The development of the illegality defence marches on: recent input from the English and Cayman Islands courts

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A UK Supreme Court decision from the end of 2020 (*Stoffel & Co v Grondona* [2020] UKSC 42) has provided further helpful guidance to common law jurisdictions on the availability of the recently overhauled illegality defence. [1] This article considers what can be learned from the latest analysis from the English Supreme Court and the Grand Court of the Cayman Islands. [2]

This is highly relevant to fraud and asset recovery practitioners in the Cayman Islands, as well as defendants in commonwealth proceedings generally where there is some illegality in the fact pattern.

The essence of the illegality defence was reconfirmed by Lord Lloyd-Jones in the *Stoffel* decision [3] as follows: "The true rationale of the illegality defence... is that recovery should not be permitted where to do so would result in an incoherent contradiction damaging to the integrity of the legal system". This means the courts will not assist a litigant (or anyone claiming through them) to benefit from their own wrongdoing, if to do so would undermine the integrity of the legal system. For example, in a situation where someone has hired an assassin and then tried to sue them for breach of contract when the intended target was not assassinated: given the nature of the illegal activity involved, it would undermine the integrity of the legal system if the hiring party was then able to obtain damages for breach of contract.

The examples in the cases are not always so obvious and the application of the defence can sometimes lead to arguably unfair consequences. The classic example is where negligent auditors, in circumstances where a director has perpetrated a fraud, successfully rely on the defence to defeat a professional negligence claim against them notwithstanding that there has been negligent conduct by the auditor.

Until 2016, there had been a period of considerable uncertainty on the appropriate approach to

the illegality defence, with Chitty on Contracts calling this a "problematic topic". [4] The historic position was the reliance principle as expounded in the English cases of *Tinsley v Milligan* [5] and *Stone & Rolls*, [6] and applied in the Cayman Islands in *TCB Creditor Recoveries Ltd v Arthur Andersen.* [7] Under the reliance principle, relief would be refused to parties who had to rely on their own illegality to establish their claim. However, this broad approach meant that, according to Lord Mance, "by the end of the twentieth century it [the defence of illegality] had become encrusted with an incoherent mass of inconsistent authority". [8]

The illegality defence was radically reconsidered and restated by the UK Supreme Court in *Patel v* Mirza, [9] where there was a rejection of the reliance principle, and the adoption of a more flexible policy-based approach that openly addresses the underlying public policy factors. This was to deal with the uncertainty that had been caused by the inconsistent body of case law and to address the unfairness of the results that the "reliance approach" sometimes produced. In this new approach, the court undertakes a balancing exercise of the relevant policy considerations, as well as taking account of the proportionality of the outcome in each case. The *Patel v Mirza* case has been explored in a previous Ogier article [10] in more detail, but in summary, in his judgment on behalf of the majority Lord Toulson set out a three part test to determine whether enforcing a claim would be harmful to the integrity of the legal system. The Court must look at this "trio of necessary considerations": [11]

i. the underlying purpose of the prohibition that the Plaintiff has transgressed and whether that purpose will be enhanced by denial of the claim

ii. any other relevant public policy on which the denial of the claim may have an impact

iii. whether denial of the claim would be a proportionate response to the illegality, bearing in mind that punishment is a matter for the criminal courts

The "trio of considerations" was accepted in the Cayman Islands by the Chief Justice in *Ahmad Hamad Algosaibi and Brothers Company v SAAD Investments Company Limited (In Official Liquidation) (SICL) and Others* [12] (discussed in more detail in Ogier's previous article on this topic [13]). The Cayman Islands Court of Appeal has also recently acknowledged [14] that *Patel v Mirza* has "radically reformulated "the principles governing the illegality defence, by introducing a structured, purposive and policy-based approach.

Last year, the Chief Justice again considered the *Patel v Mirza* principles in *Arnage Holdings Ltd (and others*). [15] The *Arnage* judgment made clear that the law in the Cayman Islands is now that a claim can no longer be dismissed simply by reliance on the doctrine of ex turpi causa, with the Chief Justice saying that "the mere assertion that [one of the Plaintiffs] would be profiting from her wrongdoing as an automatic bar to the Plaintiffs' claims, failed to engage with the principles from Patel v Mirza". The Court will therefore need to grapple with weighing up the competing policy considerations and the severity of any possible illegality.

In *Arnage*, the relevant point for these purposes was the Defendant's strike out application based on the illegality defence. However, the Chief Justice considered that the allegation of illegal conduct was unproven and "entirely moot" [16] and so he considered that he did not need to make any finding as to whether the *Patel v Mirza* illegality defence could be applied in this case. [17] The Chief Justice did go on to make some non-binding but helpful observations about the illegality defence, noting (among other points) that the burden is on the defendant to make out the illegality defence and to satisfy the Court that each and every one of a plaintiff's claims should be barred for illegality. [18] The Chief Justice also noted that in the *Arnage* case there were only allegations of illegality made against some but not all of the Plaintiffs, meaning that to the extent those particular Plaintiffs could show loss or damage, the Defendant could not argue that their claims were unsustainable. [19] In respect of the proportionality exercise required by the third limb of *Patel*, the Chief Justice considered that it would be disproportionate to reject the Plaintiff's claim against the Defendant on account of her "lie" to a Brazilian Court, because that would result only in an unjustified windfall for the Defendant. [20]

Issues relating to the illegality defence came before the UK Supreme Court in *Stoffel v Grondona.* [21] The facts and procedural background to this matter were as follows:

i. this case related to the sale and purchase of a 125-year lease, the buyer was a Ms Grondona. The defendant was the solicitor firm Stoffel & Co involved in that transaction, who had negligently failed to register with the Land Registry: (i) the transfer of the property from the buyer to Ms Grondona; (ii) the release of the seller's lender's charge over the property; or (iii) Mr Grondona's bank's new charge over the property. This meant that the seller continued to be the registered owner of the property, and the property continued to be subject to his lender's charge

ii. Ms Grondona later defaulted on her mortgage repayments. Her bank then brought claims against her, and she sought damages from Stoffel & Co for negligent breach of their retainer and a concurrent claim in breach of contract and in tort

iii. however, Ms Grondona had only obtained her mortgage advances by mortgage fraud, having made dishonest representations in the mortgage application form about the nature of the sale and the source of the deposit moneys (among other things). Stoffel & Co had conceded negligence and/or breach of retainer, however against the factual background of the mortgage fraud undertaken by Ms Grondona, Stoffel & Co sought to run an illegality defence. At first instance and before the Court of Appeal, the illegality defence was not accepted and Ms Grondona was successful in her claim. Stoffel & Co then appealed to the Supreme Court

On the three limbs of the *Patel* approach, the Supreme Court considered the following points:

i. **the underlying purpose of the prohibition that the Plaintiff has transgressed and whether that purpose will be enhanced by denial of the claim** – Ms Grondona had been

knowingly and dishonestly involved in mortgage fraud to obtain an advance to purchase the property. Lord Lloyd-Jones noted (among other points) that there is an important policy that the law should condemn mortgage frauds, however, he did not think that permitting Ms Grondona's claim would undermine that policy to any significant extent. He considered that "the risk they [ie mortgage fraudsters] may be left without a remedy if their solicitor should prove negligent in registering the transaction is most unlikely to feature in their thinking [in deciding to carry out mortgage fraud] "[22]

ii. **any other relevant public policy on which the denial of the claim may have an impact** – a key countervailing public policy factor that the Supreme Court considered here was that conveyancing lawyers should perform their duties to their clients diligently and without negligence, and that if they do not do so their clients should be entitled to seek a civil remedy for any loss suffered. Therefore, Lord Lloyd-Jones said that "to permit solicitors to escape liability for negligence in the conduct of their client's affairs when they discover after the event that a misrepresentation was made to a mortgagee would run entirely counter to these policies" [23]

iii. **whether denial of the claim would be a proportionate response to the illegality** – in light of the Court's conclusions on the first two factors (that to permit the claim in the circumstances of this case would not undermine the public policies underlying the criminalisation of mortgage fraud, and that to deny Ms Grondona's claim would be inconsistent with the policy that the victims of lawyers' negligence should be compensated for their loss), Lord Lloyd-Jones considered that it was not strictly necessary to go on to consider the third limb on proportionality because the claim would be allowed so there was no risk of disproportionate harm to the plaintiff by refusing relief to which they would otherwise be entitled. [24] However, he did go on to address it. The Court concluded that it would not be proportionate to deny Ms Grondona's claim because it is "conceptually entirely separate" from the mortgage fraud: [25] by the time Stoffel & Co was required to register the transactions, the loan had been advanced and used to discharge the pre-existing charge on the property, therefore the defrauding of the mortgagee had already been achieved [26]

Submissions had also been made on whether Ms Grondona's claim should be barred because she was profiting from her own wrongdoing. Stoffel & Co had accepted in their application for permission to appeal that Ms Grondona's claim was in respect of losses suffered rather than to enforce an illegitimate gain; [27] if the claim were to succeed, she would acquire the means of meeting a substantial judgment against her. However, Lord Lloyd-Jones considered that the fundamental answer to Stoffel's submission on this point was that although "profiting from one's own wrong" remains a relevant consideration, it is "no longer the true focus of the enquiry", because the key rationale of the illegality defence is that recovery should not be permitted where to do so would result in an incoherent contradiction damaging to the integrity of the legal system. [28]

Therefore, Lord Lloyd-Jones giving judgment of the Supreme Court (with which all members of the Court agreed) was to reject Stoffel's appeal and hold that Ms Grondona's claim was not barred by illegality. The judgment made it clear that the application of the trio of considerations should not be applied in a mechanistic way. [29] Further helpful guidance from the *Stoffel v Grondona* judgment is confirmation that the Court is not required to evaluate the underlying policies themselves or to carry out a policy-based evaluation of the relevant laws. Instead, the court is simply seeking to identify the policies that are engaged by the question of whether or not to allow the claim, to ascertain whether to allow the claim would be inconsistent with those policies, or where the policies complete, determine where the overall balance lies. [30]

This is a complex area, and judgments will undoubtedly be very fact specific on each case. On its face, the *Stoffel v Grondona* decision might be thought to be counterintuitive, in that the illegality defence did not protect a defendant in circumstances where the plaintiff was an admitted mortgage fraudster. Therefore, the new Supreme Court decision and the Cayman Islands *Arnage* decision, are both examples of a Plaintiff successfully thwarting an illegality defence. As the illegality defence body of case law develops in commonwealth jurisdictions following the 2016 *Patel v Mirza* decision, we hope that we will continue to gain greater clarity on the operation of this defence and its consequences, particularly in the realm of commercial fraud and asset recovery actions.

Four key points to take away from these recent illegality cases are:

i. **demonstrating illegal conduct by the plaintiff is no longer enough** – as emphasised by both the Chief Justice in *Arnage* and Lord Toulson in *Stoffel*, a defendant trying to avail itself of the illegality defence cannot simply assert the claim should be automatically barred on the basis that "to allow the claim would allow the Plaintiff to profit from their wrongdoing"

ii. **illegality defences will be more difficult to establish** – running a successful illegality defence is now much more exacting than merely showing that some illegal conduct has been committed by the Plaintiff (as can be seen on the facts of *Stoffel*, where the Plaintiff was a mortgage fraudster, but her claim was not barred by the illegality defence)

iii. **balancing the policy considerations at play is paramount** – a defendant must fully engage with the "trio of considerations" set out in *Patel v Mirza* (which is what the Defendant in *Arnage* had not done), which effectively requires a detailed and careful balancing of different policy considerations

iv. **not always strictly necessary to consider proportionality** – finally, the third point in the "*Patel* trio of considerations" is whether denial of the claim would be a proportionate response to the illegality. Lord Toulson in *Stoffel* made clear that if the outcome of the

balancing exercise for the policy considerations at stages one and two is such that the Court is not going to accept the illegality defence, then the Court does not necessarily need to go on to consider this third stage (because no question of the impact on the denial of the claim then arises, since the claim is not being barred for illegality)

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[1] Also referred to as the ex turpi causa non oritur actio defence (no claim arises from a disgraceful cause)

[2] *Arnage Holdings Ltd, Brooklands Holdings Ltd and others*, FSD 0105 of 2014 (ASCJ), unreported, 16 May 2019, see paragraphs 434 to 466

[3] *Stoffel & Co v Grondona* [2020] UKSC 42, paragraph 46

[4] *Chitty on Contracts*, 33rd Edition, [16-002]

[5] *Tinsley v Milligan* [1994] 1 AC 240

[6] *Stone & Rolls Ltd v Moore Stephens* [2008] EWCA Civ 664

[7] *TCB Creditor Recoveries Ltd v Arthur Andersen* [2008 CILR 486]

[8] *Jetivia SA v Bilta (UK) Ltd* [2015] UKSC 23, [2016] AC 1 at paragraph 61

[9] *Patel v Mirza* [2016] UKSC 42

[10] For more information, read our briefing "The latest interpretation of the illegality defence in the Cayman Islands"

[11] *Ibid*, paragraph 120

[12] 31 May 2018, [2018 (3) CILR 1]

[13] The latest interpretation of the illegality defence in the Cayman Islands

[14] *Palladyne International Asset Management B.V. v Upper Brook (A) Limited and others*, CICA Appeal No 5 of 2019, unreported, 18 November 2019, see paragraph 106

[15] *Arnage Holdings Ltd, Brooklands Holdings Ltd and others*, FSD 0105 of 2014 (ASCJ), unreported, 16 May 2019, see paragraphs 434 to 466 (and particularly 446 onwards)

[16] *Ibid*, at paragraph 461(ii) the Chief Justice said: "denying these claims would allow the Defendant to escape from the consequences of its numerous and serious breaches of duty owed to the Plaintiffs because, entirely separately, unproven allegations by the Defendant itself of

illegal conduct in Brazil have been made against one (but not others) of the Plaintiffs"

[17] *Ibid*, paragraph 455

[18] *Ibid*, paragraph 455

[19] *Ibid*, paragraph 456

[20] *Ibid*, paragraph 459

[21] *Stoffel & Co v Grondona* [2020] UKSC 42

[22] *Ibid*, paragraph 29

[23] *Ibid*, paragraph 32

[24] *Ibid*, paragraphs 26 and 35

[25] *Ibid*, paragraph 43

[26] *Ibid*, paragraph 40

[27] *Ibid*, paragraph 44

[28] *Ibid*, paragraph 46

[29] *Ibid*, paragraph 26

[30] *Ibid*, paragraph 26

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