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Illegality and fraud – effects on contracts and arbitration proceedings

An overview of legal issues

LMAA/CIArb Seminar 7 Dec 2015

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The taxonomy: *Les Laboratoires Servier v Apotex* [2015] AC 430

- *I've always favoured illegality in the narrow sense that it leads to some of the more colourful cases encountered by a commercial lawyer. It is the English common law at its best and, perhaps also, its worst. Frequently there is agreement that a just outcome has been reached. Almost as frequently there is concern that a bad precedent may have been set.*

- *A number of recent cases in the Supreme Court have clarified certain aspects of the law, but left one big unanswered question. In the 15 minutes I have, I will try to summarise the current law but, unlike most Judges faced with an illegality case, I may struggle to do it justice.*

- *As a starting point, the majority of the Supreme Court in Les Laboratoires Servier provided a helpful taxonomy.*

The taxonomy: *Les Laboratoires Servier v Apotex* [2015] AC 430

- *[22.] The application of the ex turpi causa principle commonly raises three questions: (i) what acts constitute turpitude for the purpose of the defence; (ii) what relationship must the turpitude have to the claim; (iii) on what principles should the turpitude of an agent be attributed to his principal, especially when the principal is a corporation?*
- Lord Sumption, with whom Lords Neuberger and Clarke agreed, said three questions arise: first, what constitutes relevant illegality or turpitude, secondly, what relationship is required between the illegality and the claim, and, thirdly, the issue of attribution.
- Spoiler alert. The law on questions (i) and (iii) is now relatively settled, and so we'll deal with those first and briefly. The law on question (ii) is arguably more open than ever.
- So question (i): turpitude. This was squarely addressed in Les Laboratoires Servier. The question was whether breach of a Canadian patent was relevant illegality.

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Q(i) Turpitude: *Les Laboratoires Servier*

- *[25.] … acts which are contrary to the public law of the state and engage the public interest. The paradigm case … a criminal act. In addition, … a limited category of acts which … can conveniently be described as "quasi-criminal" because they engage the public interest… this…includes cases of dishonesty or corruption…some anomalous categories of misconduct, such as prostitution…and the infringement of statutory rules enacted for the protection of the public interest and attracting civil sanctions of a penal character...*

- *[28.] Torts (other than those of which dishonesty is an essential element), breaches of contract, statutory and other civil wrongs offend against interests which are essentially private, not public. … The public interest is sufficiently served by the availability of a system of corrective justice to regulate their consequences as between the parties affected.*

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Q(i) Turpitude: *Les Laboratoires Servier*

- *Lord Sumption for the majority explained that qualifying acts were criminal and quasi-criminal acts such as, for our purposes in commercial arbitration, those involving dishonesty or corruption, where the public interest was engaged. Torts, breaches of contract and other civil wrongs did not qualify.*

- *Accordingly, he held that, although a patent was a public grant, its effect was to give rise to rights of a private character no different in principle from contractual or tortious rights. The public interest was not engaged and the defence failed.*

Q(iii) Attribution: *Bilta (UK) Ltd v Nazir (No 2)* [2015] 2 WLR 1168

- *Question (iii): attribution. Some of you may recoil in horror at the mention of Stone & Rolls. There is some very good news in that respect. The Supreme Court in Bilta sat with seven Justices and consigned Stone & Rolls to the historical scrapheap. Lord Neuberger, with whom Lords Clarke & Carnwarth agreed, indicated that, save perhaps in relation to one-man companies suing third parties, Stone & Rolls could be put on one side and marked "not to be looked at again". Lord Toulson and Lord Hodge said Stone & Rolls should be regarded as a case that has NO majority ratio decidendi and stands only as authority that on its facts no claim lay against the auditors.*
- *Bilta involved a different question. It was a "missing trader" fraud, with Bilta left owing HMRC £38 million in VAT. Bilta and its liquidators sued Bilta's directors and others who it was alleged had dishonestly assisted in a conspiracy to injure Bilta.*

Q(iii) Attribution: *Bilta (UK) Ltd v Nazir (No 2)* [2015] 2 WLR 1168

- *The Justices were unanimous that the directors' wrongdoing could not be attributed to the company FOR THE PURPOSE of defeating a claim by the company and its liquidators against those directors and their co-conspirators. Such dishonesty may be attributed to the company in MANY other types of proceedings, but not for the purpose of defeating the company's own claim, or that of the liquidators.*
- *For the purposes of claims between two counterparties advanced in arbitration, including fraud claims, this authority will usually lead to the agent's knowledge of any relevant illegality being imputed to the principal so as to bar a claim.*
- *[9.] [We] agree with Lord Mance's analysis …that the question is simply an open one: whether or not it is appropriate to attribute an action by, or a state of mind of, a company director or agent to the company or the agent's principal in relation to a particular claim against the company or the principal must depend on the nature and factual context of the claim in question.*

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Q(ii) Relationship with the claim: the developments

- An affront to the public conscience to grant the relief?
- *Tinsley v Milligan* [1994] 1 AC 340: "reliance" test preferred over a sufficiently close factual connection
- *Hounga v Allen* [2014] 1 WLR 2889: balancing the public policy founding the illegality defence against any other aspect of public policy to which application of the defence would run counter
- *Les Laboratoires Servier*: probably still the "reliance" test, but "room for argument" that in *Hounga* the Supreme Court has refused to follow it…
- *Bilta* : *"*reliance" test as precedent vs. approval of *Hounga* balancing test…

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Q(ii) Relationship with the claim: the developments

- So we turn to question (ii): what relationship must the illegality have with the claim? It is hard to escape the conclusion this seems like a question of degree and therefore one where a satisfactory bright line rule might be hard to attain. The developments over the last 25 years bear this out.
- A few years before Tinsley v Miligan, the Court of Appeal decided that the mass of authority illustrated that the test was as follows: Whether in all the circumstances it would be an affront to the public conscience to grant the relief sought, because the Court would thereby assist or encourage such illegal conduct.
- The House of Lords in Tinsley was unanimous in rejecting this test. They were not unanimous as to its replacement. Lord Goff and Lord Keith considered that the defence should bar any claim tainted by a SUFFICIENTLY CLOSE FACTUAL CONNECTION with the illegal purpose. The majority, Lords Browne-Wilkinson, Jauncey and Lowry preferred a "reliance" test, whereby the claim was barred only if the claimant needed to rely in its pleadings or evidence on facts disclosing the illegality.

Q(ii) Relationship with the claim: the developments

- The “reliance” test is probably still the law, but the three recent Supreme Court decisions in Les Laboratoires, Bilta and Hounga v Allen suggest its days are numbered. The bigger question is probably what will replace it when this question next falls squarely to be decided by the Supreme Court.

- The first case in time was Hounga v Allen from July 2014. This was a racial discrimination dismissal claim by the 14-year old Miss Hounga, brought to the UK by the Allens, knowingly working illegally, and being mistreated instead of paid. Lord Wilson perceived a softening of the “reliance” test in, dare I mention it, Stone & Rolls, and derived a balancing test as follows. “So it is necessary, first, to ask *“What is the aspect of public policy which founds the defence? and, second, to ask “But is there another aspect of public polcy to which application of the defence would run counter?”*

Q(ii) Relationship with the claim: the developments

- Lord Hughes, with whom Lord Carnwarth agreed, reached the same outcome, but was unwilling to try a general synthesis of the illegality defence. He did, however, say in passing that before such a defence will work, there must be "a sufficiently close connection" between the illegality and the claim. A hint of the minority view from Tinsley.
- Next in time came Les Laboratoires Servier handed down in October 2014, but heard before Hounga. Lord Sumption gave the majority speech, and Lords Neuberger and Clarke agreed with him. None of them had been part of the Committee in Hounga. They reiterated that the "reliance" test from Tinsley remained the law, and stated that they had not been invited to depart from it. Lord Mance also referred to the clear-cut, if potentially harsh, approach of Tinsley. But Lord Toulson does not appear to have thought Tinsley had, or still had, such impact as a precedent. He cited with approval Lord Wilson's balancing test from Hounga.

Q(ii) Relationship with the claim: the developments

- Next came Bilta in April 2015. The issue of the relationship with the claim did not really arise, given that the claim was centrally based on the directors' illegality. But the schism in views on the approach to illegality generally came to the fore. Lord Sumption reiterated that Tinsley was binding authority, subject to review by the Supreme Court, and said that in the 20 years since it was decided the highest court had never been invited to overrule it. For him Les Laboratoires Servier had reemphasized that the illegality defence was based on a rule of law, not a discretionary power. He would probably have stopped there, but the speech of Lords Toulson and Hodge caused him to add further views on policy. He said arguments based on policy can easily degenerate into the kind of discretionary weighing of equities that was rejected in Tinsley and Les Laboratoires. As to Hounga, Lord Sumption said the Supreme Court had not been purporting to depart from Tinsley without saying so and the result in Hounga was consistent with the narrow "reliance" test.

Q(ii) Relationship with the claim: the developments

- Lord Toulson and Lord Hodge in Bilta continued where Lord Toulson had left off in Hounga. They set out certain well-known criticisms of the "reliance" test, namely that it is purely procedural and can be entirely arbitrary. They approved Lord Wilson's test from Hounga. They refuted Lord Sumption's suggestion it was a judicial value judgment on the balance of the equities. They said it was a statement of principle and appeared to suggest it was distinct from the "public conscience" test rejected in Tinsley.

- Lord Mance stood on the sidelines, only agreeing that the issue and the inter-relationship between Hounga and Les Laboratoires Servier merited re-examination when the opportunity arises. Lord Neuberger, with whom Lords Clarke and Carnwath agreed, were the referees, and linesmen. Lord Neuberger referred to Lord Sumption as saying the law remained the Tinsley reliance test.

Q(ii) Relationship with the claim: the developments

- Perhaps tellingly, he summarized Lords Toulson and Hodge as preferring the "public conscience" test and as saying that Hounga supported this approach.

- Lord Neuberger concluded that until the Supreme Court refuses to follow Tinsley it is at the very least difficult to say that the law is as flexible as Lords Toulson and Hodge suggest, but in the light of Hounga there is ROOM FOR ARGUMENT that this Court has refused to follow Tinsley. He said that only after full argument should the Court address this issue, and that this should be with a panel of seven, or conceivably nine justices.

- So what will they decide when they do?

Q(ii) Relationship with the claim: the future?

- It seems probable they will do away with the “reliance” test. It is hard to find those who defend this test. But what will be the replacement? I can only hazard a guess.
- It will partly depend upon the constitution of the Court, and of course they will all hear further argument with an open mind. All five of Lords Toulson, Hodge, Wilson, Kerr and Baroness Hale have recently favoured a more discretionary approach balancing competing policies.
- Those who consider this is, or may be, in conflict with Tinsley have not, for obvious reasons, really developed their alternative . But Lord Hughes and Lord Carnwath in Hounga favoured a “sufficiently close connection” test, just like the minority back in Tinsley, and that could yet curry favour with the others.

Q(ii) Relationship with the claim: the future?

- … sufficiently close factual connection…?

- In my view, the "sufficiently close connection" test would create a relatively sensible, workable balance, in that it will be a rule of law, albeit one that is applied fact-sensitively. That it may produce unjust results could be the price for some clarity in the law – as Lord Mansfield said - in pari delicto potior est conditio defendentis. Where fault is equal, better to be the defendant.

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What is clear?

So what's clear? This is a horse-drawn vehicle. It's unclear to me whether its pronounced BROAM or BRO-HAM .

But it is clear that, if you were knowingly to rent this, or indeed probably any other vehicle, to a prostitute for professional use, you would be unable to sue for the hire. Beyond that, the law on what connection is required between claim and illegality is wide open…

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What is clear?

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Thank You

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