FINAL

ILLEGALITY AND FRAUD – EFFECT on CONTRACTS and ARBITRATION PROCEEDINGS

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E.J.C. Album Presentation

Good Evening

1. INTRODUCTION

(a) Introduction by the Chairman

[As the Chairman has mentioned], I am going to look at illegalities affecting the commodity markets and other non-maritime transactions. Of course, we have a big overlap with the maritime world because, apart from dealings on the terminal markets themselves, commodities bought and sold are typically transported by sea.

(b) Commodity Arbitrations

As a member of the London Metal Exchange, I am familiar with disputes about the non-ferrous metals traded on the exchange, such as copper, lead and aluminium, but also about iron and steel which is traded almost entirely outside the Exchange. As an arbitrator, I have dealt also from time to time with coal and coke, and a lot of strange things happen in that trade. Certainly, you are well advised not to pay for more than is actually received and weighed at the arrival port. What happens is that coal partially disintegrates into dust in transit and there can be genuine differences between what is shipped and what arrives. But, it can also happen that a barge load of coal fails to get shipped at all and is delivered elsewhere.

2. TAX EVASION

(a) Case Facts

You may be wondering about the picture you are looking at. Actually it's the Cayman Islands, an off-shore location that may attract holiday makers (as appears to be the case in this picture) or those with more dubious objectives, such as tax evasion. The latter gave rise to a case based on the illegality defence. This is the first example I want to give of that defence.

The claimant had established wrongdoing by a firm of brokers in a series of commodity transactions, with incorrect prices being given to the clients and other claims. There was a very large award against the brokers. The defence was that the claimant was involved in an illegal scheme to evade tax. However, it was accepted that the transactions themselves were entered into for genuine commercial purposes. The claimant had two companies, one off-shore, and one on-shore. One procedure was to buy at the start of the day but delay the allocation of the deal until the end of the day or even later. If the claimant found that the price was going up he gave the deal to his off-shore company (no tax to pay). If the price was going down, he gave it to his on-shore company.

The Tribunal responsible for deciding the dispute had about 90 cases on illegality cited to them, going back to Lord Mansfield in Holman v. Johnson in 1775. There were also over 100 transcripts of telephone conversations, some very incriminating and reminiscent of those that surfaced recently in the LIBOR exposures.

(b) Tax Evasion Arguments

In the decision on the brokers defence, each of the current illegality theories was referred to. One, which I call the classical theory, is that any reliance on an illegal contract prevents a claim succeeding. In recent times, this theory is often treated as whether there is or is not a direct connection between the claim and the illegality. The other and more modern theory, as has already been explained, gives the Court a discretion (sometimes called a structured discretion) to consider the whole of the circumstances and to decide to some extent on the merits. This may involve an enquiry as to whose conduct is more underserving. With a background in commodity arbitrations, I do not favour a discretionary approach because it can lead to uncertainty and appeals. In fact, the cases show that appeals do often happen and many cases are going to the

House of Lords or now the Supreme Court. There is also uncertainty as to how the case will turn out, but probably this is a feature of all illegality cases.

(c) **Case Facts**

In the tax evasion case, the decision was that the dishonest conduct of the brokers in giving wrong prices to the client was not "connected" with the tax illegality. There was still an argument for the opposite point of view. It was necessary for the claimant to plead the transactions and these, it could be and was said, were tainted with illegality. The connection test fitted better. It so happened that the tax authorities in the country concerned, not the UK, had waived the illegal tax returns after full disclosure – but this would not have excused the illegality under normal legal principles. The principle concerned is known as the locus poenitentiae rule. That rule, in broad terms, is that if someone plans an illegal act but repents or withdraws before the act is done, he can get his money back but it does not apply if he is caught out first by the authorities.

If tax issues had been found to be a relevant consideration in these cases, most commercial disputes would require the production by the parties of their tax returns – not, I think, a good idea and definitely not a popular one.

3. FRAUDS – DOUBLE SALE

Another commodity illegality, which occurs regularly and which I know of by direct experience is the sale of the same specific consignment of goods twice, one with genuine documents and again with fraudulent ones. This is a simple fraud which just involves producing two sets of printed forms. One incident involved a double sale of a large quantity of scrap metal located in Northern Mozambique, the genuine documents coming to my client. Litigation ensued brought by the disappointed buyer, but allegations of illegality did not go anywhere because only the seller had acted dishonestly. After three years of litigation in Mozambique and an interesting trp to the capital, Maputo, the case was settled by litigation in South Africa.

4. INSIDER TRADING

Patel –v- Mirza

Let me give another example of improper behaviour and illegality. In the reported case of Patel v. Mirza (Court of Appeal 2014), the claimant had given £620,000 to a foreign exchange broker

who claimed he could get advance inside information about Government decisions on the Royal Bank of Scotland and would make money for the claimant by speculating on RBS shares when he obtained this information. Later, after receipt of the payment, he said his source was no longer available and he couldn't perform. The claimant wanted his money back but his claim was turned down both by the money broker (who said he had paid the money to someone else) and then by the Judge. The Court of Appeal reversed the Judge's decision and allowed the repayment, largely based on an extension of the locus poenitentiae doctrine but I think more in line with the theory of Court discretion. The Claimant had not repented of his illegal action or withdrawn but, as performance became impossible and did not happen, this was treated as the same thing. I disagree personally because the Claimant did actually enter into an illegal agreement and performed his part by paying over the money. There was certainly a direct connection.

The Judges in that case were given by Defence Counsel the theoretical example of a person paying someone to commit a murder for him. The murder did not happen because the person died first from natural causes. Surely, said Counsel, recovery of the payment would not be allowed. It was said in reply that this was different from the case before the Court because murder was a serious crime. However, this distinction looks to me like a discretion argument based on an assessment of the merits. In fact, in this case, I did not think there was anything between the parties on the merits and I would not, if acting as arbitrator, have allowed repayment (but we may, of course, be overruled later. The leading judgment of Rimer LJ is certainly helpful in giving details of the dealings between the parties.

5. BREACH OF STATUTE

(a) St John Shipping Case

An older well-known case on illegality is St John Shipping v. Rank, 1956, with an entertaining judgment by Mr Justice Devlin as he then was. I have to stray into the maritime area here but, after all, nearly all international commodity contracts involve the movement of goods by sea – in this case grain from the United States to Birkenhead. The recipient of part of the cargo found out that the vessel had arrived at Birkenhead overloaded, i.e. submerged below the plimsoll line. The pictures on display show container ships, one probably overloaded and suggests that there was a good reason behind Mr. Plimsoll's law. Overloading was illegal and, based on this, part of the freight due (the extra amount earned by overloading) was withheld by the consignee. When the full freight was claimed by the shipowner from the consignee, the Judge pointed out that, on the

principle put forward by the claimant, the whole of the freight for the vessel could have been withheld for a trivial breach. The same would apply if a truck carrying goods for delivery exceeded the speed limit by one mile an hour. The Judge said:

"Of course, as Mr. Wilmers says, one must not be deterred from enunciating the correct principle of law because it may have startling or even calamitous results. But I confess I approach the investigation of a legal proposition which has results of this character with a prejudice in favour of the idea that there may be a flaw in the argument somewhere."

The Judge refused the illegality claim, essentially based on the lack of connection between the claim for freight and the infringement of the Shipping Act. Some cases suggest that this theory should be whether the claim is "based" on the illegal action, but I prefer the "connection" argument. Actually, this gives all reasonable scope for judicial or arbitration decision making.

(b) Hounga Case -Tort

Another case, similar in principle to the St. John case is that of a young woman from Africa employed as a domestic help. This is the Hounga case referred to by David Lewis. The Claimant was an illegal immigrant, as was well known to the employer. She was dismissed wrongfully, and her illegal status was used as a defence. The defence was rejected by the Supreme Court. The judges preferred to deal with the case as one of tort based on discrimination. The employer and the anti-slavery society was involved. I recommend reading the leading judgement of Lord Wilson. [Expand on content and tort issues].

6. BILLS OF LADING

I must add a short comment on the issue of letters of indemnity issued to obtain clean bills of lading which will be dealt with by Paul Herring. The problem arises when defects are found in the goods to be shipped, pictured here in a Chinese warehouse. I can only say, from knowledge of the market, that a trader who has sold a cargo of rusty steel beams and sections as shown in the picture, for, say US$5 million is under the strongest temptation to offer the shipping company a letter of indemnity for a clean bill especially if the price has fallen.

7. SUMMARY OF THEORIES

(a) State of Illegality Law

Where, in summary, are we now?
The Common Law is not currently in a settled condition and this comment is based on the remarks of the Judges themselves in the Supreme Court case of Bilta v. Nazir, reported this year and referred to by David Lewis.

The Law Commission has produced a number of reports, the main one supporting what may be called a structured discretion. I hope that there can be further thinking on the subject with support for the classical position, together with a clean-up of the locus poenitentiae rule and other special situations. I am sure there would be no support for statutory-type rules. I hope we can rely on decisions based on the classical or connection theory in the cases which come before the Court and the ones we make ourselves as arbitrators. [Reason for preferring connection theory, as opposed to reliance, involving whether the claim is based on an analysis of the pleadings, e.g. in Patel v Mirza]

(b) Appeals under Discretion Theory

[If discretion is to prevail or exist, there is a particular problem in the case of appeals to the High Court on arbitration awards. Under the procedural rules, the Judges, when dealing with an appeal, can only look at a very limited number of documents, usually just the Award itself and the main underlying documents referred to in the Award, particularly the disputed contact. The Court does not see the expert evidence or the communications between the parties, or most of the other documentation.]

"Practice Direction 62 (unless it has recently changed) says:
12.5 Unless there is a dispute whether the question raised by the appeal is one which the tribunal was asked to determine, no arbitration documents may be put before the court, other than:
(1) the award; and
(2) any document (such as the contract or the relevant parts thereof) which is referred to in the award and which he court needs to read to determine a question of law arising out of the award."

This limitation is perhaps understandable as the Court wishes to avoid re-hearing the whole case. However, when illegality issues surface, and if the Court is exercising a discretion, the restricted access to documents is not desirable.

(c) Common Law and Precedent

Thus, where do arbitrators now fit in? If we are operating under English Law, I believe we must follow the English cases. There is a theory (at least one person has put this forward) that arbitrators are not bound automatically by decided cases. I disagree with this. As arbitrators under English Law, we must follow precedent in accordance with Common Law principles even if, as regards illegality, it is currently hard to work out what these principles are. Lawyers might remember what was said about the complicated rule against perpetuities. "It is one thing to put the law in a nutshell, it is another thing to keep it there". In fact, in one case where I was a member of the Tribunal, we expressed a view based on the classical (connection) approach but added that, if there was discretion under the modern approach, the result would be the same. We did not want to have our award subsequently overruled by the Court or even, as the Arbitration Act puts it, receive a finding that we were not "obviously wrong".