

# Commercial Briefing

## Anthropomorphism and attribution; carousel fraud and the illegality defence (part 2)

*The author considers company fraud and the illegality defence in light of Bilta (UK) Ltd (in liquidation) v Nazir (No 2) [2015] 2 WLR 1168.*



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# Anthropomorphism and attribution; carousel fraud and the illegality defence (part 2)

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*In the second part of this article, the author considers *Bilta (UK) Ltd (in liquidation) v Nazir (No 2)* [2015] 2 WLR 1168 in the High Court, the Court of Appeal and the Supreme Court.*

## ***Bilta* in the High Court**

Jetivia's application for summary dismissal was heard by Sir Andrew Morritt C who, in dismissing it, agreed with Bilta's submissions that *Stone & Rolls* could be distinguished on the ground that Bilta was the victim rather than the villain of the fraud and also that the duties were owed as directors, and not auditors, and extended to the interests of creditors (Companies Act 2006 s.172 read with *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250). At para.32 he accepted the argument that *Stone & Rolls* could be distinguished because, on the pleadings, the conspiracy was aimed at Bilta to denude it of its assets out of which it could satisfy its VAT liability and that Bilta was not a party to or a beneficiary of the conspiracy. In fact, pleading aside, the position of the two companies was indistinguishable. His succinct ground of distinction from *Stone & Rolls* was that the majority decision in that case depended on the fact that the scope of the auditors' duty was restricted to the company and its members because it was a one man company; that *ratio* did not apply to a claim based on a breach of duty the scope of which encompassed persons or interests other than the fraudsters in corporate form, in *Bilta's* case the interests of a company's creditors as the conspiracy to denude the company meant it was or might become insolvent. Without addressing the issues of attribution or *ex turpi causa*, he suggested that either the duty to creditors meant that the company was not a one man company or that the scope of the duty extended to persons not implicated in the fraud and that as a result the illegality defence was not available, which he said was consistent with Lord Mance's view in *Stone & Rolls*. Jetivia appealed.

## ***Bilta* in the Court of Appeal:**

Patten LJ, giving the only speech (with which Lord Dyson MR and Rimer LJ, who had given the majority speech in the Court of Appeal in *Stone & Rolls*, agreed), dismissed the appeal. He set out the director's statutory duty to creditors; as the conspiracy made Bilta insolvent from the moment it entered into the back to back transactions, the duty to consider the interests of creditors was engaged from the start [at para.22]; as a result, *Stone & Rolls* was readily distinguishable because MS owed no



fiduciary duties to S & R or its creditors. He noted that attribution was at the heart of Jetivia's argument that Bilta was relying on its own wrong for the purposes of *ex turpi causa* because the law attributed to Bilta its directors' unlawful conduct and those directors were Bilta's directing mind and will for whose fraud the company was personally responsible.

After noting at para.4 that there were two versions of the conspiracy (Bilta claimed that the object of the conspiracy was to defraud the company whereas Jetivia argued that the intended victim was HMRC which was deprived of VAT), he then resolved the all or nothing victim/villain analogy by distinguishing between proceedings brought against the company by third parties where the company is treated as a villain ('liability cases') and proceedings brought by the company against its agents where 'the position of the company as victim ought to be paramount...the company will itself be seeking compensation...for a breach of the fiduciary duty which the director or agent owes to the company'. As between it and the director, it was the victim and it ought not to matter whether the fraudulent conduct was directed at a third party or the company itself [at para.35].

Jetivia relied on *Stone & Rolls* in arguing primarily that the true and only victim was HMRC in which case the *Belmont* rule, which required the company to be the victim, did not prevent attribution of the directors' fraud to Bilta and, in the alternative, because Bilta was a one man company with no innocent and independent directors or shareholders who would be prejudiced by the company's inability to recover compensation for the directors' fraud (the 'sole actor exception' per Lord Walker and Lord Brown) [at para.70]. In rejecting the primary submission Patten LJ held that he was bound by the *Belmont* rule to hold that a director even of a one man company could be held liable to account for breaches of fiduciary duty committed against the company [at para.75] while in the context of a claim against the directors for breach of fiduciary duty the company was the victim regardless of whether its loss was consequential on that of a third party [at para.77].

He rejected the alternative 'one man company' submission and said that it had no place in English law in the context of a company's claim against fraudulent directors since it would directly contradict the protection given to creditors by s.172 of the 2006 Act. He also said that he was not bound by *Stone v Rolls* to apply the sole actor exception because there was a significant difference between an auditor's liability for failing to notify the company and a conspiracy against the company by its directors [at para.81]. Jetivia appealed again.

### ***Bilta* in the Supreme Court**

Lord Neuberger JSC set out the strict *ratio* of the Supreme Court decision; illegality was not a defence to Bilta's claim because the directors' fraudulent conduct could not



be attributed to *Bilta* [at para.6]. The route to that *ratio* is less straightforward. Lord Neuberger JSC (with whom Lord Clarke and Lord Carnwath JJSC agreed), Lord Mance JSC (who substantially agreed with Lord Neuberger JSC), Lord Sumption JSC and Lords Toulson (who as a first instance judge had dealt with the banks' claim against Stone & Rolls Ltd) and Hodge JJSC all handed down judgments. Lords Neuberger and Mance JJSC's judgments were relatively short. Lord Sumption JSC and Lords Toulson and Hodge JJSC considered attribution and the illegality defence at some length although on attribution they generally adopted Lord Hoffmann's approach in *Meridian Global Funds* (para.7). Disagreement between Lord Sumption JSC on the one hand and Lord Toulson and Lord Hodge JJSC on the other on the illegality defence and policy and on *Stone & Rolls*, as well as Lord Neuberger JSC's observations on those disagreements, makes it risky to suggest a wider *ratio decidendi*.

On attribution, Lord Neuberger JSC emphasised the common ground between Lord Sumption JSC and Lords Toulson and Hodge JJSC; in his view they said in effect the same, namely that where a company had been the victim of wrongdoing by its

directors, or of which its directors had notice, then the wrongdoing, or knowledge, of the directors could not 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 [at para.7]. He did not side with either Lord Sumption JSC or Lords Hodge and Toulson JJSC but agreed with Lord Mance JSC that the question of whether or not it was appropriate to attribute an action by, or a state of mind of, a company director or agent to the company or agent's principal in relation to a particular claim against the company or principal must depend on the nature and factual context of the claim in question [at para.9].

He noted three areas of disagreement between Lord Sumption JSC and Lords Toulson and Hodge JJSC: (i) the proper approach to the illegality defence; (ii) the role of statutory policy; and (iii) the proper interpretation of *Stone & Rolls*. On (i), although he accepted that Lord Sumption JSC was right that the law was not as flexible as Lords Toulson and Hodge JJSC suggested, in his view the Court should only address the 'difficult and controversial topic' after full argument since *Bilta* was concerned with attribution. On (ii) he noted that Lords Toulson and Hodge JJSC would dismiss the appeal on the grounds of statutory policy (in this case the need to enforce the statutory duty to consider creditors' interests) but in his view it was unnecessary to decide the right approach even in order to determine whether the illegality defence could be run in relation to that statutory duty because attribution already provided the answer.

On (iii) he noted three propositions which Lord Sumption JSC considered could be derived from the decision. In keeping with *Stone & Rolls*' trademark confusion, he disagreed with the first but agreed with the second and third 'although even the second and third propositions are supported by only three of the judgments at least one of which is by no means in harmony with the other two' [at para.25]. He did not agree that the first proposition, that the illegality defence was available against a company only where it was directly as opposed to vicariously responsible, could be derived from *Stone & Rolls* even if it was correct in law. He considered the second proposition, that the fraud of the directing mind and will would not be attributed to the company where there were innocent shareholders, to be well founded. The third proposition, that a third party could raise the illegality defence against a one man company, was subject to Lord Mance's qualification where the company was in or near insolvency. He then said that it was not in the interests of the future clarity of the law for the decision to be treated as authoritative except as he had outlined [at para.31].

The only Justice of the Supreme Court who also sat as a Law Lord in *Stone & Rolls*, Lord Mance JSC agreed substantially with Lord Neuberger JSC. For him the issue was whether a company could pursue its directors and sole shareholder for breaches of duty towards the company depriving it of its assets [at para.35]. He noted that for Lords Toulson and Hodge JSC the straightforward answer was that the directors' duties to the company would be deprived of all content if the illegality defence was available; if analysed in terms of attribution, the shareholder/directors' state of mind should not be attributed to the company. He did not examine their preference for a policy based approach to illegality but noted that Lord Sumption JSC, by contrast, considered that attribution (to the company of the acts and state of its directing mind and will) applied regardless of the nature of the claim or the parties involved, subject to a 'breach of duty' exception to avoid injustice and absurdity. Lord Mance disagreed because it would 'unjust and absurd' to attribute to the company the very misconduct by which the director had damaged it, even though the 'breach of duty' exception meant that the outcome would be the same [at para.37]. Lord Sumption JSC in fact described the breach of duty exception as no more than a valuable tool of analysis which illustrated the rule that attribution of legal responsibility for the act of an agent depended on the purpose for which attribution was relevant [at para.92].

In relation to companies, Lord Mance JSC considered that rules of attribution faced a problem because companies were artificial constructs and could only act through natural persons. It 'has no actual mind, despite the law's persistent anthropomorphism' ('brain and nerve centre' or 'hands') [at para.39]. He approved Lord Hoffmann in *Meridian Global Funds* that the key to any question of attribution was the context and purpose: 'whose act or knowledge or state of mind is for the purpose of the relevant rule to count as the act, knowledge or state of mind of the

company’ [at para.41]. Although he did not refer specifically to Patten LJ’s ‘victim and villain’ analysis in the Court of Appeal, he said that the company could rely on attribution for one purpose (to establish liability to third parties) and disclaim it for another (separating the acts, knowledge and state of mind of the fraudulent director from that of the company in order to enforce the director’s duties) [at para.43]. He endorsed *Bowstead & Reynolds on Agency* (20th Ed, at para.8–213) that knowledge of the agent’s breach of duty had never been imputed to the principal since there was no purpose for deeming the principal to know what the agent knew of the latter’s breach of duty.

Lord Mance JSC did ‘not propose to say very much’ about *Stone & Rolls*. He re-emphasised his own view that the central issue in the case ought to have been the scope of the auditor’s duty and the classes of innocent parties whose interests the contract of audit was designed to protect rather than *ex turpi causa*. In relation to the three propositions which Lord Sumption JSC drew from *Stone & Rolls* he agreed with Lord Neuberger JSC although the correctness in law of the third proposition ‘may one day fall for reconsideration’ [at para.50].

The most substantial judgments came from Lord Sumption JSC and from Lords Toulson and Hodge JJSC. In common they identified three situations where attribution might arise at paras 87–92 and 204–209: (i) where a third party was pursuing a claim against the company arising from the misconduct of a director, attribution would fix the company with the state of mind of the director for the purposes of the company’s liability; (ii) where the company was pursuing a claim against a director for breach of duty, the director’s knowledge was not to be attributed to the company to defeat its claim; (iii) where the company was pursuing a claim against a third party, whether or not there was attribution depended on the nature and context of the claim, although Lord Sumption JSC identified *Stone & Rolls* as an example of attribution to prevent an innocent but negligent third party being sued for failing to prevent a director defrauding the company.

The main issue for Lord Sumption was the scope of the rule of public policy *ex turpi causa* [at para.55]. Since there was no dispute that the claim was founded on the criminal and dishonest VAT fraud, the only question was whether that fraud, which engaged the illegality defence, was to be attributed to Bilta in order to defeat its claim against the fraudulent directors. He approved the conclusion of the courts below that an agent was not entitled to attribute his own dishonesty to the company to give himself immunity from the ordinary legal consequences of his breach of duty [at para.64]. In his analysis of why that was correct he said that identifying the persons who were so far identified with the company that their state of mind would be attributed to it did not admit of a single answer; the ‘special insight’ of Lord Hoffmann in *Meridian Global Funds* was that the attribution of the state of mind of an agent to a

corporate principal might also be appropriate where the agent was the directing mind and will for a particular function without being the directing mind for other functions [at para.67]. Although criticised as a distraction or an artificial anthropomorphism, the concept of a 'directing mind and will' was valuable in describing a person who could be identified with the company for the purposes of personal or direct, rather than vicarious, liability; the latter did not involve any attribution of wrongdoing to the principal but was a rule of law holding the principal strictly liable for the agent's wrongdoing in the course of his employment.

Although *Stone & Rolls* was a difficult case to analyse [at para.79], in Lord Sumption JSC's view it was authority for three points on which Lords Brown, Phillips and Walker were agreed (see above): (i) the illegality defence was available against a company only where it was directly rather than vicariously liable (Lords Neuberger and Mance JJSC disagreed); (ii) the dishonesty of a directing mind and will would not necessarily be attributed to a company to bar a claim where there were innocent directors or shareholder; (iii) as between a "one man" company (i.e., whether there was more than one controller, there were no innocent controllers or directors) and a third party, the latter could raise the illegality defence on account of the agent's dishonesty where it was not itself involved in the dishonesty. He said that the difference of opinion between Lords Phillips and Walker on why the illegality defence could be taken against a one man company made it difficult to treat *Stone & Rolls* as authority beyond those three points; Lord Walker had adopted the 'sole actor' exception while Lord Phillips considered that S was the entire constituency whose interests the auditors had a duty to protect so his knowledge could be attributed to S & R; in addition, his view that the purpose of an audit report was not to protect the interests of current or prospective creditors was 'peculiarly his own' [at para.81].

Lord Sumption JSC distinguished between basic rules of attribution, which might apply regardless of the nature of the claim or the parties involved, and the breach of duty exception which did not; it reflected the fact that rules of attribution derived from agency whereas the breach of duty exception and the illegality defence which it qualified were rules of public policy. He saw a fundamental difference between an agent relying on his own dishonest performance to defeat a claim by his principal for his breach of duty (*Bilta*) and a third party not privy to the fraud but sued for negligently failing to prevent the principal from committing it (*Stone & Rolls*) [at para.86]. Where the directors stole from the company the law did not attribute the agent's fraudulent knowledge to the company, whether the company was one man or not, because the objection to the attribution of the culpable director's state of mind to the company was that they were being sued for abusing their powers; it was the same objection whether they were one, some or all of the directors and whether or not they were the shareholders [at para.91]. He considered this reasoning to correspond substantially with that of Patten LJ and with Lords Toulson and Hodge

JJSC's judgment on attribution.

However, Lord Sumption JSC was unwilling to follow Lords Toulson and Hodge JJSC down the route that the application of the illegality defence was inconsistent with a statutory policy requiring directors to have regard to the interests of the creditors of an insolvent or prospectively insolvent company [at para.98]. In his view it did not follow that the public policy in the duty of directors to have regard to the interests of creditors required the imposition of civil liability notwithstanding the illegality defence because the members of the company could give authority for an act which would otherwise be a breach of duty and the liquidator had powers to give effect to the duties via a misfeasance action. In addition, the case was about attribution and the policy argument focused too narrowly on the status of the defendants as directors and the particular way in which Bilta was insolvent. Since it was perfectly clear that the illegality defence would fail even if the defendants had not been directors but agents who were the directing mind and will for that particular purpose, and if the company was solvent, he was unwilling to decide the case on a basis which invited distinctions between different situations which were irrelevant to the principle applied. He agreed with Lords Toulson and Hodge JJSC that 'Occam's Razor is a valuable analytical tool, but only if it is correctly understood... Do not gratuitously multiply your postulates' [at para.105].

Like Lord Sumption JSC, Lords Toulson and Hodge JJSC noted the principal issues as the purpose of *ex turpi causa* and its application to Bilta's claim and attribution of the knowledge of directors to a company [at para.120]. However, having emphasised the nature of the directors' duties to Bilta, and in particular the fiduciary duty where the company was insolvent or bordering on insolvency to have proper regard for the interests of creditors and prospective creditors, they stated that the protection afforded to creditors was enforced by the liquidators' action to recover for the creditors' benefit the loss caused to the company. If that action was barred by illegality because the errant directors were in sole control of the company then the law 'would truly deserve Mr Bumble's epithet — "a ass a idiot" since it would make a nonsense of the directors' duty to act in good faith with proper regard to creditors' interests' [at para.128]. It would be contrary to the public interest underlying the directors' fiduciary duty to protect creditors' interests if their control of the company provided a means for them for them to be let off the hook because their illegality tainted the liquidators' claim [at para.130]. The appeal could be decided by the simple and central point that the defence of illegality would undermine the rule of law which existed for the protection of creditors; there was no need to get into the subject of attribution [at para.131]. The real issue in the case was not attribution but whether it was contrary to public policy that Bilta, through the liquidators, should enforce for the benefit of its creditors the duty which the directors owed for the protection of the creditors' interests as part of their fiduciary duty to the company. That depended on

whether the scope of the duty extended to protecting the interests of those for whose benefit the claim was brought [at para.166].

They rejected Jetivia's argument, based on *Stone & Rolls*, that Bilta's claim was barred by the illegality doctrine because it was a 'one man' company' which engaged in deliberate fraud on the ground that it was plainly distinguishable; Bilta's directors, unlike the auditors, owed duties for the protection of the interests of creditors [at para.136]. They also rejected the 'false premise' that Bilta's role (victim or villain) had to be characterised in the same way when considering Bilta's liability to third parties and Bilta's rights to enforce its directors' duties. However, they went further by endeavouring 'to apply Occam's razor in concentrating on the critical features' of *Stone & Rolls*; the fact that auditors owed no duty for the benefit of those for whose benefit the claim was brought and the inability of the company to show that anyone who had any part in the ownership or management of the company was misled by the auditors' negligence [at para.151]. In their view, it was not the illegality which drove that conclusion although they accepted that Lord Sumption JSC analysed the case differently.

Lords Toulson and Hodge JJSC dealt with attribution, even though it was not the issue, because it had caused 'a fair amount of confusion'. After analysing the three contexts in which knowledge was attributed to a company (see above) they agreed with Patten LJ that as between the company and the defrauded third party the company should be treated as the perpetrator of the fraud but defaulting directors should not be able to rely on their own breach of duty to defeat the operation of Companies Act provisions intended to protect the company. Even were illegality insensitive to context and competing aspects of public policy, attribution would achieve the same result and preserve Bilta's claim [at paras 208–209].

## Conclusion

Inevitably, this review of a Supreme Court decision of *Bilta's* complexity will fail to do justice to all the arguments raised. The question of the scope of statutory policy in the illegality defence has been reserved for another day with Lord Mance JSC suggesting at para.15 that it needed to be addressed by a panel of seven or conceivably nine Justices, although increasing the number of Justices is no guarantee of unanimity. Another unanswered question is whether, if *Stone & Rolls* was about the scope of the auditor's duty rather than attribution, Lord Mance JSC's more robust approach to that scope of duty will result in the boundaries of *Caparo* being redrawn against the interests of auditors. It might be premature to put *Stone & Rolls* on that 'not to be looked at again' pile.