Illegality Defense Developments In UK And Cayman Islands

By James Elliott and William Peake November 27, 2018, 4:39 PM EST

The principles that a person should not benefit from his own wrongdoing and that the law should not condone illegality are longstanding. Keen legal historians might be aware that these are precepts in Roman law and there are echoes in Deuteronomy. In its broadest form, it extends to conduct which is not just illegal but also unethical.

The parameters of the common law illegality defense and equitable “clean hands” doctrine[1] have undergone significant developments in recent years and the English and Cayman Islands courts have recently given further guidance.

The origins of the illegality defense date back to 1725 when this was considered in Everet v. Williams,[2] also known as the Highwayman’s Case, in which it was held that where the court is faced with an unlawful partnership or a partnership formed to carry out an unlawful purpose the court will not redistribute the proceeds of ill-gotten gains among wrongdoers.

The application of the defense was further developed in Tinsley v. Milligan,[3] in which the court set out a necessary "reliance" test to be applied when considering the defense. This comprised a strict, rule based approach whereby a party could not succeed in bringing a claim in respect of an illegal contract if it was necessary for him to rely on his own illegal conduct in the pursuit of such a claim.

In July 2016, Tinsley v. Milligan was overruled in Patel v. Mirza[4] by a panel of nine judges in the U.K. Supreme Court. The decision of the majority substantially clarified the scope of the defense. The central issue before the court concerned the necessary connection between unlawfulness and a plaintiff’s claim before the court will bar it from proceeding.

**Patel v. Mirza — A Departure From Tinsley v. Milligan**

In Patel v. Mirza, funds were transferred to Mirza by Patel for the purpose of betting on the price of RBS shares. Mirza anticipated receiving certain insider information which would affect the price of the shares, conduct which amounted to an offense pursuant to section 52 of the Criminal Justice Act 1993. In fact, the announcement was not released and the illegal bet was not, in the event, placed. In the circumstances, Patel brought a claim for payment of
the monies transferred, including a claim for unjust enrichment.

Patel's claim was unanimously upheld by a nine-person panel of the Supreme Court. By its judgment, the above "reliance" test was rejected by Lord Toulson (a finding with which Lady Brenda Hale and Lords John Kerr, Nicholas Wilson and Patrick Hodge concurred), who directed that the illegality defense should apply when the result would be contrary to public interest and harmful to the integrity of the legal system. Lord David Neuberger also adopted Lord Toulson's approach, which he concluded "as reliable and helpful guidance as it is possible to give in this difficult field."

Lord Toulson referred to two broad policy reasons underpinning the maxim or illegality principle, namely that: (1) a person should not be allowed to profit from his own wrongdoing; and (2) the law should be coherent and not self-defeating, condoning illegality by giving with the left hand what it takes away with the right hand.

Expressing disapproval of the "reliance" test, Lord Toulson referred to various criticisms of this approach, including the following:

- The test was vulnerable to producing different results based on procedural technicality which was unrelated to the underlying policy;
- There was no distinction between minor and serious or "peripheral" and "central" illegality;
- There was no distinction between serious criminality and minor breaches of statutory regulation;
- Individual cases did not always fit the rules;
- The attempts to remove deficiency by appropriate exceptions had never been satisfactorily achieved.

In the circumstances, it was held that Tinsley v. Milligan should no longer be followed, the court finding in favor of a more flexible tripartite policy based approach which was based on the circumstances of each case:
The way is now open for this court to make its choice between, on the one hand, cleaving to the rule-based approach exemplified by Tinsley v. Milligan … and, on the other, a more flexible approach, taking into account the policy considerations that are said to favour recognising the defense of illegality, those which militate against such recognition and the proportionality of allowing the defense to prevail.[8]

**New Test for Illegality**

As a result of Patel v. Mirza, the correct approach when considering the application of the illegality defense is to consider[9]:

- Whether the purpose of the prohibition that had been transgressed would be enhanced by denying the claim;

- Whether denying the claim might have an impact on another relevant public policy; and

- Whether denying the claim would be a proportionate response to the illegality.

In considering the above principles, the court held that it was necessary to take account of potentially relevant factors when considering all of the circumstances of the case including the seriousness of the conduct, its centrality to the contract, whether it was intentional and whether there was a marked disparity between the parties’ respective culpability.

**Application in the Cayman Islands**

The factors in Patel v. Mirza were the subject of detailed consideration in the landmark judgment in AHAB v. SICL & Ors[10], a $9.2 billion fraud claim arising from one of the largest corporate collapses of the financial crisis. In brief, Maan Al Sanea was the head of AHAB’s investment division, known as the Money Exchange and married to the daughter of one of the AHAB founding partners. It was alleged by AHAB that, over a 30-year period, Al Sanea abused his authority to enter into billions of dollars’ worth of revolving credit facilities using only the AHAB name as collateral, unknown to the AHAB partners. The AHAB partners insisted that they had no knowledge of the level of borrowings incurred on their behalf, and that they were in fact the victims of fraud.
AHAB accepted that some of its borrowing had been authorized in accordance with a policy entitled “New for Old,” but argued that remaining borrowing had been fraudulent and unauthorized.

In a judgment stretching to over 1,300 pages, the chief justice dismissed AHAB’s claims, holding that AHAB had at all times known about, approved and participated in Al Sanea’s fraud in “one of the largest Ponzi Schemes in history”[11].

In contesting the claim, the defendants raised the raised the illegality defense citing the new test in Patel v. Mirza.

As a consequence of the court’s conclusions in the judgment that: (1) the AHAB partners authorized Al Sanea’s conduct; and (2) were complicit in the fraud, it was not ultimately necessary for the illegality defense to be invoked, the court having ruled there to have been no misappropriation. However, the court helpfully considered the application of the defense and whether the same would have resulted in AHAB’s claim being barred. The court held that the defense was entitled to succeed as a result of AHAB’s continuous complicity in the fraud from beginning to end, a finding which was unaffected by AHAB’s alleged “New for Old” policy, in view of AHAB’s indisputable involvement and the fact that the “New for Old” policy itself involved the continued dissemination to the banks of falsified accounts, in order to induce the banks to continue to lend at least as much as was required to prevent the collapse of the Money Exchange and other Financial Businesses.”[12]

In reaching its findings, the court accepted the argument that the criminality inherent to the Money Exchange ought to be regarded as akin to that of the highwayman in Everet v. Williams, who was seeking an account from his fellow robber of the ill-gotten gains of their venture:

…this case is even more brazen because, unlike Everet, AHAB is seeking to trace the ill-gotten gains into the hands of third party transferees…rather than merely from their fellow wrongdoer. AHAB’s case is not simply akin to seeking to sue AHAB’s fellow highwayman but also akin to bringing proceedings against the highwayman’s publican for the funds transferred to him.[13]

The court gave detailed consideration to the factors identified in Patel v Mirza, holding that AHAB lacked clean hands and was not entitled to invoke the equitable remedies sought by AHAB.
Further Developments

In February 2018, the illegality defense was again considered by the English High Court in Saeed & Saeed v. Ibrahim & Ors.[14]

The plaintiffs, Mr. and Mrs. Saeed were husband and wife and had a disharmonious marriage. This led to Mr. Saeed entering into various arrangements with the first defendant, Ibrahim, who together implemented a "warehousing" fraud designed to defraud Mrs. Saeed by divesting her of her interests in various assets through the transfer of these to trustees who were Ibrahim’s own nominees.

A series of sham transactions ensued by which documents were forged and assets transferred away from Mrs. Saeed, following which cash was paid to Ibrahim and used to purchase properties registered to his sons. Mr. Saeed subsequently requested the transfer of the assets back to him and Ibrahim refused. Having reunited, Mr. and Mrs. Saeed issued proceedings against Mr. Ibrahim.

Applying the factors in Patel v. Mirza, the court found that unlike the contract there, the relevant agreements in this case were acted upon and that notwithstanding the illegality of dealings of Mr Saeed, Mr. Ibrahim was equally guilty and that Mr. Saeed and his wife should not be barred from recovering in the action:

As things stand, a proportion of the fruits of that illegal activity remains in [Mr Ibrahim’s] hands or under his control. To leave matters as they presently are would offend both policies underpinning the illegality principle and condone and produce an unjust outcome. That is not to overlook or condone or diminish [Mr Saeed’s] culpable involvement.[15]

Harb v. Aziz

The factors-based approach in Patel v. Mirza was again applied by the English High Court in Harb v. Aziz[16], a case involving very different facts. There, the claimant, Harb, sought specific performance of an alleged oral agreement between her and the defendant, whereby the defendant agreed to pay Harb £12 million and to procure the transfer of two properties. The defendant denied making the agreement and argued, in the alternative, that the agreement was unenforceable on grounds of illegality. Such an argument was founded upon a statutory declaration made by Harb concerning statements made about her ex-husband, the contents of which she later accepted she believed to be untrue. The defendants argued
that as a result of making a false declaration, the underlying contract was illegal and should be held to be void. The court held that the contract was not intended to create legal relations or (if it was) was too uncertain to be enforceable. However, the court gave consideration, albeit obiter, to the factors in Patel v. Mirza in concluding that, if the agreement had been intended to create legal relations and sufficiently certain, Harb should not be prevented from enforcing it by the doctrine of illegality.

**Henderson v. Dorset Healthcare**

In August 2018, the English Court of Appeal gave further consideration to the parameters of the defense and how far it can be deemed binding outside claims for restitution in Henderson v. Dorset Healthcare.[17] There, the claimant suffered from a psychotic illness and stabbed her mother to death. She subsequently issued proceedings in tort against the NHS trust, which were dismissed by the High Court on the basis of illegality. Dismissing her appeal, the Court of Appeal held, inter alia, that the principles in Patel v. Mirza was not applicable in circumstances where binding authority existed that could not be distinguished:

Nevertheless, in view of the actual contractual and unjust enrichment issue in Patel, considerable caution must be taken, in the context of the rules of binding precedent, in determining whether there are any other cases in other areas of the law which the Supreme Court in Patel held by necessary implication to be overruled or such that they should no longer be followed.[18]

**Stoffel & Co v. Grondona**

In September 2018, the Patel v Mirza tripartite test was applied in Stoffel & Co v Grondona.[19]

The defendant, Stoffel & Co, had failed to register relevant conveyancing forms when acting for Maria Grondona in relation to the purchase of a property in England. In the meantime, an underlying arrangement was in place between Grondona and her associate, Cephas Mitchell, whereby Grondona entered into the mortgage to raise funds on behalf of Mitchell, who was not able to do so due to poor credit history. Mitchell was at all times to remain the true owner of the property and promised to pay Grondona 50 percent of any profit made on a future sale of the property.

Grondona later defaulted on payments due under her mortgage and the lender issued proceedings. Grondona brought a Part 20 claim against Stoffel & Co for an indemnity and/or contribution, which the firm defended on grounds that Grondona had committed mortgage
fraud, since the purpose of the arrangement was to defraud the bank.

Applying the test in Patel v. Mirza, the Court of Appeal concluded that: (1) while mortgage fraud was a "canker on society," there was no public interest in allowing negligent conveyancing solicitors not party to the illegality to avoid their professional obligations because of the "happenstance that two of the clients for whom they act are involved in making misrepresentations to the mortgage financier"[20]; and (2) on the other hand, there was a genuine public interest in ensuring that clients who used the services of solicitors were entitled to seek civil remedies for negligence and/or breach of contract arising from a lawful retainer. In reaching its conclusion, the court gave consideration to the factors in Patel v. Mirza and held:

- The lender had not raised any complaint on grounds of fraud, instead adopting the transaction;
- Stoffel & Co did not allege fraud in the evidence filed on its behalf;
- Grondona had not sought to evade her obligations pursuant to the mortgage;
- Grondona’s illegal conduct was not central, or indeed relevant, to the otherwise proper and legitimate contract of retainer between her and Stoffel & Co;
- Grondona’s claim was not pursued in order to profit from the fraud, but to obtain funds to reduce or discharge her liability under the mortgage;
- In all the circumstances, there was no risk that the enforcement of her claim would undermine the integrity of the justice system.

Where Are We Now?

As a result of Patel v. Mirza, there has been a radical change in the Cayman Island court’s application of the illegality defense under common law, including an endorsement of a much broader test based on the circumstances of each individual case. While the new test appears more suitable than the arbitrary Tinsley test, there is a greater degree of uncertainty as to
how the court will apply the above factors within the context of individual cases, meaning it will inevitably be harder to predict the outcome in any particular instance. It is also clear that the Patel v. Mirza test will not be applied in certain cases, where the doctrine of precedent requires a court to apply existing binding authority.

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Disclosure: Harneys represents Nick Matthews and Mark Longbottom of Duff & Phelps, the joint official liquidators of one of the defendant entities, SIFCO5, in the AHAB v. Saad proceedings, and led the illegality defense at trial.

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[1] A principle maxim of equity has long been that “he who seeks equity must come with clean hands.” This does not extend to general moral iniquity, but concerns the connection between the plaintiff’s misconduct and the relief he seeks (Dering v Earl of Winchelsea [1787] 1 Cox Eq. 318)

[2] [1725] reported in [1893] 9 LQR 197

[3] [1994] 1 AC 340

[4] [2017] AC 467

[5] Paragraph 174


[7] Paragraphs 87-92

[8] Paragraph 133

[9] Paragraph 120


[12] Section 7D, paragraph 4

[13] Section 7D, paragraph 32

[14] [2018] EWHC 1804 (Ch)

[15] Paragraph 95

[16] [2018] EWHC 508 (Ch)

[17] [2018] EWCA Civ 1841

[18] Paragraph 87

[19] [2018] EWCA Civ 2031

[20] Paragraph 37