

Illegality defence: The position of directors considered - the latest from the Court of Appeal

Published 14 January 2016

In *Sharma v Top Brands Ltd* [2015] EWCA Civ 1140, the Court of Appeal refused to allow a former liquidator of a company (which was a vehicle for VAT fraud) to rely on the illegality defence to avoid liability for a claim brought against her for breach of duty under section 212 of the Insolvency Act 1986 (IA 1986).

Background

The "illegality defence" also referred to as the defence of *ex turpi causa* (meaning a claimant should not profit from the consequences of its own illegal act) has long been an established principle in English law, but its application has been and remains a matter of great uncertainty.

In our [June newsletter](#), we commented on the Supreme Court decision in *Jetivia SA and another (Appellants) v Bilta (UK) Limited and others (Respondents)* [2015], which confirmed that directors cannot attribute their own unlawful conduct to their company to invoke the "illegality defence" to escape liability.

Jetivia followed on from the House of Lords decision in *Moore Stephens v Stone & Rolls* [2009], which held that liquidators were prevented from claiming against a company's auditors, because the company was set up for the sole purpose of committing the fraud in issue, and because the company was run by a sole shareholder and director who perpetrated the fraud.

In *Jetivia*, the Supreme Court commented that *Stone & Rolls* should be confined to its own particular facts and is not authority for any general principle. Sharma adds further support for a limited application of the illegality defence.

Facts in *Sharma v Top Brands Ltd*

The case concerns the appeal by Mrs Sharma, the former liquidator of Mama Milla Limited (MML), against a judgment requiring Mrs Sharma to contribute £548,074.56 to MML's assets by way of compensation awarded in connection with Mrs Sharma's breaches of duty. In her role as insolvency practitioner, Mrs Sharma authorised payments out of the company's bank accounts for payment of invoices, which she believed were due. The invoices should not have been paid because, unknown to Mrs Sharma, they had been issued as part of a VAT fraud.

Mrs Sharma's illegality defence

Mrs Sharma put forward an argument that the loss was so closely connected, or inextricably linked to MML's unlawful conduct, that the court could not permit recovery against Mrs Sharma without appearing to condone the illegality, citing *Stone & Rolls* in contending that the illegality defence should be permitted. It was asserted that what the court was in fact being asked to do was to award compensation for the loss to MML of criminal property, which the company had obtained by means of VAT fraud committed before Mrs Sharma's involvement in the company's affairs. It was also argued that MML had in effect suffered no loss caused by Mrs Sharma's actions, because the sums paid out by Mrs Sharma came from cash assets that were not legitimately MML's to begin with. Citing Lord Phillips in *Stone & Rolls* at [5]: "If a person starts with nothing and never legitimately acquires anything he cannot realistically be said to have suffered any loss."

There was an attempt to distinguish Mrs Sharma's conduct from the conduct in *Jetivia* (in which a company successfully claimed against its directors in respect of their unlawful conduct) on the basis that Mrs Sharma was not a party to illegal conduct.

Decision

On the question of whether the loss claimed was inextricably linked to the illegality, the Court of Appeal found there was no inextricable link as the case turned on whether Mrs Sharma was negligent in paying out company assets - it was not necessary for MML to rely on anything illegal to put the company's claim against Mrs Sharma.

In addition, the court considered the public policy elements within sections 107 and 212 IA 1986, which require a liquidator to properly collect in and properly distribute company property among creditors in accordance with the statute. It was held that in respect of the particular facts and creditors in this case, primarily HMRC, allowing an illegality defence would be both

"illogical and impractical."

The court held that Mrs Sharma had not properly distributed assets as required by the duty set out in section 107 IA 1986 and therefore, under section 212 IA 1986, it was held that Mrs Sharma was liable for mis-applying the funds.

What are the implications for Directors and Officers and their insurers?

This is by no means the end of cases that test the application of the illegality defence, and which call in aid arguments rehearsed, but not determined, before their Lordships in *Stone & Rolls*.

Jetivia, is thankfully a straightforward decision to follow: Rogue directors will not be allowed to seek to rely on the illegality defence where it is their frauds that have caused their company's loss. Accordingly, D&O insurers will not face the uncomfortable proposition of being asked to fund the cost of running such an argument in the directors' defence. This is welcome for insurers.

The decision in *Sharma* does not take the illegality defence debate much further. It turned on the fact that the claim against the liquidator was based on allegations concerning her negligent actions in disseminating the company's assets, it was not a claim based upon the original fraud. What it does perhaps illustrate is that the courts are reluctant to entertain extending the defence beyond the narrow facts in *Stone & Rolls*.

Of specific relevance to Directors and Officers and their insurers, an area which we have yet to see tested, concerns claims against non-executive directors and "innocent" directors. Their Lordships in *Stone & Rolls* expressly acknowledged that if there had been such directors, or innocent shareholders, their decision might have been different. It is a shame that they did not take the opportunity to make clear, albeit obiter dictum, what that decision would have been given different facts.

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