

The latest interpretation of the illegality defence in the Cayman Islands

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In the long-awaited decision of *Ahmad Hamad Algosaibi and Brothers Company (AHAB) v SAAD Investments Company Limited (In Official Liquidation) (SICL) and Others*, [1] the Cayman Court (**the Court**) dismissed AHAB's claims of fraud alleged against Mr Al Sanea's Cayman companies. In doing so, numerous complex areas of the law concerning commercial fraud and the ability to trace assets through corporate groups and into sophisticated financial products were considered. In this article, we unpick what was said about the illegality defence and what lessons can be derived for future Cayman cases where this defence might be engaged.

In *AHAB*, the Court found that AHAB and Al Sanea had acted in concert, in order to fraudulently obtain billions of dollars in borrowings. The loans would not have been made had the banks known the true financial position of the Money Exchange, an unincorporated division of the AHAB Partnership of which Mr Al-Sanea was Managing Director. The Court found that the fraud perpetrated by AHAB and Al Sanea was an enormous, long standing scheme (and was effectively a Ponzi Scheme) which had defrauded more than a hundred banks and that the Money Exchange was, from its very inception, a criminal enterprise and remained so throughout its existence. This decision has recently been appealed on very wide ranging grounds.

As the Court found that the fraudulent actions of Al Sanea were either explicitly or implicitly authorised by AHAB, thus there was no factual basis on which AHAB could show it had been defrauded, there was no need for the Court to find that the defendant Cayman Companies (represented by a number of different official liquidators) could invoke an illegality defence. However, the Court, no doubt in anticipation of the appeal to be heard in 2019, said that if its factual finding of complicity was overturned then the illegality defence would have been engaged. Consequently, the Court gave useful guidance on how to approach the "notoriously knotty" [2] defence of illegality.

The illegality defence is underpinned by the principle that a person should not be able to use the

justice system to benefit from their wrongdoing. A claim or counterclaim which falls foul of the principle will not be enforced. While the aim of the doctrine is simple to state, the law of illegality has been in a state of flux for many years primarily due to the inconsistent judicial approaches adopted by the English Supreme Court Justices grappling with its application in practice. It has long been difficult to discern a principled approach to the application of the doctrine in the various factual contexts in which it has been invoked.

AHAB now confirms the Court's view that Lord Toulson's majority speech in the nine-judge panel Supreme Court case of *Patel v Mirza* (**Patel**) [3] represents an authoritative statement of law on the issue of illegality [4] and that as a result of that decision, the proper approach for the Court in respect of the illegality defence is to consider the new tripartite test as articulated by Lord Toulson in *Patel*. [5] We think that this means that the circumstances in which the illegality defence can be invoked should become somewhat easier to distinguish and apply.

The test for illegality

It had previously been commonly accepted that where a claim or counterclaim necessarily relied on any illegal conduct, then the claim would not be permitted to proceed. This was known as the "reliance test" or the rule in *Tinsley v Milligan* [6] (**the reliance test**), and was famously applied by the English Court of Appeal in *Stone & Rolls Ltd v Moore Stephens* (**Stone & Rolls**). [7] In the Cayman case of *TCB Creditor Recoveries Ltd v Arthur Andresen*, [8] allegedly negligent auditors successfully relied on the illegality defence to defeat a professional negligence claim against them for failing to detect that TCB Creditor Recoveries Ltd (**TCB**) an investment fund, had been used by its director to defraud investors. Arthur Anderson argued that in bringing the claim, TCB relied on its own illegal publication of false financial statements as part of its pleaded claim, and therefore the claim was barred. The Court agreed and applying the reliance test, ruled that the illegality defence was engaged so to bar TCB's claim.

The "reliance test" applied in *TCB* has been the subject of significant criticism as exemplifying the problems of arbitrariness, uncertainty and potential for injustice. [9] Lord Toulson in *Patel* endorsed the English Law Commission's view that the reliance test led to uncertainty "because there was much confusion over what exactly amounted to 'reliance' which had the potential to force the court into unjust decisions because, focusing on procedural matters, the reliance principle precluded the court from paying attention to the policies that justified the existence of the defence, or taking into account such matters as the seriousness of the illegality and the value of the interest at stake." [10] Lord Toulson rejected this strict rule-based approach in favour of a more flexible application of a framework of clear principles so as to take into account the particular circumstances of the case.

The Court in *AHAB* agreed with Lord Toulson's approach in *Patel* and ruled that the deployment of illegality as a defence should be dependent, not on the procedural concept of "reliance" as applied in *Stone & Rolls* (and therefore *TCB*) but upon a range of factors, based upon the nature

and circumstances of the illegal conduct involved and the purpose behind the public policy violated. Thus, when considering a defence of illegality, the Court should now apply the following test (**the tripartite test**):

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
3. whether denial of the claim would be a proportionate response to the illegality [11]

Relying on Lord Toulson's judgment, the Chief Justice, accepted that a useful benchmark for the Court when considering the application of the illegality defence is to ask:

1. how seriously illegal or contrary to public policy the conduct was
2. whether the party seeking enforcement knew of, or intended, the conduct
3. how central to the contract or its performance the conduct was
4. how serious a sanction the denial of enforcement is for the party seeking enforcement
5. whether denying enforcement will further the purpose of the rule which the conduct has infringed
6. whether denying enforcement will act as a deterrent to conduct that is illegal or contrary to public policy
7. whether denying enforcement will ensure that the party seeking enforcement does not profit from the conduct
8. whether denying enforcement will avoid inconsistency in the law thereby maintaining the integrity of the legal system [12]

Application to other cases

While the analysis of the Chief Justice in *AHAB* has simplified the approach to be adopted where a plaintiff has, itself, been a direct party to the wrongdoing alleged against the defendant, as in *AHAB*, the application of the tripartite test is yet to be tested in Cayman in the various other factual contexts in which the illegality defence has historically been raised.

In particular, a common related issue in a corporate context is whether the wrongful conduct of a company insider, such as a fraudulent director, can be attributed to the company and thus, by reason of an application of the illegality defence, bar any claim by the company for redress against either the fraudulent insider themselves or a third party.

In the case of a corporate plaintiff 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 that dishonesty being attributed to the company, so that the claim will be barred by the illegality defence.

However, where a company is bringing a claim against the fraudulent director or his accomplices for losses sustained, the director's fraudulent state of mind will not be attributed to the company where the knowledge relates to his own breach of duty to the company. [13] In this scenario, the company tends to be treated as a victim of the fraud, and as such, the illegality defence cannot be invoked so as to permit the defendant to rely on his own fraud to defeat the company's claim. Complexities arise however where there are a variety of wrongdoers and innocent parties involved. It is in these different scenarios where the application of the tripartite test will likely see the Court striving to do justice on behalf of (and to balance the interests of) any innocent parties. The present difficulty is that the tripartite test is very new, and it is therefore difficult to predict how the English and Cayman Courts will apply the test and what broad categories of differing treatment will emerge as a consequence.

As far as claims made by the company against third parties which require reliance on illegal conduct to make good a claim, some guidance can be derived from the recent decision of *Singularis Holdings Ltd (In Official Liquidation) v Daiwa Capital Markets Europe Ltd* [14] which is a case in which the English Court of Appeal applied the new tripartite test in *Patel*. Here, the English Court held that the claim of the company against a bank for negligence should not be barred on the basis of the illegality defence in circumstances where the company's sole shareholder and director (in fact the very same, Mr Al-Sanea) had acted fraudulently in directing payments to be made out of the company's account. In this case, the court found that the director's fraud should not be attributed to the company. Applying the more flexible tripartite test, the English Court found that any bar to the company's claim would undermine the bank's established duty to the company (which had clearly been breached) and would not therefore be a proportionate response.

Conclusion

The new tripartite test confirmed in *AHAB* goes some way to clarify the law in an area which has traditionally been marked with considerable confusion.

AHAB makes it clear, albeit obiter, that the defence of illegality will be successfully invoked where the claimant is complicit in the wrongful act of the defendant. By contrast, the illegality defence is unlikely to be invoked in circumstances where the company seeks redress against the fraudulent insider itself and such defence would permit the fraudster to defeat the claim by reliance on his own wrongdoing.

In all other circumstances the position is less clear and will require a more complex analysis of the factors identified by the court in *Patel* when applying the new tripartite test. We look

forward to watching the development of the law in this area and particularly as to how the tripartite test will be construed in the context of the familiar corporate scenarios which arise in Cayman. This will hopefully result in the emergence of more obvious (and so easier to apply) rules and so further clarify the role of the illegality defence in each of those scenarios.

[1] unreported, 31 May 2018

[2] *Parking Eye Ltd v Somerfield Stores Ltd* [2013] Q.B. 840 at [28]

[3] [2016] UKSC 42 SC

[4] *AHAB* (n 1) at section 7D, paragraph 46, page 1175

[5] *Ibid* at paragraph 58, page 1180

[6] *Tinsley v Milligan* [1994] 1 A.C. 340

[7] *Stone & Rolls Ltd v Moore Stephens* [2008] 2 W.L.R. 1146; [2008] EWCA Civ 644

[8] *TCB Creditor Recoveries Ltd v Arthur Andresen* [2008] CILR 486

[9] 'The Illegality Defence' (Law Com No 320).

[10] *Patel v Mirza* [2016] UKSC 42 para 23

[11] *AHAB* (n 1) at section 7D, paragraph 58, page 1180

[12] *Ibid* section 7D, paragraph 59, 1180

[13] *Moulin Global Eyecare Trading Limited (In liquidation) v Commissioner of Inland Revenue* FACV 5/2013 [2014] HKCFA 22

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