

## Focus on fraud and asset tracing: assistance to the creditors of insolvent fraudsters? The modern illegality defence to the rescue

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The illegality defence (which aims to prevent a party benefiting from its illegal conduct via legal claims) has been the subject of considerable judicial analysis in commonwealth jurisdictions in recent years. The Cayman Islands Court of Appeal in its recent judgment in the long running *AHAB v SAAD* litigation [1] has now added its voice to the debate and given guidance as to the application of the defence. [2] The illegality defence is highly relevant to the practices of fraud and asset recovery practitioners in the Cayman Islands, and has broader application in common law jurisdictions. In this article, we examine some of the Cayman Islands Court of Appeal's key findings on this defence.

### What is the illegality defence?

At its simplest, 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. The classic statement of the illegality principle is that of Lord Mansfield CJ in *Holman v Johnson*:

"The objection, that a contract is immoral or illegal as between plaintiff and defendant, sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; but it is founded in general principles of policy, which the defendant has the advantage of, contrary to the real justice, as between him and the plaintiff, by accident, if I may say so. The principle of public policy is this; *ex dolo malo non oritur actio*. No Court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act. If, from the plaintiff's own stating or otherwise, the cause of action appears to arise *ex turpi causa*, or the transgression of a positive law of this country, there the Court says he has no right to be assisted. It is upon that ground that the Court goes; not for the sake of the defendant; but because they will not lend their aid to such a plaintiff."

The classic example of the operation of the illegality defence, is the "*Highwayman's case*" of *Everet and Williams*, [3] where two highwaymen had agreed to split the proceeds of their robberies. However, Everet alleged that Williams had taken more than his agreed share of the proceeds, and Everet sought an account seeking to recover his proper share of "profits" from the "partnership". The Court dismissed the claim as "both scandalous and impertinent". [4] A more modern example has been given by the UK Supreme Court of a drug trafficker who should not be permitted to recover ill-gotten gains. [5]

In recent years, the application of the illegality defence has moved on from the "reliance-based" approach, in other words, where a defendant would have a successful defence if the plaintiff would have to rely, in support of their claim, on the plaintiff's illegal conduct irrespective of the sometimes arbitrary, disproportionate and unjust outcome. [6] Since 2016, the English courts have adopted a more flexible approach, following guidance from the UK Supreme Court in *Patel v Mirza*. [7] As shall be seen from the below, the Cayman Islands Court of Appeal (CICA) in *SAAD* agreed that the appropriate test in the Cayman Islands is now the test as expressed in *Patel v Mirza*. It therefore agreed that the different potential outcomes of allowing recovery for something which was illegal would need to be carefully weighed, and that the primary concern of the court in conducting this exercise is not to cause damage to the integrity of the legal system.

## What were the relevant facts in *SAAD*?

The key facts of the claims in *SAAD* as relevant to the illegality defence were described by the CICA as follows (after having said that they were akin to the facts of the Highwayman's case):

"*AHAB and Al Sanea* were both parties to ...[a]... fraud committed against the banks... [that had lent very substantial sums to AHAB]... Al Sanea subsequently defrauded AHAB/the Money Exchange by misappropriating a substantial proportion of the fraud on the banks for his own benefit. AHAB now seek to claim back the share of the proceeds of which they have been defrauded. It is therefore a case of one criminal participant seeking to recover the proceeds of crime from another criminal participant (or the companies to which the latter criminal has paid the proceeds)."

A relevant factor for the purposes of the application of the illegality defence in *SAAD* was that the status of the plaintiff had changed between the first instance trial and this matter coming before the CICA (which status impacts who might benefit from AHAB's claim). By the time of the hearing before the CICA a new bankruptcy law had come into effect in Saudi Arabia, and in April 2019 two of AHAB's creditors petitioned the Saudi Arabian court to commence a liquidation procedure against AHAB. AHAB objected and renewed an application for a "Financial Restructuring Procedure" (FRP) instead, to which the Saudi Court acceded. The CICA Judgment describes the FRP as a procedure similar to an English Creditor's Voluntary Arrangement or to the Chapter 11 procedure in the US. [8] The CICA summarised the practical effect of the arrangement as follows: "The upshot is that...there is likely to be some form of agreement between the creditors and AHAB (subject to

approval by the Bankruptcy Trustee) under which creditors will make recovery from the proceeds (if any) of this litigation but AHAB may also benefit". [9] As shall be seen, the identity of who might benefit from litigation in which the illegality defence might be engaged is an important factor as to whether the defence may successfully be deployed.

## What was the first instance decision in SAAD?

At first instance, the Chief Justice found that the SAAD defendants' illegality defence succeeded. He held that AHAB's claim ought to have been barred "through the application of the Court's policy that it will not enforce an illegal arrangement and/or because AHAB lacks clean hands and so is not entitled to invoke the equitable remedies". [10]

The Chief Justice had concluded that the *Highwayman's* case laid down the principle that, where the court is faced with an unlawful partnership the court will not condescend to redistribute the proceeds of ill-gotten gains among wrongdoers.

## What did the CICA hold in SAAD?

At the appellate level, the CICA considered "whether the Chief Justice was right to say that AHAB's claim was barred by its own illegality/lack of clean hands". The CICA concluded that its view as to the application of the illegality defence differed from that of the Chief Justice.

### No free-standing head of illegality for "highwaymen"

The appellants argued that the Chief Justice erred in law in holding that the *Highwayman's case* amounted to a free-standing head of the illegality defence which applied as between partners in illegal conduct and which had determined this issue at first instance. The CICA agreed with this submission, and held that although the Chief Justice had considered the modern and more flexible illegality test in *Patel v Mirza*, he was "viewing the essential question raised by *Patel* very much through the prism of a free-standing rule in the *Highwayman's case*". [11] So in the circumstances, the CICA concluded that it was necessary for it to form its own view on the application of the *Patel v Mirza* principles to the facts in *SAAD*.

### Application of the *Patel v Mirza* tripartite test

The CICA confirmed that when considering if illegality bars a claim, the court is to utilise the "Tripartite Test" as articulated in the judgment of Lord Toulson in *Patel v Mirza*.

The first limb of the Tripartite Test is for the court to consider the underlying purpose of the applicable prohibition which has been transgressed and whether that purpose would be enhanced by denial of the claim. On this, the CICA said that because AHAB was seeking to recover the proceeds of vast sums of money fraudulently obtained by AHAB from a large number of creditor

banks, on the face of it, denial of the claim would be supportive of the fight against fraud.

The second limb of the Tripartite Test requires the court to consider any other relevant public policies which may be rendered less effective by denial of the claim. Here the CICA said that if the plaintiff's claim were barred then the respondents and their creditors would obtain a windfall and remain enriched by the proceeds of Al Sanea's fraud on AHAB, which is also an unsatisfactory outcome.

## Proportionate response?

So the first and second limb effectively cancelled each other out and the CICA said that the key factor in this case was therefore the third limb of the Tripartite Test, whether denial of the claim would be a proportionate response. The CICA said that, in the hope of offering assistance in future cases, it would first consider the outcome on the basis that the plaintiff did not have creditors and was claiming for its own benefit and also upon the basis that the plaintiff was subject to an FRP in Saudi Arabia.

The CICA said that if AHAB were claiming entirely for its own benefit, it would be of the clear view that it would not be disproportionate to deny relief on the ground of illegality. This was on the basis that otherwise this would amount to the court allowing its processes to be used by a criminal to recover the proceeds of its criminal enterprise from a fellow criminal in circumstances where the criminal courts would wish to punish the wrongdoer and quite possibly confiscate the proceeds of that crime (and so that would be the court system giving "extremely mixed and inconsistent messages"). [12] So, the CICA said that if AHAB had been claiming for its own benefit then it would have upheld the Chief Justice's decision that the claim should be barred for illegality, but not because the *Highwayman's* case remains a freestanding head of illegality but because the application of the Tripartite Test would lead to the same result.

However, AHAB was not entirely claiming for its own benefit. The plaintiff was subject to its own restructuring process (namely the FRP). The CICA considered that if AHAB had been subject to a conventional liquidation with an independent liquidator appointed, then the denial of relief to AHAB would be harmful to the integrity of the legal system. This was on the basis that the creditor banks in this case are victims of fraud and if relief were to be denied on the grounds of illegality "the consequence would be that the victims of the crime would not recover the proceeds", and the respondents and their creditors would obtain a windfall. [13] The CICA could not see any public interest that would be served by preventing the victims of the fraud from regaining the proceeds. Its view was that enforcement of AHAB's claim in such circumstances would not adversely impact the integrity of the legal system, rather it would be entirely consistent with the objective of the criminal law to assist the victims of fraud with recovery.

As set out above, AHAB's restructuring was slightly different to that of a conventional liquidation. The key distinction being that any recoveries were likely to be allocated as between AHAB and its creditors so that AHAB would derive some benefit. The CICA considered that the question of

whether denying the claim would be a proportionate response in such circumstances was "more finely balanced". [14] However, the CICA concluded that: "the overall justice of the case would be better served by allowing AHAB to share in the recovery of any proceeds with the creditors to such extent as may be permitted by the Bankruptcy Trustee...rather than by preventing the creditors, as victims of the fraud, from being able to recover at all". [15]

So, after the application of the Tripartite Test, the CICA did not consider that AHAB's claims would be barred on the ground of illegality.

In reaching that conclusion the CICA found that a further aspect of the House of Lords decision of *Stone & Rolls Limited (in liquidation) v Moore Stephens*, [16] was no longer good law. That case concerned a claim by a company in liquidation against its auditor, where the sole directing mind and will, and beneficial owner of the company had caused the company to defraud banks by means of false documents. The auditors had pleaded that the case was barred because of that illegal conduct and the House of Lords agreed. In dealing with an argument from the appellants that illegality should not bar claims brought by a company in insolvent liquidation where creditors were innocent parties who had been defrauded, Lord Walker had said that "would create a very large gap in the public policy defence, since most fraudsters (individual and corporate) become insolvent sooner or later and have liabilities to those whom they have defrauded." The appellants had conceded that if the defrauding director in that case had carried out the fraud personally and directly (rather than through the now insolvent company), then the illegality defence would have barred the claim. Lord Walker went on to say "there is no good reason to apply a different rule to a company in liquidation [and]... [a]part from special statutory claims in respect of misfeasance, wrongful trading and so on, it cannot assert any cause of action which it could not have asserted before the commencement of its liquidation".

The CICA said [17] that this observation did not prevent them from deciding *SAAD* in the way they did, on the basis that: (i) *Stone & Rolls* itself has been subject to widespread and sustained criticism, [18] and (ii) more significantly, that *Stone & Rolls* was decided before the important change in approach to the illegality defence brought about by *Patel v Mirza*.

## Key takeaways?

1. The Tripartite Test is not limited to particular causes of action and is to be applied in all civil cases in which a party alleges that illegality bars a claim
2. Illegal conduct will not automatically bar a claim. Deciding whether the illegality defence can be relied on requires a careful examination of the relevant fact pattern and the weighing up of competing public policies, interests, and culpabilities of the parties involved with the ultimate intent of upholding the overall scheme and integrity of the legal system
3. Given the helpful guidance in the CICA *SAAD* decision, the trend of injecting further clarity into

this complex area of law continues

4. The Tripartite Test may well more frequently assist the liquidators of insolvent entities to succeed in claims for the benefit of the insolvent entity's estate, which historically would have been barred by illegality

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[1] *Ahmad Hamad Algosaibi and Brothers Company v SAAD Investments Company Limited, Maan Al Sanea and others* (Cayman Islands Court of Appeal, unreported 21 December 2021)

[2] This article represents an update to Ogier's previous articles on the illegality defence in the Cayman Islands - [The latest interpretation of the illegality defence in the Cayman Islands](#) and [The development of the illegality defence marches on: recent input from the English and Cayman Islands courts](#)

[3] *Everet v Williams* (1729), unreported but noted at (1893) 9 LQR 157

[4] It is widely reported that both "highwaymen" were eventually hanged for their "business activities", and the solicitors on the record arrested and fined for their involvement in the case.

[5] *Patel v Mirza* [2016] UKSC 42, at paragraph 110

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

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

[8] *Ibid*, paragraph 1037

[9] *Ibid*, at paragraph 1041

[10] *AHAB v SAAD*, First Instance, Chief Justice, 2018 (3) CILR 1, Section 7D, paragraph 77(4)

[11] *Ibid*, at paragraph 1059

[12] *Ibid*, at paragraph 1069

[13] *Ibid*, at paragraph 1075

[14] *Ibid*, at paragraph 1078

[15] *Ibid*, at paragraphs 1078-1080

[16] *Stone & Rolls Limited (in liquidation) v Moore Stephens* [2009] 1 AC 1391

[17] *SAAD*, CICA decision, at paragraph 1083 to 1085

[18] With Lord Neuberger in *Bilta (UK) Limited (in liquidation) v Nazir (No2)* in the Supreme Court decision saying of Stone & Rolls that it should be *"put "on one side in a pile and marked 'not to be looked at again"*.

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