

ILLEGAL AGREEMENTS AND PUBLIC POLICY

Mirza v. Patel [2016] UKSC 42, (S.C.), (Lords Neuberger, Mance, Kerr, Clarke, Wilson, Sumption, Toulson, Hodge and Lady Hale)

INTRODUCTION

The maxim *ex turpi causa non oritur actio* (an action does not arise from a base cause) is premised on the notion that the courts will not assist a claimant who founds his claim on an immoral or illegal act. The principle, however, which seeks to discourage fraud, has had a notable exception when the claimant voluntarily withdraws from an illegal transaction before the illegal purpose has been wholly or partly carried into effect. In *Patel v Mirza*,¹ the Court of Appeal held that the exception could apply equally to cases where the withdrawal takes place because the illegal agreement can no longer be performed because of events outside the control of the parties.

The illegality doctrine has, however, since been more fully explored by the Supreme Court in *Mirza v Patel*² (on appeal from the Court of Appeal) who has effectively abandoned the so-called “reliance test” adopted by the House of Lords in *Tinsley v Milligan*³ in favour of a policy-driven approach requiring the court to consider a range of relevant factors in deciding whether the claimant should be allowed to recover his money despite the illegal transaction.

FACTS

The defendant, Salman Mirza, was a foreign exchange broker who had offered the claimant, Chandrakant Patel, and their mutual friend, George Georgiou, the opportunity to use his spread-betting account to bet on the movement of Royal Bank of Scotland (RBS) shares. The claimant had paid the defendant £620,000 on hearing that the defendant had contacts with the bank who could supply advance information about a statement anticipated to be made by the Chancellor of the Exchequer about the Government’s investment in the bank which would affect the bank’s share prices.

The plan was that the defendant would use the money, along with his own, to bet on the Investor’s Gold Index on movements in the quoted share price over a specified period using insider information. As it turned out, the defendant did not place any bets because the Government statement never materialised. The money was later mistakenly paid to Mr Georgiou. Unable, however, to recover from Mr Georgiou, the claimant sought to recover the money from the defendant as money paid for a consideration which had wholly failed and/or that it was held by the defendant on a resulting trust for him.

At first instance,⁴ Mr Donaldson QC (sitting as a deputy judge of the High Court) held that the claim was barred by illegality because it was founded on an illegal agreement which sought to take advantage of insider information. Moreover, the relief could not be granted as the claimant had not withdrawn from the agreement voluntarily before its implementation became frustrated. In his view, the rationale for the defence of *locus*

¹ [2014] EWCA Civ 1047.

² [2016] UKSC 42.

³ [1994] 1 AC 340.

⁴ [2013] EWHC 1892 (Ch).

poenitentiae was missing where the illegal purpose is not achieved because it is frustrated other than by the action of the claimant.

COURT OF APPEAL DECISION

On appeal,⁵ the majority (Rimer and Vos LJ) concluded that the deputy judge had been correct to find that the claimant needed to rely on the illegal arrangement, aimed at achieving a profit from the movement of the RBS shares by using insider information,⁶ in order to make out his claim. According to Rimer LJ, it was apparent that the claimant was positively relying on the illegal agreement in order to support his claim for the return of the money. Vos LJ, agreeing, added that the claimant had pleaded, relied upon and succeeded (in the deputy judge's judgment) in establishing the illegal agreement and could not now be heard to say that he could have succeeded as well had he not done so.⁷

Gloster LJ, however, felt unable to agree with the majority on the primary issue of whether the claimant had to rely on the illegality in order to found his claim for recovery of the money. In her Ladyship's view, the correct approach was to consider the *ex turpi causa* rule by reference to a number of policy considerations underlying the rule. So far as the present case was concerned, no insider information was ever received or used and no insider dealing ever took place. More importantly, the claimant was not seeking to enforce the criminal conspiracy entered into between the parties – on the contrary, his claim was to recover the money which he originally deposited with the defendant in circumstances where no bets were placed and the consideration under the contract had wholly failed. Significantly, he was not seeking to recover any benefit from his own wrongdoing. Moreover, the obvious consequence of denying recovery to the claimant would be to allow the defendant (as the more blameworthy agent) to profit disproportionately from the illegal agreement.

The Court of Appeal, however, was unanimous in reversing the deputy judge's decision on the application of the *locus poenitentiae* defence. According to Rimer LJ, the decision in *Bigos v Bousted*,⁸ relied on heavily by the deputy judge, was distinguishable in so far as it was concerned with the frustration of the illegal agreement because of the other party's refusal to perform it. It did not assist in resolving the issue where the illegal purpose had become impossible of performance by reason of a change of circumstances beyond the control of either of the parties to the illegal contract. On this point, it was open to the claimant to rely on the wholly unperformed illegal agreement because no distinction was to be made between "(a) cases where the withdrawal is from an illegal agreement which is no longer needed for the purpose for which it was designed, and (b) where the withdrawal is from an illegal agreement that cannot be or is anyway not going to be performed."⁹ In his Lordship's view, to recognise such a distinction would require proof of "genuine repentance" on the part of the withdrawer – something which was emphatically rejected by Millett LJ in the earlier case of *Tribe v Tribe*,¹⁰ who confined the defence to cases where the claimant "has withdrawn from the transaction before the illegal purpose has been wholly or partly carried into effect."¹¹

⁵ [2014] EWCA Civ 1047.

⁶ Insider dealing is an offence under s.52 of Part V of the Criminal Justice Act 1993. It may also amount to a conspiracy contrary to s.1 of the Criminal Law Act 1977.

⁷ [2014] EWCA Civ 1047, at [102].

⁸ [1951] 1 All ER 92.

⁹ [2014] EWCA Civ 1047, at [45].

¹⁰ [1996] Ch 107.

¹¹ *Ibid.*, at [134]–[135].

The other members of the Court took a similar approach. Vos LJ¹² concluded that a claimant may take advantage of the exception to the illegality principle:

“. . . if he voluntarily withdraws from an illegal transaction under which property has been transferred, without the need for genuine repentance, before the fraud or the illegal purpose has been wholly or partly carried into effect.”

In the present case, it was apparent that the transfer of money only allowed the defendant “to be ready to undertake”¹³ the illegal insider dealing. On this analysis, the payment of the money did not by itself “wholly or partially carry the illegal purpose into effect, since it remained open to [the defendant] to withdraw from the transaction and to reclaim his funds at any time before the shares were purchased with the benefit of insider information.”¹⁴ Moreover, since the reason for the withdrawal is irrelevant, there was no justification for drawing a distinction between “withdrawal from an illegal agreement that is no longer needed . . . and withdrawal because the illegal agreement can no longer be performed.”¹⁵

Similarly, according to Gloster LJ, the *locus poenitentiae* defence did not depend on the “vague and subjective concept of genuine ‘repentance’ or ‘withdrawal’ prior to the time at which the illegal agreement no longer is, or appears to be, capable of performance”.¹⁶ The simple fact in the present case was that the illegal purpose had not been carried into effect. The bet on the RBS shares was never placed and all that happened was that the £620,000 was received by the defendant in his private bank account.¹⁷

CRITICISM OF THE RELIANCE TEST

The so-called “reliance rule”, stated by the House of Lords in *Tinsley*, has been the subject of much debate. It has been criticised for producing uncertainty as to the exact meaning of reliance and for precluding the courts from paying attention to the policies underlying the illegality defence. The Law Commission, in its final report, *The Illegality Defence*,¹⁸ considered that the rule applied in *Tinsley* was arbitrary in differentiating between situations where a presumption of resulting trust and a presumption of advancement arose. The rule generated different results which were entirely fortuitous depending on the relationship of the parties. In an earlier report, *Illegal Transactions: The Effect of Illegality on Contracts and Trusts*,¹⁹ the Commission recommended the abandonment of the rule altogether in favour of granting the courts a discretion to declare a contract or trust illegal or invalid. The Commission also identified a number of potentially relevant factors to be applied in determining whether a claim should be disallowed by reason of illegality.

As we saw earlier, the deputy judge in *Mirza*, held that the claimant’s right to recover the money paid to the defendant was unenforceable because he had to rely on his own illegality to establish it, unless he could have brought himself within the exception of

¹² [2014] EWCA Civ 1047, at [113].

¹³ *Ibid*, at [116].

¹⁴ *Ibid*, at [116].

¹⁵ *Ibid*, at [116].

¹⁶ *Ibid*, at [96].

¹⁷ *Ibid*, at [95]. In the words of Gloster LJ: “Other than the illegal agreement itself, nothing illegal actually occurred”.

¹⁸ (2010), Law Com. 320.

¹⁹ (1999), Law Com. CP, No. 154.

locus poenitentiae. In the Court of Appeal, the majority agreed with the deputy judge on the reliance issue, but disagreed with him on the application of the exception. The minority view of Gloster LJ, however, was to reject the *Tinsley* approach and to consider instead whether the policy underlying the rule which made the contract illegal would be stultified by allowing the claim to succeed. In addressing that issue, her Ladyship applied, as we have seen, a number of factors including the degree of connection between the wrongful conduct and the claim made and the disproportionality of disallowing the claim to the unlawfulness of the conduct. This so-called “range of factors” approach has much to recommend it, not least because it permits flexibility and allows the court to reach a result having regard to a variety of policy considerations underlying the illegality doctrine – it has been adopted in other Commonwealth jurisdictions, notably, Australia, Canada and the United States.

CRITICISM OF THE *LOCUS POENITENTIAE* DEFENCE

In *Tribe v Tribe*,²⁰ a father transferred company shares to his son as a means of safeguarding them from his landlord who had required substantial repairs to be carried out on two properties occupied by the company. In the event, the father was not required to carry out the repairs and sought to recover the shares from his son. The father was allowed to recover the shares. The Court of Appeal held that, since the illegal purpose had never been carried out, the father could adduce evidence of the agreement that the son would hold the shares on a bare trust for him pending settlement of the repairs claim and thereby rebut the presumption of advancement. Although the *transaction* (i.e., the transfer of shares) had been carried into effect, the *purpose* had not since the landlord had not actually been deceived by the transaction. This was the view taken by Nourse L.J. The same conclusion was reached by Millett L.J., although he stated the principle in much broader terms – it would be open to the transferor to voluntarily withdraw from the transaction before the purpose had been wholly (or partly) performed. Moreover, a voluntary withdrawal did not require genuine repentance. The underlying rationale for the *locus poenitentiae* doctrine was to encourage withdrawal from a proposed fraud before it was implemented. This was in itself a desirable end just as the converse rule serves justice by discouraging fraud in the first place by refusing to provide assistance to a claimant who seeks to found his action on an illegal act.

Despite its apparent merits, the approach taken by Millett L.J. has been the subject of criticism, not least because it is unclear at what point the transaction has been carried into effect so as to prevent a withdrawal. The notion that a withdrawal can take place before the illegal purpose has been only *partly* carried into effect only adds to this uncertainty and confusion. Moreover, the superficiality of seeking to draw a distinction between the *transaction*, on the one hand, and the *purpose* on the other, inevitably leads to fine and artificial distinctions. Surely, in *Tribe*, the illegal purpose had, in every sense, been carried out once the shares had been transferred to the son. After all, this had the effect of divesting the father of all interest in the shares. On one view, the illegal purpose was to deceive creditors, but an equally plausible interpretation is that the father’s purpose was to make it look as if he no longer owned the shares by transferring them to his son. Although there was no deception, there can be no denying that the father had clearly fulfilled *that* purpose.

²⁰ [1996] Ch 107.

Interestingly, the point was addressed briefly in *Mirza* in the Court of Appeal, where Vos LJ²¹ noted that property could be transferred under an illegal transaction without the illegal purpose of the transaction being wholly or partly performed. He said:²²

“The transfer of the property may, in some circumstances, be properly regarded as simply preparatory and unconnected to the illegal purpose that was ultimately in view.”

Like *Tribe*, therefore, where the creditors had never been told of the transfer, the transfer of money in *Mirza* merely allowed the defendant the *opportunity* to further the criminal conspiracy without actually (wholly or partly) carrying the illegal purpose into effect. As his Lordship observed, “no shares were purchased here, and no information was obtained.”²³

SUPREME COURT RULING

The Supreme Court unanimously dismissed the defendant’s appeal and allowed the claimant to recover the £620,000 which he had paid to the defendant. This was done, however, by adopting a public policy analysis similar to that applied by Gloster LJ in the Court of Appeal. In so doing, the Supreme Court has overruled the decision in *Tinsley*.

According to the majority of their Lordships, (Lords Toulson giving the leading speech with whom Lady Hale and Lords Kerr, Wilson and Hodge agreed) the essential rationale of the illegality doctrine was that it would be contrary to the public interest to enforce a claim if to do so would be harmful to the integrity of the legal system. In assessing whether the public interest would be harmed in this way, it was necessary for a court to consider: (1) the underlying purpose of the prohibition which has been transgressed and whether that purpose will be enhanced by denial of the claim; (2) any other relevant public policy on which the denial of the claim may have an impact; and (3) whether denial of the claim would be a proportionate response to the illegality. Moreover, within that framework, various factors might be relevant, including the seriousness of the conduct, its centrality to the contract, whether it was intentional and whether there was marked disparity in the parties’ respective culpability.²⁴

So far as the question of *locus poenitentiae* was concerned, this was no longer relevant because it assumed importance only because of the wrong approach to the issue whether the claimant was entitled to the recovery of his money enunciated in *Tinsley*. In place of the reliance rule and the limited exception to it, a person who satisfies the ordinary requirements of a claim in unjust enrichment will not now be debarred from recovering money paid by reason of the fact that the consideration which has failed was an unlawful consideration. So far as the present appeal was concerned, it was apparent that the claimant satisfied those requirements. Moreover, he was not prevented from enforcing his claim simply because the money he sought to recover was paid for an unlawful purpose. In particular, there were no circumstances suggesting that enforcement of his claim would undermine the integrity of the justice system.²⁵ Accordingly, the claimant was entitled to the return of his money.

A dissenting view, however, was expressed by three of the Law Lords who preferred to dismiss the appeal on conventional principles. Lord Mance called for “a limited

²¹ [2014] EWCA Civ 1047, at [114].

²² *Ibid*, at [114].

²³ *Ibid*, at [116].

²⁴ [2016] UKSC 42, at [120], per Lord Toulson.

²⁵ *Ibid*, at [121], per Lord Toulson.

approach to the effect of illegality”²⁶ focusing on the need to avoid inconsistency in the law. In his view, replacing the current law with an “open and unsettled range of factors”²⁷ would only create more problems for future courts. In his Lordship’s words:²⁸

“What is apparent is this approach would introduce not only a new era but entirely novel dimensions into any issue of illegality. Courts would be required to make a value judgment, by reference to a widely spread melange of ingredients, about the overall ‘merits’ or strengths, in a highly unspecified non-legal sense, of the respective claims of the public interest and of each of the parties.”

Lord Clarke, adopting a similar stance, expressed concern that the court’s power to deny recovery on the ground of illegality should be limited to well-defined circumstances. In his view, there was no need to replace that approach with an open-ended discretionary jurisdiction²⁹ which was “far too vague and potentially far too wide to serve as the basis on which a person may be denied his legal rights.”³⁰ The correct approach, in his view, was to “address the problem by supplying a framework of principle which accommodates legitimate concerns about the present law.”³¹ Lord Sumption, again in similar vein, acknowledged that the reliance test, if devoid of the arbitrary requirements associated with the equitable presumptions of resulting trust and advancement, was sound in principle. This was because:

“First, it gives effect to the basic principle that a person may not derive a legal right from his own illegal act. Second, it establishes a direct causal link between the illegality and the claim, distinguishing between those illegal acts which are collateral or matters of background only, and those from which the legal right asserted can be said to derive. Third, it ensures that the illegality principle applies no more widely than is necessary to give effect to its purpose of preventing legal rights from being derived from illegal acts.”³²

In his Lordship’s view, therefore, justice could still be achieved by the application of the *Tinsley* doctrine without the necessity of revolutionising the law. An entirely discretionary approach, on the other hand, based on a range of evolving factors, converts “legal principle into an exercise of judicial discretion, in the process exhibiting all the vices of ‘complexity, uncertainty, arbitrariness and lack of transparency’ which [the majority of the Supreme Court] attributes to the present law.”³³

CONCLUSION

The flexible “range of factors” approach taken by the majority³⁴ of the Supreme Court opens the way for a structured analysis of the facts in a given case which hopefully will promote, rather than detract from, consistency in this area of law. As Lord Kerr

²⁶ *Ibid*, at [192].

²⁷ *Ibid*, at [192].

²⁸ *Ibid*, at [206].

²⁹ *Ibid*, at [214].

³⁰ *Ibid*, at [217].

³¹ *Ibid*, at [217].

³² *Ibid*, at [239].

³³ *Ibid*, at [265].

³⁴ As we have seen, Lords Sumption, Mance and Clarke dissented. In their view, the range of factors approach converted the legal principle in *Tinsley* into an exercise of discretion and required the courts to make value judgments about the respective claims of the parties. For that reason, it was unjustified and not necessary to achieve substantial justice in most cases.

observed, it also has “the added advantage of avoiding the need to devise piecemeal and contrived exceptions to previous formulations of the illegality rule.”³⁵

What essentially the Supreme Court has done is to replace a rule of principle (enunciated in *Tinsley*) with an expression of policy. The weighing of rival policy considerations is now the proper approach in determining whether a defence of illegality should be allowed to succeed. In the words of Lord Neuberger (agreeing in principle with Lord Toulson’s analysis):³⁶

“When faced with a claim based on a contract which involves illegal activity (whether or not the illegal activity has been wholly, partly or not at all undertaken), the court should, when deciding how to take into account the impact of the illegality on the claim, bear in mind the need for integrity and consistency in the justice system, and in particular (a) the policy behind the illegality, (b) any other public policy issues, and (c) the need for proportionality.”

Undoubtedly, this marks a significant change in the law, not least because the policy factors identified by the majority of the Supreme Court will now be used to influence an essentially new discretionary jurisdiction as to whether a claimant should be entitled to the return of his money or property. It remains to be seen, however, whether this “revolutionary”³⁷ approach will lead to clarity or serve as a tool for further complexity and arbitrariness by simply substituting “a new mess for an old one”.³⁸

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³⁵ *Ibid*, at [123].

³⁶ *Ibid*, at [174].

³⁷ *Ibid*, at [264], per Lord Sumption.

³⁸ *Ibid*, at [265], per Lord Sumption.

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