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ILLEGALITY AND CLAIMS BY COMPANIES

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1. The question of illegality was recently considered by the English Commercial Court in a trial arising out of the Madoff frauds[1]. Popplewell J had to consider what was decided in *Stone & Rolls v. Moore Stephens* ("*S&R*"). He said in passing that that it was "notoriously difficult to extract a ratio from the judgments" of the House of Lords. If anything, that is an understatement. Whatever the merits of the individual judgments in *S&R*, when the decision is considered as a whole, it is not fit for purpose. Five years after the decision, the courts are still struggling to understand what it means. My aim is to offer some practical guidance in negotiating a way through this minefield. What makes this issue so challenging is that it lies at the intersection between two areas of law, each of which itself bristles with complications. One area is illegality; the other is the juridical nature of a company as a legal person.

2. The Cayman courts considered these issues in the years before *S&R*, including a decision of the current Chief Justice in 2007[2], but as far as I am aware there are no reported decisions in Cayman since *S&R*.

3. Illegality is usually traced back to *Everet v. Williams*[3]. This was the famous case of the two highwaymen. The bill (i.e. pleading) euphemistically described them as engaged in the business of dealing "with several gentlemen for divers watches, rings, swords" etc, which they acquired "at a very cheap rate". Everet's complaint was that Williams had failed to account to him for his share of the robberies. Not

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[1] *Madoff Securities International Ltd v. Raven* [2013] EWHC 3147 (Comm) at [306] to [319], Popplewell J.

[2] *Valgarden v. Chestnut* [2007] CILR 375, Smellie CJ.

[3] (1725) reported in (1893) 9 LQR 197.

only did the Court of Exchequer throw out the claim, but it also ordered the arrest of Everet's solicitors for contempt of court in bringing the claim. Judges of the 21st century tend to be more restrained in their disapproval of solicitors, which rarely extends beyond an order for indemnity costs.

4. Fast forward 270 years to *Tinsley v. Milligan*[4], where Lord Goff said that:

> "The principle is not a principle of justice; it is a principle of policy, whose application is indiscriminate and so can lead to unfair consequences as between the parties to litigation. Moreover the principle allows no room for the exercise of any discretion by the court in favour of one party or the other."

5. In that case the CA had sought to refashion the principle as one of justice based on a test of unconscionability. The CA's test was unanimously rejected by the HL but for different reasons. The majority view, stated by Lord Browne-Wilkinson, was that the test was a narrow test based on reliance. A claimant

> "is entitled to recover if he is not forced to plead or rely on the illegality, even if it emerges that the title on which he relied was acquired in the course of carrying through an illegal transaction."[5]

This is an all-or-nothing test which can lead to serious anomalies. The result appears to depend on whether it is necessary to plead the illegal transaction.

6. The minority view was that it was part of the doctrine of "clean hands" in equity. Lord Goff said that if a person hides property in someone else's name in order to conceal his own interest and does so for an illegal purpose, the courts will not allow him to recover his property by asserting his equitable interest. This is also an all-or-nothing test. Once the illegality has crossed the threshold, the claimant is deprived of all benefit, however disproportionate that result might be to the nature of the illegality.

[4] [1994] 1 AC 340, HL.

[5] *Ibid*. at 376E.

7. Thus the result of *Tinsley* was that the "public conscience" test was rejected and the HL by a majority accepted a test based on reliance. However, the waters were muddied by *Gray v. Thames Trains Ltd*[6]. In that case the victim of a serious rail crash suffered post-traumatic stress disorder which led him to commit manslaughter. This led to his being detained in a mental hospital. He claimed damages (inter alia) for loss of earnings. The HL unanimously concluded that his claim was barred by illegality. However, the HL did not apply the reliance principle set out in *Tinsley*. Lord Hoffmann[7] explained that *ex turpi causa* expresses a policy which is based on a group of reasons which vary in different situations. In this case the HL based its decision on a principle of causation, which might be thought to have more in common with Lord Goff's minority view in *Tinsley*. The rule, as stated by Lord Hoffmann in its wider version, is that a claimant may not claim damages for losses which are the consequence of his own criminal act. Unfortunately Lord Hoffmann did not fully explain what he meant by causation. He confined himself to drawing a distinction between something which is the effective cause and something which merely provides the opportunity for the loss in a "but-for" sense. This distinction used to be the basis of causation in professional negligence cases[8] until Lord Hoffmann himself provided a more sophisticated analysis in *SAAMCO*[9]. It is unfortunate that he did not give the same level of guidance in *Gray*.

8. Such was the state of the law when the HL gave judgment in *S&R*. The company was a one-man company controlled by a fraudster, Stojevic. It engaged in fictitious trading, which generated real money advanced by victims of the fraud which was paid to other participants in the fraud. The main victim was a bank which obtained judgment against the company and then had it wound up. The company by its

[6] [2009] 1 AC 1339, HL.

[7] At [30] and [31].

[8] e.g. *Galoo v. Bright Grahame Murray* [1994] 1 WLR 1360, CA.

[9] *South Australia Asset Management Co Ltd v. York Montague Ltd* [1997] A.C. 191, HL.

liquidator sued the auditors for negligence and the auditors applied to strike out the claim on the ground of illegality.

9. There was very little common ground in the judgments in *S&R*. They could not even agree on the juridical basis of illegality. Lord Phillips considered that it had been rescued by *Gray* from the narrow confines of the reliance rule. He said that *Tinsley* did not lay down a universal test but was concerned only with the effect of illegality on title to property. He subdivided illegality into two principles. The first is that the courts will not enforce a contract which is expressly or impliedly forbidden by statute or made with the intention of committing an illegal act. The second is that the courts will not assist a person to benefit from his wrongdoing; that was the principle which applied in *Gray*.

10. Lord Phillips' view as to the juridical basis of illegality was not shared by Lord Walker, who thought that the position had been fully set out in *Tinsley*. It is not clear where the other judges stood on this point, but nobody else said that they agreed with Lord Phillips. It does not appear that this difference of opinion had much effect on the result in *S&R*. There were other differences between the judgments which proved to be more significant. Nevertheless, the failure to reach agreement as to the juridical basis has not made it easier for subsequent courts to understand the concept of illegality.

11. The HL unanimously accepted that the test for illegality required the claimant personally to have committed the wrong. It did not apply where his liability was merely vicarious. This was more or less the only thing that they all agreed on. In consequence, it became necessary to consider whether the company itself was to be regarded as a wrongdoer. It was at this point that the judges parted company with one another.

12. Lord Phillips's reasoning begins with the decision in *Caparo Industries plc v Dickman*[10]. In that case HL held that an auditor is usually appointed to report to the

[10] [1990] 2 AC 605, HL.

company in general meeting and hence prima facie his duty of care is owed only to the shareholders as a body. In *S&R* Stojevic was the mastermind behind the fraud as well as being the sole beneficial owner of the company and its directing mind and will. In these circumstances Lord Phillips held that there was no basis for looking behind the company to consider who it was that the auditor had a duty to protect. The effect of *Caparo* was that there was no duty to protect creditors or other third parties whom the company might defraud.

13. Lord Walker and Lord Brown reached the same conclusion as Lord Phillips, but by a different route. They both focused on the question whether the fraud was to be attributed to the company itself. The claimant sought to rely on the principle in *Re Hampshire Land Co*[11]. This is the principle that the knowledge of an agent is not to be attributed his principal where the knowledge relates to the agent's own breach of duty to his principal. Lord Walker, applying U.S. authority, held that there was an exception to the *Hampshire Land* principle in the case of a one-man company. Lord Brown preferred to apply Occam's razor. He reached the same conclusion as Lord Walker by a simpler route, saying that the *Hampshire Land* principle was inapplicable in the case of a one-man company. Both held that the company could not be separated from the fraudster behind it and that the company was therefore the villain and not the victim.

14. Lord Scott and Lord Mance both dissented. They adopted the "very thing" argument, i.e. the uncovering of the fraud was the very thing for which the auditor was responsible as an officer of the company. The minority concluded that *ex turpi causa* did not apply because the real victims were the company's creditors. This argument involved equating the duty of an auditor as officer of the company with the duty of a director. However, as Lord Phillips pointed out, that would involve subverting *Caparo* and imposing a duty on auditors towards creditors.

[11] [1896] 2 Ch 743, Vaughan Williams J.

15. *S&R* has left the law in an unsatisfactory state. In the first place, it is very difficult to establish the ratio. The decision was made by a 3:2 majority, but there was no majority for the reasoning either of Lord Phillips or of Lords Walker and Brown.

16. Secondly, the majority all avoided deciding what the position would have been if the company had not been a one-man company. This is particularly unfortunate, because it indicates that the judgments are of no general application outside the specific circumstances of a one-man company – not a satisfactory basis for the highest appellate court.

17. Thirdly, it is not easy to see whether justice was on the side of the majority or the minority. Each side appealed to common sense. Lord Phillips quoted with approval Mummery LJ in the CA:

> "Does common sense matter? Yes. It is contrary to all common sense to uphold a claim that would confer direct or indirect benefits on the corporate vehicle, which was used to commit the fraud and was not the victim of it, and the fraudulent driver of the fraudulent vehicle."

Conversely, the dissenting judgments show that there is significant judicial dissatisfaction with a principle of law that gives no compensation to the creditors who are the real victims of the fraud.

18. The clash between the competing demands of justice was particularly acute in *S&R* because it was a claim against auditors. As Lord Phillips recognised, this meant that the trump card was *Caparo*. There is a debate to be had about whether the scope of the duty owed by auditors should be widened to benefit creditors, but this debate needs to be had in the context of much wider policy considerations about the role of auditors. If one strips out the fact that the claim was against an auditor, and one substitutes a claim against a director, the merits become more obvious.

19. Such was the position in *Bilta (UK) Ltd v. Nazir (No 2)*[12]. Once again, this involved frauds committed by a one-man company, but this time in conjunction with third parties. The third parties were sued for damages for conspiracy and they sought summary judgment on the ground that the claim was barred by illegality. Although the defendants were third parties, it was common ground that the same issues would have arisen if the claim had been brought against the dishonest director. The CA was unanimous in distinguishing *S&R*.

20. The CA began by saying that the reliance test in *Tinsley* had been reaffirmed in *S&R*. However they stated the test in a form which is much closer to the causation test adopted by Lord Hoffmann in *Gray* and by Lord Phillips in *S&R*. Patten LJ, who gave the only reasoned judgment, considered that no causal connection less than reliance would suffice. On the facts of *Bilta* he said that the defendants would need to plead they were parties to a conspiracy with the directors to commit a breach of the directors' fiduciary duties to the company. He referred to the principle that the directors of a company owe a duty to act in the interest of creditors if the company is or is likely to become insolvent: *West Mercia Safetyware Ltd v. Dodd*[13]. This principle has now been given statutory recognition in s. 172 of the Companies Act 2006[14]. This is sufficient to engage the illegality defence.

21. Patten LJ continued by saying that the question of attribution depended on the context. A company could be treated as the villain for one purpose and the victim for another purpose. If the company was sued by a third party victim, it was treated as the villain. But if the company itself sued its director who had caused the loss by his breach of duty to the company, then the company was the victim.

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[12] [2014] Ch 52, CA.

[13] [1988] BCLC 250, CA. Patten LJ found support for this part of his reasoning in *Prest v Petrodel Resources Ltd* [2013] 2 AC 415, SC, which will be the subject of a separate paper at this Conference.

[14] S. 172 imposes on directors a duty to promote the success of the company "subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company".

22. At this point Patten LJ had to confront *S&R*. The CA's reasoning was contrary to the judgments of Lords Walker and Brown, who had both held that a one-man company was regarded as the villain for all purposes. However, it was consistent with the reasoning of Lord Phillips, who based his decision on the limited duty of care of an auditor according to *Caparo*. It was also consistent with the two dissenting judgments. Lord Mance had said that the use of the company as a tool in the fraudulent scheme made it the victim. Patten LJ managed to construct a majority ratio by adding together the judgments of Lords Scott and Mance, who were in the minority, with that of Lord Phillips, who formed part of the majority but by a separate minority route. On this basis the CA distinguished *S&R* as applying only to a claim against an auditor. The CA held, contrary to Lords Walker and Brown, that where a one-man company was the primary or even the secondary victim of the wrongdoing, the principle in *Hampshire Land* applied. The state of mind of the fraudulent director should not be attributed to the company, except in relation to a claim against an auditor. There was therefore no defence of illegality.

23. This leads to the odd result of confining the ratio in *S&R* to the judgment of Lord Phillips, with whom no one else agreed. In effect, CA sought to limit *S&R* to its own facts. *Bilta* was a more extreme case than *S&R*, first because the defendants were themselves the fraudsters and secondly because their fraud involved assisting directors, who have a wider duty than auditors, and one which requires them to consider the interests of creditors.

24. The final instalment in the journey so far is the recent judgment of Popplewell J in the *Madoff* case which I mentioned at the outset. Although the Madoff business was, of course, a massive Ponzi scheme, the claimant company was a genuine company within the Madoff empire. It had a legitimate business and some innocent directors. This made it distinguishable from the one-man companies in *S&R* and *Bilta*. The claim was brought by the company in liquidation against its directors and against a third party. The claim failed for a variety of reasons. On the issue of illegality the judge followed *Bilta* in holding that the test was based on reliance. He

concluded that Bernard Madoff's fraud was merely the occasion for the claim by the Madoff company against its directors and was not the effective cause (thereby conflating the reliance test in *Tinsley* with Lord Hoffmann's causation test in *Gray*). Hence the defence of illegality was not engaged.

25. However, if reliance had been established thereby triggering the defence of illegality, it would have been necessary to consider whether Bernard Madoff's dishonest state of mind was to be attributed to the company. The defendants argued that the *Hampshire Land* principle did not apply because the company was not the primary victim of the fraud but only the secondary victim. This required the judge to consider the treatment of the question of attribution in *S&R* and *Bilta*. In *S&R* Lord Phillips and Lord Walker, for differing reasons, both held that the principle of attribution applied where the company was only the secondary and not the primary victim. Lord Phillips reached this result by holding that the *Hampshire Land* principle did not apply, whereas Lord Walker reached this result by holding that there was an exception to the principle in the case of a one-man company. In *Bilta* the CA reached the opposite conclusion and said that the principle applied because the claim was based on the misconduct of the particular director which was the subject matter of the attribution question. In other words, as a matter of policy the defendant director could not rely on his own fraud. Popplewell J treated *Bilta* as applicable only where the defendant is himself the wrongdoer. In cases where the defendant was innocent of the fraud, the company was not entitled to avoid attribution by relying on *Hampshire Land*.

26. Let me summarise the current state of the law in relation to *Hampshire Land*:

    26.1. A claim will be barred if it is founded on illegality by the claimant personally. The current position is that the courts will pay lip service to *Tinsley* by labelling the test as one of reliance, but they will require a causal connection between the claimant's wrongdoing and the loss claimed. The courts have not yet sought to define the causal test in a principled way. It is like the definition of an elephant: you know one when you see it.

26.2. In the case of a corporate claimant, the state of knowledge of the company's directing mind is usually attributed to the company. If the director dishonestly causes the company to act illegally, prima facie this results in the dishonesty being attributed to the company, so that the claim is barred by illegality.

26.3. The principle in *Hampshire Land* is an exception to this rule of attribution. The director's guilty knowledge will not be attributed to the company where the knowledge relates to his own breach of duty to the company.

26.4. Lords Phillips, Walker and Brown all held that the *Hampshire Land* principle did not apply in the case of a one-man company, but they reached that conclusion by different routes. One route was that the principle did not apply to a one-man company; the other was that it did apply but was subject to an exception for a one-man company. Either way, it means that the fraudster's knowledge is to be attributed to the company in the case of a one-man company.

26.5. However, *Bilta* said that the *Hampshire Land* principle <u>does</u> apply where the defendants are themselves the fraudsters or associated with them. But *Madoff* says that it does <u>not</u> apply where the defendants are honest.

27. These cases show how slight variations in the facts can lead to different views as to what is the just result. On the current state of the authorities:

27.1. Where the company is a genuine company with at least one honest director and where the defendant is also honest, the defendant is allowed to plead illegality as a defence to a claim by the company. The usual rule of attribution applies (*Madoff v. Raven*).

27.2. Where the company is a one-man company which is run by a fraudster, the company is treated as the victim when it seeks to recover from the fraudster or his accomplices. This is because the key factor which trumps everything else is that the defendant cannot rely on his own fraud to defeat the company's claim. Hence *Hampshire Land* applies and the director's fraud is not attributed to the company (*Bilta)*.

27.3. But the position is different where the company is a one-man company which is run by a fraudster and a claim is made against a third party for negligence and not fraud. If the third party is an auditor, the claim will be barred by illegality (*S&R*). The explanation offered by the subsequent cases is that the key factor is the limited scope of the duty of care of an auditor. The courts have not yet decided what is to happen if the claim is brought against a different kind of defendant, but I think it likely that it will depend on how far an analogy can be drawn with the position of an auditor.

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