Briefing

BURGES SALMON

Dispute Resolution

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When can a company sue its directors for their illegal acts?

The Supreme Court has confirmed in *Jetivia v Bilta* that where a company brings a claim against its directors for losses caused by their wrongdoing, the directors cannot escape the claim by arguing that their actions are attributed to the company itself.

The Supreme Court also held that s.213 of the Insolvency Act, (which permits the Court to take action against those who have conducted the business of a company in order to defraud creditors) was not jurisdictionally confined and applied to people and companies resident outside the UK.

This result may be seen as an 'as expected' result on the issue of attribution of the knowledge of company directors and the application of s.213, which will come as welcome news to those involved in corporate recovery, such as fraud and insolvency practitioners.

However, the judgment demonstrates that greater clarity is required over the law surrounding the *ex turpi causa* defence (or illegality defence), which professional advisors often look to when their corporate clients become embroiled in fraudulent activity.

An unusual case

Jetivia v Bilta was an unusual case. Bilta was a UK company that had two directors, one of whom owned all of Bilta's shares. Jetivia was a Swiss company that had entered into transactions with Bilta concerning European Emissions Trading Scheme Allowances. Bilta accused its two directors, Jetivia and its chief executive of conspiring to use Bilta as a vehicle to perpetrate a VAT carousel fraud (essentially, this involved requiring HMRC to pay input VAT to Jetivia but Bilta would never account for its obligation to pay HMRC the output VAT).

In particular, a central part of Bilta's claim was that its directors had acted in breach of their duties by being party to the conspiracy and that Jetivia had dishonestly assisted those breaches.

Jetivia argued that Bilta's claims could not succeed because:

- the knowledge and actions of its directors that constituted the alleged breaches of duty should be attributed to Bilta on the basis that the directors were its agents; and
- as those acts were illegal in nature, once attributed to Bilta it should not be able to rely on them as the foundation of a claim against Jetivia *(ex turpi causa non oritor actio)*.

Jetivia also argued that Bilta could not bring a claim under s.213 of the Insolvency Act on the basis that it did not have any effect outside the UK (Jetivia being based in Switzerland).

s.213 of the Insolvency Act

The Supreme Court flatly, and without much deliberation, rejected this proposition and held that the English courts are permitted to exercise the jurisdiction granted by s.213 on individuals and companies resident outside of the UK.

Given the lack of clarity surrounding the issues of attribution and the illegality defence (discussed below), the decision on the extra-territorial effect of s.213 is the most useful part aspect of the Supreme Court's decision. But the decision is unlikely to come as a surprise to many given that it has been long established that the similar power under s.238 of the Insolvency Act (relating to preferences and transactions at an undervalue) was held to have extra-territorial effect over 20 years ago.

Attribution

The attribution of the knowledge and actions of directors to their principal company is a complex area. It is a well-established principle that a company, which has no physical existence itself, has to act through its agents – i.e. its directors and its employees and, therefore, will be taken to have their knowledge and committed their acts. So where a director signs a contract on behalf of its employer company (absent unusual circumstances) that will be taken to be the act of the company and it will be bound to the contract.

Almost equally as well-established as the principle of attribution between directors and companies is the exception to the general rule – often called the '*Hampshire Land* principle' or the 'fraud exception' (albeit that the principle is not restricted to instances of fraud).

In the present case the directors' knowledge and acts were clear breaches of the duties they owed Bilta that arose out of the agency relationship directors share with their principal company. What was more, those duties had been wilfully breached by the directors in order to injure Bilta itself, the very person to whom those duties were owed.

In those circumstances it would be paradoxical to allow the directors to rely on the nature of their relationship with Bilta in order to escape liability for abusing that relationship. As a result, this was not a case where the directors' knowledge could be attributed to the company.

While this is a welcome, and undoubtedly correct, result, the Supreme Court appears to have avoided laying down any general principles for how and when there will be an exception to the attribution rule

Ex turpi causa – the illegality defence

The *ex turpi causa* principle, in essence, provides that a claimant cannot succeed on a claim that requires him to rely on his own illegal acts (the "illegality defence"). This has long been an opaque area of law, which became murkier still following the House of Lords decision in *Stone & Rolls v Moore Stephens*. In that case a firm of accountants raised the defence to a claim for failing to prevent the claimant, 'one shareholder, one director' company from perpetrating a massive fraud on a bank.

The Supreme Court discussed *Stone & Rolls* and the law on the illegality defence in great detail but were unable to reach a conclusion as to where the law now stands. The most that was achieved appears to be: (i) a warning that the decision in *Stone & Rolls* should effectively be shelved and not treated as authority in future cases; and (ii) that the law of the illegality defence needs to be clarified by the Supreme Court as soon as possible.

Clarity in this area would be welcomed by insolvency practitioners, auditors, accountants, solicitors and many others as, following *Stone & Rolls*, it has become an increasingly popular defence, occasionally in quite unexpected contexts.

In recent times it has been raised, with varying degrees of success, as a defence based on: (i) contracts effecting human trafficking[1]; (ii) breaches of intellectual property rights[2]; and (iii) anti-competitive activity[3]. But there is still no clear statement of how and when the defence will arise.

Public Policy

Although no decision was made on the extent of the illegality defence, the Supreme Court did appear to agree that as a matter of public policy the defence should never be available to directors accused of breaching the statutory duties they owe to shareholders and (in an insolvency situation) creditors. The very purpose of those duties is to give shareholders or creditors (through the company of its liquidator) some form of recourse against directors who have committed wrongdoing that has caused the company loss.

However, as the Supreme Court decided the case on the basis of no attribution, it did not reach a binding decision on this issue.

Conclusion

With numerous cases raising the illegality defence in increasingly inventive ways it is hoped that this issue will reach the Supreme Court sooner rather than later and some clarity can be brought to the issue.

No doubt any future cases that raise the issue will be keen closely followed.

[1] Hounga v Allen, [2] Les Laboratoires Servier v Apotex

[3] Safeways v Twigger and Tesco v MasterCard

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