"Does the availability of an illegality defence depend on the scope of the duty owed?"

Introduction

1. "*Ex turpi causa non oritur actio*"; "*no court will lend its aid to a man who founds his cause of action on an immoral or illegal act*".[1] Upon this ancient incantation rests one of the most troublesome defences in English law. Under the illegality defence, the Court refuses to allow certain claims on grounds of illegality or immorality. The defence exists not to protect the Defendant but rather arises from the Court's refusal to allow claims founded on illegal or immoral acts[2] of sufficient turpitude.[3]

2. The operation of the defence is a vexed question with multiple Law Commission reports[4] and no fewer than five recent House of Lords (**HL**) or Supreme Court decisions on the subject. Two of these - *Stone & Rolls* and *Bilta (UK) Ltd (in liquidation) v Nazir (No. 2)*[5] – have seen judicial consideration of whether the answer as to when the illegality defence is available lies in the concept of the "*scope of duty*".[6]

3. Such considerations may appear surprising; the law has a fundamental distinction between *claims* - which are made up of various elements the Claimant must prove (in a tortious negligence claim, for example, the existence of a duty of care which the Defendant breached causing the Claimant recoverable loss) – and *defences* which are legal routes by which a Defendant can escape liability *despite all the elements of a claim being present*.

4. Questions about "*scope of duty*" historically belong on the *claim* side of the distinction. In claims based on statutory, contractual, equitable or common law duties the Court asks, among other things, whether the *scope* of the Defendant's duty extends to the facts which found the claim. In *United Bank of Kuwait v Prudential Property Services*[7], for example, negligent valuers were found only liable to lenders for damages representing the difference between their (incorrect) valuation of the security and its correct value but not for losses arising from

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1 *Holman v Johnson* (1775) 1 Cowp 341, 343, Lord Mansfield CJ

2 *Holman* 341, 343

3 *Stone & Rolls (in liquidation) v Moore Stephens* [2009] UKHL 39; [2009] 1 AC 1391, [24], Lord Phillips

4 A summary of the Law Commission's various reports is located in Burrows, *A Restatement of the English Law of Unjust Enrichment* (Oxford: 2012), 137ff.

5 [2015] UKSC 23; [2015] 2 WLR 1168

6 The other recent decisions are: *Gray v Thames Trains* [2009] UKHL 33; [2009] 1 AC 1339; *Allen v Hounga* [2014] UKSC 47; [2014] 1 WLR 2889 and *Les Laboratoires Servier v Apotex* [2014] UKSC 55; [2015] AC 430

7 [1997] A.C. 191 HL

the borrower's default. The scope of the valuer's duty to the lenders extended to valuation of the security but not to risk of default.[8]

5. The illegality defence, however, traditionally belongs on the *defence* side of the distinction. Accordingly, an illegality defence would traditionally enable a Defendant to escape liability *despite all the elements of a claim (including scope of duty enquiries) being satisfied*.

6. As noted, however, certain cases have explored merging the illegality defence and scope of duty enquiries. It is argued below that this recent trend is undesirable because it elides, or muddles, two separate concepts – the illegality defence and the scope of duty.

7. It is argued below that the illegality defence does not as a matter of *precedent*, and should not as a matter of *principle*, depend on the scope of the duty owed. The answer to the question posed by this essay is "*No*".

8. Rather, the availability of the illegality defence should depend, it is argued below, on a structured discretion which takes account of multiple factors, along the lines previously recommended by the Law Commission.

Precedent

9. This section argues that despite *Stone & Rolls* and *Bilta*, no binding precedent exists which requires availability of the illegality defence to depend on the scope of the duty owed.

10. In *Stone & Rolls*, Mr Stojevic had been the sole directing mind and will and beneficial owner of the company. Mr Stojevic procured the company to commit fraud on various banks including Komercni Banka AS (**Komercni**) which sued the company for damages for deceit, rendering the company insolvent.[9]

11. The insolvent company sued the company's auditors for negligently failing to detect the fraud. The commercial reality was that the liquidators were suing to recover on behalf of the company's innocent creditors.[10] The auditors raised a preliminary issue that, even had they been in breach of their duty of care, the claim against them failed because of the operation of the illegality defence. It was this preliminary question which was put before the HL who, on a

8 222, Lord Hoffmann
9 [1], [2], Lord Phillips
10 [5], Lord Phillips

3-2 majority (with all the majority judges adopting differing reasoning), held the claim failed.[11]

12. Certain judges based their reasoning on the idea that the scope of duty enquiry and the illegality defence were linked. Lord Phillips stated at [86] that although the *"scope*" of the auditor's duty was "*not directly in issue*" he could not isolate that question from the question of whether the illegality defence was raised. He was of the view that "*all those whose interests formed the subject of any duty of care owed by [the auditors] to [the company], namely… Mr Stojevic, were party to the illegal conduct that forms the basis of the company's claim. In these circumstances I join with Lord Walker and Lord Brown in concluding that ex turpi causa provides a defence*."

13. It is respectfully argued that merging the scope of duty enquiry and the illegality defence was unnecessary. Relying on *Caparo v Dickman*[12] the majority appear to have been of the view that an auditor's duty was owed to shareholders rather than to creditors and, therefore, the claim in *Stone & Rolls* which was brought (as a matter of commercial reality) on behalf of the creditors failed.[13] However, "*if the duty of an auditor simply does not extend to creditors' interests and is exclusively shareholder oriented, the failure of an auditor to detect a fraud perpetrated by all of the shareholders cannot be said to be a breach of the auditor's duty that has caused recoverable loss*."[14] The auditors' negligence in failing to detect the fraud did not cause any loss in *Stone & Rolls* because, as noted by Lord Walker, "*[i]f the only human embodiment of the company already knew all about its fraudulent activities, there was realistically no protection that its auditors could give*".[15]

14. The above shows that merging the illegality defence with scope of duty enquiries in *Stone & Rolls* was unnecessary – a simpler analysis would have been that the auditor's negligence did not cause the company loss. There was no need to include illegality reasoning at all much less merge such reasoning with the scope of duty enquiry.

15. It is suggested that the reason that certain judges were forced to shoehorn illegality reasoning into their analysis was because it was the availability of the illegality defence which had come before them as the preliminary issue to be tried.[16] The shoehorning of these two concepts is likely owing to an accident of litigation as to the way the case came before their Lordships, it is suggested. A Supreme Court decision, *Bilta*, has since largely confined *Stone & Rolls* to its

11 [1], Lord Phillips
12 [1990] 2 AC HL
13 E.g. [19], Lord Phillips, [168], Lord Walker, [202], Lord Brown
14 Ferran, 127 LQR (2011), 254
15 [168]
16 [1], Lord Phillips, Ferran, 253

facts and, to the extent that it remains as authority for propositions about the illegality defence, these do not include the proposition that the availability of the illegality defence depends on the scope of the duty owed (Lord Neuberger, [24], Lord Sumption, [80], Lords Toulson and Hodge, [154]).

16. Nor does *Bilta* itself establish as a matter of precedent that the availability of the illegality defence depends on the scope of the duty owed. In *Bilta*, D1 and D2 were the sole directors of the company, C1. A claim was brought by C1 and its liquidators against D1 and D2 on the basis that D1 and D2 had procured C1 to engage in fraud which rendered C1 insolvent. An application brought by D6 and D7 (who were alleged to have assisted in the conspiracy to defraud C1) to have the claim struck out on the grounds of the illegality defence (in that C1 had been a party to the fraud) failed before the Supreme Court.

17. The *ratio* of *Bilta* did not turn on scope of duty considerations. Rather, the case turned on the fact that the fraudulent actions of the directors could not be attributed to the company (C1) and, therefore, the illegality defence would not apply (see for example, Lord Neuberger [7]-[9], Lord Mance [39]-[48], Lord Sumption [86]-[97] and Lords Toulson and Hodge [208]-[209]). It is true that Lords Toulson and Hodge did make statements to the effect that ([130]):

> *"the purpose of the inclusion of the creditors' interests within the scope of the fiduciary duty of the directors of an insolvent company towards the company is so that the directors should not be off the hook if they act in disregard of the creditors' interests. It would be contradictory, and contrary to the public interest, if in such circumstances their control of the company should provide a means for them to be let off the hook on the ground that their illegality tainted the liquidators' claim."*

Nonetheless, such reasoning was unnecessary in the light of the decision on attribution. Additionally, the reasoning only appeared in two of seven judicial opinions and so does not establish binding precedent that the availability of the illegality defence depends on the scope of the duty owed.

Principle

18. Having established that the availability of the illegality defence does not depend on the scope of the duty as a matter of precedent, four reasons are provided below as to why, as a matter of principle, the illegality and scope of duty enquiries ought not to be elided.

19. Firstly, elision creates undesirable conceptual confusion; it blurs the traditional distinction between elements which make up a claim and defences (see paragraphs 3-6 above). Such elision accordingly undermines the rational structure of the law.

20. Secondly, elision tends towards the conceptual fragmentation of the illegality defence. A proposition that the availability of the illegality defence depends on the scope of the duty owed may have some potential pertinence in respect of, for example, negligence claims where scope of duty enquiries are relevant because the scope of a Defendant's duty is relevant to whether the Defendant has any *prima facie* liability in negligence at all (a duty of care being one of the elements of a negligence claim).

21. However, the illegality defence also has to operate in respect of types of claim where scope of duty enquiries are irrelevant such as, for example, claims founded on proprietary rights,[17] unjust enrichment claims[18] and certain tortious claims aside from negligence.[19] If the proposition were accepted, it would mean that the illegality defence would have to operate in a different way in respect of claims (such as negligence) which include scope of duty considerations (where the availability of the defence would depend on scope of duty enquiries) from those claims (such as unjust enrichment claims) where scope of duty enquiries are irrelevant. The potential fragmentation of the way the illegality defence operates across a variety of claims is a reason to reject the proposition that the availability of the defence depends on the scope of the duty owed.

22. Thirdly, elision is unnecessary:

    (1) It is correct that, in some cases, a claim could be rejected on the alternative bases that either: (i) the scope of the duty requirement is not satisfied; or (ii) that the illegality defence is raised. However, this is not a reason to merge separate enquiries.

    (2) For example, in *Carlo Vellino v Chief Constable of Greater Manchester*[20], C attempted to evade arrest by jumping from the window of his second floor flat and sustained severe injuries.[21] C sued the Chief Constable and, by majority, lost. One basis for C to have lost was that the scope of the Chief Constable's duty to C did not extend to circumstances where C was illegally or immorally attempting to evade arrest. An alternative basis was that the Chief Constable could raise the free-standing defence of illegality.

17 *Tinsley v Milligan* [1994] 1 AC 340
18 Burrows, *Restatement*, 136ff.
19 Clerk and Lindsell on Torts, 21st Ed., [3-01]
20 [2001] EWCA Civ 1249; [2012] 1 WLR 218
21 [2], Schiemann LJ

(3) Sir Murray Stuart-Smith indicated that whether C lost because the Chief Constable owed no duty in the particular circumstances or because of the availability of a free-standing illegality defence did not matter.[22]

(4) Schiemann LJ's leading judgment, by contrast, carefully preserved the distinction between questions regarding the availability of the illegality defence from questions regarding the scope of duty. Schiemann LJ noted an "*overlap between the considerations which go to the question "is there a duty?" and those which attend the defence of ex turpi causa*." However, he was clear that his decision was based on the scope of the duty *"rather than*" on the illegality defence.[23] For Schiemann LJ, the availability of an illegality defence did not depend on the scope of duty, the two were fundamentally different enquiries which, on the facts of *Vellino*, raised overlapping considerations.

(5) Schiemann LJ's reasoning is preferable. In some cases, it is true that similar considerations may attend to the question whether the Defendant's scope of duty extends to the facts in question as to the separate question whether the illegality defence is raised. However, this is not a reason to merge the two enquiries. A conceptually clearer analysis is to acknowledge, as Schiemann LJ did, that the enquiries are separate albeit in some cases have overlapping considerations depending on the facts of the case.

23. Fourthly, elision could have unwanted consequences. Beldam LJ was conscious of this in *Pitts v Hunt*.[24] An 18 year-old plaintiff sustained injuries in a collision while being driven by his 16 year-old friend, whom he knew to be unlicensed and uninsured, on a motorcycle following significant alcoholic consumption. The pair drove irresponsibly in a manner apparently deliberately calculated to frighten others. The 16 year-old driver was killed. The injured plaintiff sued his estate.[25] Balcombe LJ based his reasoning on the view that "*the plaintiff must fail when the character of the enterprise in which the parties are engaged is such that it is impossible for the court to determine the standard of care which is appropriate to be observed*."[26]

24. Beldam LJ, however, adopted different reasoning not based on duties of care but rather based on the defence of illegality. Reasoning based on finding that there was no duty of care was undesirable for Beldam LJ because he was "*not convinced of the wisdom of a policy which might encourage a belief that the duty to behave responsibly in driving motor vehicles is*

22 [62]
23 [28]
24 [1991] 1 QB 24
25 35 and 36, Beldam LJ
26 Balcombe LJ at 49-50 quoting Mason J in *Jackson v Harrison* (1978) 138 CLR 438 at 455

diminished even to the limited extent that they may in some circumstances not owe a duty to each other, particularly when those circumstances involve conduct which is highly dangerous to others."[27] Beldam LJ's reasoning highlights that elision of two separate legal enquiries could have unintended and undesirable consequences; the finding that a defence of illegality is raised is different from findings as to the scope of the duty and it is inadvisable to merge the two separate enquiries.

The way forward

25. The defence of illegality is a public policy defence by which the Court refuses to allow certain claims founded on illegality or immorality for a variety of reasons. Bright-line rules have often been unsuccessful in establishing when the defence should operate. Thus it was once the case that occupiers were not liable in negligence to trespassers owing to *ex turpi causa*. Yet this bright-line rule was too harsh and the Occupiers Liability Act 1984 later provided that in certain circumstances occupiers are liable to trespassers.[28] Similarly, the bright-line rule of the reliance test enunciated in *Tinsley v Milligan* has been much criticised.

26. Similarly, a bright-line rule to the effect that the availability of the illegality defence depends on the scope of the duty owed is undesirable. A structured discretion is preferable, along the lines set out in the Law Commission's Consultative Report CP No. 189 (2009), which considers factors such as furthering the purpose of the rule which the illegal conduct has infringed, consistency, that the claimant should not profit from his or her own wrong, deterrence and maintaining the integrity of the legal system.[29]

27. Rather than elide fundamental distinctions between the scope of duty and the illegality defence, the defence should be a free-standing public policy defence dependent on various factors. As Lord Hoffmann noted at [30] in *Gray*, "*ex turpi causa expresses not so much a principle as a policy… not based upon a single justification but on a group of reasons which vary in different situations*." In *Bilta*, Lords Toulson and Hodge characterised the illegality defence as one of public policy, the operation of which depended on the particular claim[30] (although Lord Sumption objected preferring instead a bright-line rule apparently based on the reliance principle as to when the defence operates).[31] Whether a structured discretion will be adopted awaits further decision.

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28 *Clerk and Lindsell* [12-63]
29 CP 189, [2.35]
30 [126]-[130]
31 [62]

Conclusion

28. The availability of the illegality defence does not as a matter of precedent depend on the scope of the duty owed nor should it as a matter of principle. Rather the illegality defence should depend on a structured discretion, although it will take further decision for this to be established.

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