CJ to 'liability in an indeterminate amount for an indeterminate time to an indeterminate class': see *Ultramares Corpn v Touche*;[9] it is also to confer on the world at large a quite unwarranted entitlement to appropriate for their own purposes the benefit of the expert knowledge or professional expertise attributed to the maker of the statement. Hence, looking only at the circumstances of these decided cases where a duty of care in respect of negligent statements has been held to exist, I should expect to find that the 'limit or control mechanism … imposed upon the liability of a wrong-doer towards those who have suffered economic damage in consequence of his negligence'[10] rested in the necessity to prove, in this category of the tort of negligence, as an essential ingredient of the 'proximity' between the plaintiff and the defendant, that the defendant knew that his statement would be communicated to the plaintiff, either as an individual or as a member of an identifiable class, specifically in connection with a particular transaction or transactions of a particular kind (eg in a prospectus inviting investment) and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter upon that transaction or upon a transaction of that kind …

These considerations amply justify the conclusion that auditors of a public company's accounts owe no duty of care to members of the public at large who rely upon the accounts in deciding to buy shares in the company. If a duty of care were owed so widely, it is difficult to see any reason why it should not equally extend to all who rely on the accounts in relating to other dealings with a company as lenders or merchants extending credit to the company. A claim that such a duty was owed by auditors to a bank lending to a company was emphatically and convincingly rejected by Millett J in *Al Saudi Banque v Clark Pixley*[11] …

The main submissions for Caparo are that the necessary nexus of proximity between it and the appellants giving rise to a duty of care stems (1) from the pleaded circumstances indicating the vulnerability of Fidelity to a take-over bid and from the consequent probability that another company, such as Caparo, would rely on the audited accounts in deciding to launch a take-over bid, or (2) from the circumstance that Caparo was already a shareholder in Fidelity when it decided to launch its take-over bid in reliance on the accounts …

(p. 472) I should … be extremely reluctant to hold that the question whether or not an auditor owes a duty of care to an investor buying shares in a public company depends on the degree of probability that the shares will prove attractive either en bloc to a take-over bidder or piecemeal to individual investors. It would be equally wrong, in my opinion, to hold an auditor under a duty of care to anyone who might lend money to a company by reason only that it was foreseeable as highly probable that the company would borrow money at some time in the year following publication of its audited accounts and that lenders might rely on those accounts in deciding to lend. I am content to assume the high probability of a take-over bid in reliance on the accounts which the proposed amendment of the statement of claim would assert but I do

not think it assists *Caparo's* case …

[Lord Bridge referred to the statutory provisions dealing with the auditor's report (Companies Act 1985 (CA 1985) ss 253ff), and continued:] No doubt these provisions establish a relationship between the auditors and the shareholders of a company on which the shareholder is entitled to rely for the protection of his interest. But the crucial question concerns the extent of the shareholder's interest which the auditor has a duty to protect. The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholder, eg by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders.

I find it difficult to visualise a situation arising in the real world in which the individual shareholder could claim to have sustained a loss in respect of his existing shareholding referable to the negligence of the auditor which could not be recouped by the company. But on this part of the case your Lordships were much impressed with the argument that such a loss might occur by a negligent undervaluation of the company's assets in the auditor's report relied on by the individual shareholder in deciding to sell his shares at an undervalue. The argument then runs thus. The shareholder, qua shareholder, is entitled to rely on the auditor's report as the basis of his investment decision to sell his existing shareholding. There can be no distinction in law between the shareholder's investment decision to sell the shares he has or to buy additional shares. It follows, therefore, that the scope of the duty of care owed to him by the auditor extends to cover any loss sustained consequent on the purchase of additional shares in reliance on the auditor's negligent report.

I believe this argument to be fallacious. Assuming without deciding that a claim by a shareholder to recover a loss suffered by selling his shares at an undervalue attributable to an undervaluation of the company's assets in the auditor's report could be sustained at all, it would not be by reason of any reliance by the shareholder on the auditor's report in deciding to sell; the loss would be referable to the depreciatory effect of the report on the market value of the shares before ever the decision of the shareholder to sell was taken. A claim to recoup a loss alleged to flow from the purchase of overvalued shares, on the other hand, can only be sustained on the basis of the purchaser's reliance on the report. The specious equation of 'investment decisions' to sell or to buy as giving rise to parallel claims thus appears to me to be untenable.

LORDS ROSKILL, OLIVER OF AYLMERTON and JAUNCEY OF TULLICHETTLE delivered concurring opinions.

LORD ACKNER concurred.

➢ Notes

1. In *Galoo Ltd v Bright Grahame Murray* [1994] 1 WLR 1360, CA, it was held that, before a claim in the tort of negligence can be maintained by a third party against an auditor, a 'special relationship' must be shown to have existed between them and, in particular, an intention **(p. 473)** (actual or inferred) on the part of the auditor that the third party should rely on the audit, together with actual reliance by the third party.

2. In the same vein, in *Al Saudi Banque v Clark Pixley* [1990] Ch 313, [1989] 3 All ER 361, it was held that a company's auditors owed no duty of care to existing or future creditors who might foreseeably lend money to the company or continue its existing credit on the faith of its audited accounts.

3. *Caparo Industries plc v Dickman* may, however, be contrasted with *Morgan Crucible Co plc v Hill Samuel & Co Ltd* [1991] Ch 295, CA, where the court declined to rule, as a preliminary point of law, that the directors and financial advisers, including the auditors, of the target company in a contested takeover bid owed no duty of care towards the bidder (whose identity was publicly known) in making representations as to the target's position, as a result of which the bidder had allegedly been induced to offer more for the shares than they were worth.[12] This was, of course, only a preliminary ruling. There are several other cases in which a court has declined to strike out in advance an action brought by a party other than the company itself against its auditors—holding, in effect, that the elements going to establish a 'special relationship' could only be ascertained by hearing the evidence at the trial. Not too much can be read into such decisions: it is perhaps significant that there is no report of further proceedings in any of these cases.

4. And there are cases which seem to go much further. In *Barings plc v Coopers & Lybrand (A Firm)* [1997] 1 BCLC 427, CA, it was held that the auditors of a subsidiary owed a duty of care not only to the subsidiary, but also to its parent company. An argument (based primarily on *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* **[13.21]**) that any damage caused by the breach of the auditors' duty would be suffered by the subsidiary, and only indirectly by the parent in its capacity as shareholder, was unsuccessful. (Is this finding affected by the cases on 'reflective loss' (see *Foster Bryant Surveying Ltd v Bryant, Savernake Property Consultants Ltd* **[7.29]**)?) In *Bank of Credit and Commerce International (Overseas) Ltd v Price Waterhouse* [1998] BCLC 617, CA, the position was more defensible: the question was whether the parent company's auditors might owe a duty of care to the parent in respect of the affairs of a subsidiary which had been audited separately by another firm. Because the business of all the companies in the group was so close that they were in effect interdependent, the court held that there would need to have been a constant interchange of information between the two firms of auditors, and that in the circumstances such a duty might arise.

5. In recent years, there have been increasing obligations placed on company auditors both by legislation and by extra-statutory measures. Thus, for example, an auditor is required to state whether the directors' report (required by CA 2006 s 415) is consistent with the accounts (s 496); the Listing Rules stipulate that the auditor must review the company's statement of compliance with the UK Corporate Governance Code. The potential exposure of firms of auditors to liability for very large sums has caused concern in accountancy circles and has been the subject of debate in many countries. One suggestion advanced for some years is that auditors should be allowed to limit their liability by contract: this is now permitted by CA 2006 ss 534ff, subject to certain conditions (see 'General policy and regulatory issues', p 463). The alternatives were unacceptably limited. Auditors could, at least to some extent, cover their position by insurance, but this drives up the cost of the audit. Another solution is offered by the Limited Liability Partnerships Act 2000, which allows the members **(p. 474)** of auditing firms to limit their liability for losses caused by the negligence of *other* members of the firm. Another possibility suggested during this debate was to amend the law of joint liability in tort, so that (at least in this context) a tortfeasor should not be jointly and severally liable with the others who were at fault for all the loss sustained by the claimant, but only for a proportionate part of the loss corresponding to his share of the liability. In a number of cases decided in Commonwealth countries, auditors have successfully pleaded that their liability should be reduced because of the contributory negligence of the company itself (the acts of the company's directors being attributed to the company for this purpose). Examples include *Daniels v Anderson* (1995) 16 ACSR 607 and *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 30.

6. The UK Corporate Governance Code ('FRC and the UK Corporate Governance Code for listed companies', p 262) requires that, as a matter of good practice, the board of a listed company should establish an *audit committee* of at least three directors, all non-executive (and having a majority of 'independent' non-executive directors (NEDs)), whose duties should include keeping under review the scope and results of the audit and its cost-effectiveness, and the independence and objectivity of its auditors.

Frauds perpetrated by a 'one man company': the company cannot sue its auditors for negligence in failing to detect the fraud; nature of the auditors' liability.

[8.05] Stone & Rolls Ltd (In Liquidation) v Moore Stephens (A Firm) [2009] UKHL 39, [2009] 1 AC 1391 (House of Lords)

Read the facts of this case and another part of the judgment at **[3.32]**: the conclusion there is that a one man company cannot sue its auditors in negligence for failing to detect the fraud of the company's sole agent and owner. This conclusion relies on the application of the rules of attribution, the *Hampshire Land* principle and the *ex turpi causa* principle. The following extracts deal exclusively with the issue of auditor liability. The opinions expressed are *obiter*, but repay consideration.

LORD PHILLIPS OF WORTH MATRAVERS:

The duties of auditors

19 [T]he starting point for considering the issues raised by this appeal is the duties undertaken by Moore Stephens as auditors. … I would summarise the position as follows. The leading authority is *Caparo Industries plc v Dickman* **[8.04]**. The duties of an auditor are founded in contract and the extent of the duties undertaken by contract must be interpreted in the light of the relevant statutory provisions and the relevant auditing standards. The duties are duties of reasonable care in carrying out the audit of the company's accounts. They are owed to the company in the interests of its shareholders. No duty is owed directly to the individual shareholders. This is because the shareholders' interests are protected by the duty owed to the company. No duty is owed to creditors … The auditing standards require auditors who have reason to suspect that the directors of a company are behaving fraudulently to draw this to the attention of the proper authority. … For present purposes it suffices to note that the duty is unquestionably imposed in the interests of, at least, the shareholders of the company. …

68 One fundamental proposition appears to me to underlie the reasoning of Lord Walker and Lord Brown. It is that the duty owed by an auditor to a company is owed for the benefit of the interests of the shareholders of the company but not of the interests of its creditors. It seems to me that here lies the critical difference of opinion between Lord Walker and Lord Brown on the one hand and Lord Mance on the other. Lord Mance considers that the interests that the auditors of a company undertake to protect include the interests of the creditors. …

(p. 475) 81 I have had difficulty in this case in distinguishing between questions of duty, breach and actionable damage and, indeed, it is questionable whether it is sensible to attempt to distinguish between them. In *Caparo* … Lord Oliver [said, at p 651]:

> 'It has to be borne in mind that the duty of care is inseparable from the damage which the plaintiff claims to have suffered from its breach. It is not a duty to take care in the abstract but a duty to avoid causing to the particular plaintiff damage of the particular kind which he has in fact sustained.'

82 These comments were made in relation to duty of care in tort. In *Banque Bruxelles Lambert SA v Eagle Star Insurance Co Ltd (sub nom South Australia Asset Management Corpn v York Montague Ltd)* [1997] AC 191 Lord Hoffmann held that precisely the same reasoning applied to a duty of care in contract. …

LORD BROWN OF EATON-UNDER-HEYWOOD:

202 Lord Mance, as I understand his opinion, would find liability here in respect of all such losses as were occasioned by the fraud from the time when the auditors should have uncovered it. But what is this if not 'liability in an indeterminate amount for an indeterminate time to an indeterminate class' of claimants—whoever came to be defrauded by the company in the trading period after the fraud should have been ended to whatever was the extent of their loss. (The quoted phrase comes, of course, from Cardozo CJ's judgment in *Ultramares Corpn v Touche* (1931) 174 NE 441 …) The company, through its liquidator, would be suing to recover on behalf of all those whom it had defrauded. That, indeed, is precisely the nature of

this claim. Such an approach seems to me to run diametrically counter to the principles established in *Caparo*. …

203 I recognise, of course, that confining the *ex turpi causa* defence, as I would, to one man company frauds means that, where any innocent shareholders are involved, a claim against the auditors may well lie (through the company) at their suit. This, however, would not be an open-ended claim, wholly indeterminate as to its potential scope and extent at the time of the audit, such as that presently brought. Quite how it would fall to be confined is no doubt open to argument. But on one view it might be limited to the innocent shareholders' own loss suffered through the continuing fraud from the time when, following a diligent audit, it should have been uncovered and brought to an end. A claim of that nature would seem to me to accord altogether more readily with the policies and principles generally understood to apply in this context.

LORD MANCE (dissenting):

206 My Lords, the world has 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. The speeches of my noble and learned friends in the majority have that effect. In my opinion, English law does not require it. …

The auditors' liability where the company's directing mind is fraudulent

241 … Leaving aside situations in which the directing mind(s) is or are the sole beneficial shareholder(s), it is obvious—although the Court of Appeal's judgment is surprisingly silent on the point—that an auditor cannot, by reference to the maxim *ex turpi causa*, defeat a claim for breach of duty in failing to detect managerial fraud at the company's highest level by attributing to the company the very fraud which the auditor should have detected. It would lame the very concept of an audit—a check on management for the benefit of shareholders—if the higher the level of managerial fraud, the lower the auditor's responsibility. When Lord Bridge noted in*Caparo* that shareholders' remedy in the case of negligent failure by an auditor to discover and expose misappropriation of funds by a director consisted in a claim against the auditors in the name of the company (p 626e), he cannot conceivably have had in mind that it would make all the difference to the availability of such a claim whether the director was or was not the company's directing mind. The fact that a 'very thing' that an auditor undertakes is the exercise of reasonable care in relation to the possibility of financial impropriety at the highest level makes it impossible for the auditor to treat the company itself as personally involved in such fraud, or to invoke the maxim *ex turpi causa* in such a case. Context is once **(p. 476)** again all … Lord Phillips's statement (para 5) that 'common sense' might suggest that S & R's claim should fail because Moore Stephens were victims of deceitfully prepared company accounts must be categorically rejected. It would emasculate audit responsibility and the auditor's well-recognised duty to approach their audit role if not as bloodhounds, then certainly as watchdogs—planning and performing their audit with the 'attitude of professional scepticism' required by paras 27 and 28 of auditing standard SAS 110 in relation to the possibility of fraud as well as of error in management representations and company records and documents.[13]

242 Auditing standards and procedures have changed significantly over the years. But the potential responsibility of auditors for negligent failure to detect accounting deficiencies or managerial fraud—leading the company to sustain further loss connected with such deficiencies or the continuation of such fraud—dates back to the early days of auditing: see, eg, *In re London and General Bank (No 2)* **[8.01]** (liability for a dividend voted by shareholders on the basis of misleading accounts on which the auditors failed adequately to report) and *In re Thomas Gerrard & Son Ltd* **[8.03]** (liability for dividends voted and tax liabilities incurred on the basis of accounts containing fraudulent inflation of the company's profits by Mr Croston, its managing director and holder of 18,000 of its shares, which the auditors negligently failed to discover and report on). In the latter case, the auditors argued (somewhat faintly), that Mr Croston knew and was not misled about the true position and that the payment of the dividends and tax flowed from his or the directors' actions … Pennycuick J gave short shrift to the argument …

243 In *Galoo Ltd v Bright Grahame Murray* [1994] 1 WLR 1360 auditors were allegedly negligent in failing to detect fraudulent overvaluation of Galoo Ltd's stock by Mr Sanders, who was clearly the directing mind of

Galoo Ltd and its 100% parent. The claim was that, but for such negligence, both companies would have been wound up in 1986 instead of in 1993 and would have avoided losses made in subsequent adverse trading in that eight-year period. The claim was rejected on grounds of causation (the losses were caused by the subsequent adverse trading, and the 'but for' link to the auditors' negligence was insufficient). There was no suggestion that Mr Sanders' knowledge of or involvement in the fraud could defeat it.

244 More recently, in *Sasea Finance Ltd v KPMG (formerly KPMG Peat Marwick McLintock)* [2000] 1 All ER 676, the auditors were alleged to have failed to report promptly during the audit evidence of impropriety by two dominant figures in the group (neither however then a director). The auditors argued that it would have been no use to report to senior management consisting of the two dominant figures. In response, the Court of Appeal noted that there were six directors of whom no criticism was made and, in any event, that the Auditing Guidelines of the Institute of Chartered Accountants (Feb 1990 ed)

> 'acknowledge that there may be occasions when it is necessary for an auditor to report directly to a third party without the knowledge or consent of the management. Such would be the case if the auditor suspects that management may be involved in, or is condoning, fraud or other irregularities and such would be occasions when the duty to report overrides the duty of confidentiality.'

The Court of Appeal cannot have thought such a duty in shareholders' interests would only exist if senior management *below* the level of the company's directing mind or board were complicit in the fraud.

245 It is in principle therefore no answer to an auditor who has failed to discover fraud to point to involvement or knowledge on the part of the company's directing mind. This conclusion is justified on grounds paralleling those applicable between the company and its directing mind … That is not surprising, since both senior management and auditors owe duties to the company intended to protect shareholders' interests, and such duties must be enforceable. The two sets of relationship are essentially complementary, although the duty is in one case primary and in the other confirmatory. **(p. 477)** However the present scheme of fraud is categorised, it cannot in the context of the audit engagement be attributed to the company itself, so as to relieve the auditors from their duty or prevent the company complaining of its breach. Again, this is so as a matter of general principle having regard to the nature of the roles and duties undertaken. Again, however, it can be supported by reference to the *Hampshire Land* principle, which, in this context also, means that the interests and activities of S & R and of Mr Stojevic must be distinguished, precisely because it was among Moore Stephens's functions as auditor to ensure to the former a degree of protection against the latter. …

The auditor's position where some of the shareholders have engaged in fraud

249 Fraud of the company's directing mind is as such, therefore, no bar to a claim by the company against its auditor for loss sustained by the company due to negligent failure to detect such fraud: paras 241–247 above. It cannot in principle make any difference if (as will very commonly be the case) the same person owns some shares in the company. As a matter of basic company law, the company's separate legal personality entitles it to claim, and the situation mentioned by Lord Hoffmann in the *Meridian* case … in which it is legitimate to look behind the veil at the shareholders, applies only when *all* the shareholders in a solvent company concur in committing the company to some decision within its memorandum of association.

250 Lord Phillips expresses the view (para 61) that the position 'becomes unclear … if some of the shareholders were complicit in the directing mind and will's misconduct' because of the possibility of 'the fraudulent shareholders profiting from their dishonesty'. Self-evidently this focuses only on the presently irrelevant situation of a solvent company. But even in a situation of solvency, I consider that the doubt expressed by Lord Phillips about the company's right of recovery conflicts with the principle precluding the lifting of the corporate veil. In reality, it would, if accepted, transform the law regarding auditors' responsibility, since in many cases fraudulent management own some shares.

251 The concern behind the doubt is that auditors might be liable to the company in amounts which would then enure to the benefit of guilty shareholders. This is however an insubstantial spectre, whether or not the company is insolvent. In cases of insolvency … there is commonly no conceivable prospect of any shareholder benefiting by any recovery, however large, made against a negligent auditor. A claim against auditors will not in practice reimburse the company for all its loss, because the very basis of the claim will be that future loss was caused by failure on one or more audits to detect a continuing scheme of fraud which will *already* have caused past loss. This is quite apart from the fact that auditors' negligence cases are commonly compromised before trial. Further, if a guilty shareholder is identifiable and has current assets, the company will often look first to them and any recovery from the auditor will be reduced accordingly … And, if this does not happen, auditors commonly join fraudulent directors and others as third party defendants, and take steps to freeze any assets that they may have.

252 Nevertheless, it is appropriate to give some further consideration to the position of a solvent company (or a company which would be rendered solvent if it recovered damages from its auditors), on the remote hypothesis that, if it were to recover in full, then shareholders who had already benefited by or were involved in the wrongdoing might benefit by an increase in value of the company. A similar spectre of double recovery may be summoned in respect of the recovery from negligent auditors of dividends which a company has wrongly paid out to shareholders on the faith of fraudulent accounts. In that situation, the shareholders may either be entirely innocent or may include shareholders aware of the accounts' falsity. The spectre of double recovery was thus raised, briefly and unsuccessfully, as an objection to the recovery of damages against negligent auditors in *In re Thomas Gerrard* [1968] Ch 455. Counsel submitted that it would be 'monstrous for the shareholders to receive again what they had already received in excess dividends' (p 469f). Pennycuick J's response was simply that the auditors were 'of course entitled to credit for the account [sic] recovered from Mr Croston' (p 478g). As stated above, Mr Croston was not only the managing director, but also a significant shareholder. However, the company was in liquidation, so that the factual basis **(p. 478)** for counsel's submission that the shareholders might 'receive again what they had already received in excess dividends' is also unclear.

253 The whole topic was however comprehensively revisited by Giles J in the Supreme Court of New South Wales in *Segenhoe Ltd v Akins* (1990) 1 ACSR 691 where he held that it did not matter whether the company paying the dividend was solvent rather than insolvent. In either case the company as a separate entity was out of pocket to the extent of the money paid away. To prevent recovery by the company because the money was paid to shareholders rather than to a third party 'would negate the company's status as a legal entity separate from its shareholders' and in any event, even if the shareholders remained the same, they would not necessarily be paid twice over. Giles J's full reasoning at pp 701–702 repays reading. The only contrary suggestion in any authority appears to consist of a single dictum of Cotton LJ in *In re Exchange Banking Co (Flitcroft's Case)* (1882) 21 Ch D 519 [which he then explained in a way consistent with the analysis being advanced]. …

254 I turn now to situations where the loss consists not of dividends paid out to shareholders, but of other payments fraudulently extracted from the company. In these situations, by definition, the only shareholders, who might conceivably benefit twice over if a company were able to recover such losses from wrongdoers such as its directors or auditor, would be shareholders participating in the fraud. Again, the issue would only arise in a case where (unlike the present) the company was solvent or (improbably) would be made so by recovery from its directors or auditor. In my view, English law would find, as some American courts have found, a way of addressing this issue, even though it may be a different way. … I also believe that would be so. The common law is not so barren as to be unable to achieve in this area what Lord Goff of Chieveley once described in another context as 'practical justice'.

255 One approach that could not, with respect, be adopted is that suggested by my noble and learned friend, Lord Brown, in his judgment at para 203. That paragraph ignores separate corporate personality when it refers to 'a claim against the auditors [which] may well lie (through the company) at their [ie innocent shareholders'] suit'. A company (all the more so when in insolvent litigation) sues in its own right, not for or at the suit of its shareholders. I am also aware of no 'policies and principles', generally understood or not, which might limit a company's recovery for a wrong done to it by reference to whatever

loss its innocent shareholders might, if the corporate veil were lifted, be said themselves to have suffered. The suggestion that this could be the measure of a company's recovery again ignores the company's separate legal identity and interests. Suppose senior management own 50% of the shares, and are operating a scheme of fraud which the auditor should have detected at the end of year 1, and that fraud costs the company £1m in year 2. Why should it matter whether, but for the £1m abstraction in year 2, shareholders' equity would or would not have increased in value? What if the £1m abstraction imperils the company or renders it insolvent? The company has suffered a loss of £1m, and is entitled to recover this for its own purposes including payment of its debts. The only qualification on full recovery that might, theoretically, exist in a solvent situation (other than those inherent in conventional contractual and tortious principles of causation and remoteness) is one tailored to ensuring that no guilty shareholder actually benefits, and this could be achieved, if it were ever to be a real concern …

The auditor's position where all the shareholders have engaged in fraud

256 The issue which is, or should be, critical to this appeal arises where the person(s) responsible for the scheme of fraud own *all* the company's shares. The auditor is there to check on management and report to shareholders. But the shareholders know the true position. In a situation of solvency, the straightforward analysis is that there is nothing to report, no-one to complain and no loss. It might also be questioned whether there is any breach of duty, at least in tort and perhaps also in contract, in failing to report to persons who already know; however, this may overlook the fact that the negligent auditor will by definition not know that the shareholders do know, and it also needs to be considered in the light of the auditor's statutory role and the duties, here largely express, which an auditor undertakes. More pertinently, 'so long as the company is solvent the shareholders are in **(p. 479)** substance the company' (para 235), and the company cannot therefore say that it was ignorant or misled or suffered loss.

257 Two cases illustrate the application of this straightforward analysis to companies solvent at the audit date. In *Pendleburys Ltd v Ellis Green & Co* (1936) 181 LT 410 a company claimed against its auditor loss caused by its cashier's defalcations. It sought to attribute such loss to the auditor's failure, when reporting on the accounts, to disclose weaknesses in the company's book-keeping systems arising from the absence of certain books and internal checks. The company's only three directors were its sole shareholders and debenture-holders, and the auditor had reported the weaknesses to them from time to time. Swift J in dismissing the claim observed that the defendants had made their reports to the three men who had 'every pecuniary interest in the company', and that, 'although they, as auditors, were there to protect the shareholders it could not seriously be said that the shareholders did not receive the information and protection which the law desired should be secured to them' (p 411). The reference to the directors as having 'every pecuniary interest in the company' and the absence in the report of any contrary suggestion indicate that the company remained solvent at all times.

258 The second case is Hobhouse J's decision in *Berg* [2002] Lloyd's Rep PN 41. Berg & Co was solvent at the date of the relevant 1982 audit. (It became insolvent some years later by reason of a trading debt incurred in 1984.) The negligence it alleged against its former auditors related to a receivable of £2.39m shown in the 1982 accounts as due from a company called Gimco, in respect of which the auditors had simply accepted the uncorroborated and unsupported assurances of Gimco and Mr Golechha, Berg & Co's sole active director and ultimate beneficial owner. At p 44 Hobhouse J pointed out that, although Berg & Co was a separate and distinct legal entity, Mr Golechha was its directing mind, his knowledge was the company's and 'There was never any general body of shareholders nor any minority shareholders. In addressing their certificate to "the members" of Berg, [the auditors] were for all practical purposes addressing it to Mr Golechha alone'. Applying *Caparo* he said, at p 53:

> 'the purpose of the statutory audit is to provide a mechanism to enable those having a proprietary interest in the company or being concerned with its management or control to have access to accurate financial information about the company. Provided that those persons have that information, the statutory purpose is exhausted. What those persons do with the information is a matter for them and falls outside the scope of the statutory purpose. In the present case the first

> plaintiffs [the company] have based their case not upon any lack of information on the part of Mr Golechha but rather upon the opportunity that the possession of the auditor's certificate is said to have given for the company to continue to carry on business and to borrow money from third parties. Such matters do not fall within the scope of the duty of the statutory auditor.' …

260 The company argued in *Berg* [2002] Lloyd's Rep PN 41 that the *Hampshire Land* principle precluded the attribution to it of Mr Golechha's knowledge. The argument failed in limine (because it was not shown that Mr Golechha was guilty of any fraud on the audit or towards the company), but Hobhouse J, at p 54, also addressed the position as it would have been had there been any fraud:

> 'However one identifies the company, whether it is the head management, or the company in general meeting, it was not misled and no fraud was practised upon it. This is a simple and unsurprising consequence of the fact that every physical manifestation of the company Berg was Mr Golechha himself. Any company must in the last resort, if it is to allege that it was fraudulently misled, be able to point to some natural person who was misled by the fraud. That the plaintiffs cannot do.'

In the result, the company was entitled only to nominal damages for the technical breach of contract involved in the failure to qualify the audit report. Hobhouse J's words must be taken in context. The company was solvent at the relevant dates. There was no-one but Mr Golechha to think or act for or be interested in it. …

(p. 480) 262 Moore Stephens argue, and I understand the majority of your Lordships to consider, that this appeal is covered by the same analysis [as found in US cases]. In short, Mr Stojevic was S & R's sole directing mind and its sole beneficial owner; and the company cannot in consequence complain that it succeeded in deceiving Moore Stephens and was in consequence not stopped by others (regulatory or investigating authorities) from pursuing its scheme of fraud. Such a conclusion could be explained in various ways: the auditor's duty did not extend to supplying information which all persons who can represent the company already have; or whistle-blowing on S & R was and is outside the statutory purpose of the audit as between the company and the auditor; or the principle *ex turpi causa*applies. Which way was adopted would be presently immaterial. …

267 The decisions in *Caparo* **[8.04]** 605 and *Al Saudi Banque* [1990] Ch 313 establish that auditors' duties are normally limited to the protection of the company's interests for the benefit of its shareholders. …

268 Other than in special situations, therefore, auditors owe no direct duties towards third parties. But none of the above cases addresses the present situation of a claim by the *company* against its auditors for failure to pick up a fraudulent scheme rendering it increasingly insolvent. But in *Caparo*, both Lord Bridge and Lord Oliver recognised the company's standing to bring claims for loss which it has suffered by its officers' fraud (see para 214 above); and, further, Lord Oliver described an auditor's duty as being, first of all, 'to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing', before identifying a second duty 'to provide shareholders with reliable intelligence' (para 214 above).

269 In my opinion it is in no way inconsistent with *Caparo* … to hold auditors responsible to the company they audit in the present circumstances. I underline four points in this connection. First, the concern about indefinite exposure to third parties does not exist in the context of a claim by the company. S & R's claim is to recover its own (not its creditors') loss by reason of the continuing scheme of fraud. Loss to the company is not the same as loss to its creditors, although there may or may not be an overlap. An insolvent company may by fraud raise £1m from bank A which it uses in a Ponzi type scheme to pay off a borrowing from bank B. Bank A is £1m worse off, and bank B £1m better off. But the company itself is no worse off from the continuing fraud. It is liable to pay bank A £1m, but it has benefited by £1m by paying off bank B using bank A's £1m. Of course if (as here) it raises £1m by fraud and pays only £500,000 to bank B and if its directing mind makes off with the other £500,000, then the company is £500,000 worse off due

to the continuation of the fraud, but that is and remains its own loss. Secondly, S & R's claim is for precisely the same loss as a company with some shareholders innocent of involvement in top management's fraud would be entitled to claim from negligent auditors who had failed to detect and report the fraud (paras 249–255 above). Thirdly, it cannot be suggested that the care to be expected of Moore Stephens as auditors varied according to whether all of S & R's shares happened to be owned and/or controlled by Mr Stojevic. Their express contractual duty was under auditing standard SAS 110.10 and 110.12 to report to a proper authority without delay where suspected or actual fraud cast doubt on the integrity of directors. This duty in fact exists under SAS 110 irrespective of whether there are or are not independent shareholders of integrity. Auditors would not in any event necessarily have any idea whether any such shareholders exist.

270 Fourthly, quite apart from the express provisions of auditing standard SAS 110, a situation of insolvency introduces new considerations for reasons previously explained. The identity of interest which normally exists between a company and its shareholders ceases, and the duties of auditors, like those of directors, must recognise this. The company as a legal personality continues and the auditors' duty continues to be, in Lord Oliver's words in *Caparo* (p 630), 'to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing'. If, in Hobhouse J's words in *Berg* [2002] Lloyd's Rep PN 41, 55, 'those in charge of the affairs of a company or in control of it are acting contrary to the principles governing insolvency', then the auditors can no longer treat them as representing the company, and must take other action—according to SAS 110 'without informing the directors in advance'.
…

(p. 481) ➢ Questions

1. In *Stone & Rolls*, Lord Walker said, 'Much of the opinion of my noble and learned friend, Lord Mance, seems to me, with great respect, to be seeking to attenuate by indirect means the House's decision in *Caparo*, although we are not invited to depart from it.' Is this accurate?

2. What are the policy reasons in favour and against each of the opposing viewpoints advanced in the House of Lords?

3. Is it simply impossible in the context of a one man company to maintain purist adherence to the doctrine of separate legal personality? Or is the real problem a far more general one: we simply need special rules to deal with fraud and fraudsters?

Promoters and their dealings with the company

The term 'promoter' is not defined in the Companies Act, and such attempts at definition as have been made by the courts (mainly in the nineteenth century) seem to have been concerned only to ensure that enough flexibility was retained to catch the next ingenious rogue which the pre-incorporation period might produce. The best known of these is the description given by Cockburn CJ in *Twycross v Grant* (1877) 2 CPD 469 at 541: 'one who undertakes to form a company with reference to a given project, and to set it going, and who takes the necessary steps to accomplish that purpose'.

There is an enormous body of old case law concerned with the obligations of promoters towards the companies which they form and the investing public whose capital they seek to attract. But to all intents and purposes this law has become obsolete. This is due partly to changes in the practice of marketing securities: it is unusual for a newly formed company to make an initial public issue, and not normally possible to obtain a market listing, without an established trading record. It is also due to the stringent control of such activities now imposed by statute and by the Listing Rules (which must be complied with in order to gain access to the Stock Exchange)[14] and the professional codes of issuing houses and others whose services are nowadays essential.