

Illegality defence remains uncertain - the latest from the Court of Appeal

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This month in *Sharma v Top Brands Ltd [2015] EWCA Civ 1140* the Court of Appeal has again been asked to grapple with the question of when the illegality defence is available to defendants to actions brought by an insolvent company where the losses claimed are arguably tainted by the company's own fraudulent actions. In this instance the question for the court was whether the defence was available to a former liquidator of a company seeking to defend a claim brought against her for breach of duty under section 212 of the Insolvency Act 1986 (IA 1986).

Background

Our last Alert on this issue (which can be found [here](#)) considered the Supreme Court decision in *Jetivia SA and another (Appellants) v Bilta (UK) Limited and others (Respondents) [2015]* which is part of a lengthening line of cases where defendants seek to use "the illegality defence" to avoid liability (the defence of *ex turpi causa* - a claimant should not profit from the consequences of its own illegal act).

These cases originate from the House of Lords decision in *Moore Stephens v Stone & Rolls*. In *Stone & Rolls* a claim was brought against the auditors, Moore Stephens, who successfully argued in the House of Lords that because the company was set up for the sole purpose of committing the fraud in question, and because the company was run by a sole shareholder and director who perpetrated the fraud, the company's claim brought by its appointed liquidators was tainted by the illegal acts and was barred. Jonathan Sumption QC (before he joined the Supreme Court) drew a distinction on behalf of Moore Stephens between whether the company involved in the fraud should be treated as a 'victim' or a 'villain'; The rationale being that where a company has acted as a villain in the fraud the company could not be allowed to benefit from its illegal actions.

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 unbeknownst 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 which 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 *Bilta* (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 that 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 which require a liquidator to properly collect in and properly distribute company property among creditors in accordance with the statute. It was held that the particular facts and creditors in this case, primarily HMRC, demonstrated that 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.

Comment

There remains a lack of clarity around when the court will allow the use of the illegality defence.

- We commented previously that the decision in *Stone & Rolls* turned on its facts and would not be widely applied. In short, we suggested that the decision which allowed the illegality defence was restricted to claims where the claimant company had no innocent shareholder or director who, if informed, could have stopped the fraud.
- In *Bilta* the Supreme Court declined to recognise the illegality defence where to do so would defeat the statutory purpose of S212 under which directors in breach of duty are accountable for damages.
- Central to the *Sharma* decision is the finding that the facts relied upon to bring the claim did not involve the fraud itself, as in *Stone & Rolls*. Rather, it involved reliance upon the alleged negligence of the liquidator in paying out on the instructions of the fraudsters without proper enquiry.

In conclusion, the legal tests on which the illegality defence is founded are technical in the way they are applied, and their lordships have found different routes to reach their different conclusions in *Stone & Rolls* and *Bilta*. This is therefore unlikely to be the last of the cases where defendants seek to rely upon the Supreme Court's judgment in *Stone & Rolls* to run an illegality defence in defence of actions brought by a company which has suffered losses through the fraudulent actions of its directors and shareholders. It is therefore not surprising that the issues were recommended by the Court of Appeal for further consideration by the Supreme Court at the earliest opportunity.

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