What if you discover your contract requires you to do something illegal? Or that your counterparty had some illegal purpose in mind when you did the deal? Sadly this appears to be an increasingly common predicament. Earlier this year, the Supreme Court clarified the law in this area, steering away from the myriad of different "rules" parties have long been grappling with, towards a more discretionary approach. Will this produce more just decisions or lead to even more risk and uncertainty where illegality rears its head?

In *Patel v. Mirza* [2016] UKSC 42, the Supreme Court allowed a claimant to recover sums he had paid to the defendant, despite the illegal purpose of the contract. The parties had agreed that Mr Mirza would place bets on the price of shares using advance insider information, which he expected to obtain from contacts regarding an upcoming government announcement. Mr Patel transferred to him £620,000 for these bets. As it happened, the illegal bets were never placed, but Mr Mirza did not repay the money to Mr Patel, who sued for its recovery on various grounds including contract and unjust enrichment.

At first instance, Mr Patel's claim was refused. David Donaldson QC (sitting as a deputy High Court judge) considered the applicable test to be that in *Tinsley v. Milligan* [1994] 1 AC 340 – in determining when rights would not be enforced because of illegality, the key question was whether the claimant had to rely on the illegal contract or arrangement. He held that here Mr Patel did have to rely on the agreed basis on which the moneys were paid, and the agreed purpose, both of which were illegal. Nor could he avail himself of the *locus poenitentiae* exception, which permitted recovery under an illegal agreement if the transferor withdrew voluntarily before the agreement had been performed.

The Court of Appeal reversed the High Court's decision, agreeing with the judge on the application of the reliance principle but deciding Mr Patel could bring himself within the *locus poenitentiae* exception because the scheme had not in the end been executed.

A "range of factors" to determine if restitution undermines the integrity of the legal system

The Supreme Court also found for Mr Patel but for different reasons. Lord Toulson, with whom four other of the nine-justice panel agreed, contrasted a "rule-based approach" such as the reliance principle – which could produce different results according to procedural technicalities – with a "range of factors" approach, which he ultimately preferred. In his view, the essential rationale of the illegality doctrine is that it would be contrary to public interest to enforce a claim if to do so would be "harmful to the integrity of the legal system". In assessing whether that is the case, courts should ask:

1. whether the purpose of the prohibition (here insider trading) would be furthered by denying the claim;
whether denying the claim might have an impact on another relevant public policy; and

3. whether denying the claim would be a proportionate response to the illegality (bearing in mind that punishment is a matter for the criminal courts).

Various factors could be relevant to these questions, including the seriousness of the illegal conduct, its centrality to the contract, whether it was intentional and whether there was marked disparity in the parties’ respective culpability.

On the facts, the justices held that allowing Mr Patel to recover the £620,000 would not undermine the policy behind the prohibition on insider trading, because the intended transaction never actually took place.

The justices in the minority (Lord Mance, Lord Sumption and Lord Clarke) agreed that Mr Patel should recover the money, but considered this result could be reached on the basis of ordinary restitution principles.

The minority considered the “range of factors” approach would lead to complexity, uncertainty and arbitrariness – an objection which was anticipated by Lord Toulson. However, he pointed out that one of the principal criticisms of the previous law was its uncertainty and unpredictability. Indeed, in the Court of Appeal Gloster LJ had pointed out that it was “almost impossible to ascertain or articulate principled rules from the authorities relating to the recovery of money or other assets paid or transferred under illegal contracts”. Lord Toulson also explained he was not aware of significant problems related to uncertainty in jurisdictions which have adopted a more flexible approach, and reasoned that in any event, providing certainty to those contemplating unlawful activity is less important than in the context of everyday lawful activities.

More enforcement of illegal contracts?

The more flexible approach endorsed by the Supreme Court mandates judges to weigh the relative seriousness of the parties' wrongdoing against the policy behind the prohibition in question, and balance that with the fairness of denying relief to the claimant. Arguably this is what the courts have been doing, while purporting to shoehorn decisions into one or more of the “rules” permeating earlier case law. Going forward we should expect more open reasoning and transparency in the courts' approach to issues of illegality. However, the dissenting views of Lords Mance, Sumption and Clarke show that there is still disagreement about the optimal approach. Lord Sumption’s view that simple restitution may be adequate to put the parties back to their previous positions clearly has some validity.

Lord Toulson stated that cases where the enforcement of an unjust enrichment claim undermines the integrity of the justice system would be "rare". Could this judicial sentiment also encourage parties faced with allegations of illegality from their counterparties to resist them more confidently, and even reduce the instances of tactical allegations from parties seeking to evade their contractual obligations and pocket the proceeds? The court's approach may lead to the enforcement of more contracts that are tainted in some way. However, potential claimants will have to consider carefully the purpose of the prohibition breached, the seriousness of the breach and the overall proportionality of denying a remedy on the facts. For example, it was important in Patel v. Mirza that the bets were never placed, so the illegal act was not carried out. In cases where it is, the proportionate response could result in a different outcome for the claimant.

Lastly, how broadly will the Supreme Court's focus on the underlying policy behind the illegality doctrine be interpreted? Could it extend to issues of foreign illegality? As the law stands, English courts will not enforce contracts where performance is illegal under the law of a country where an obligation must be executed. Arguably this rule-based approach can also produce arbitrary and disproportionate results where a minor foreign regulation is transgressed. But the English courts may well be less comfortable assessing the policy behind foreign laws than domestic ones.

From a practical perspective, given the greater potential for variation in judicial approaches following Patel v. Mirza,
should you find yourself faced with an illegality defence it may be prudent to plead your claim in unjust enrichment as an alternative to direct reliance on the contract. Such claims may prove more palatable and “proportionate” to the judiciary than direct enforcement of an unlawful agreement.

Ultimately, though, the case serves as a reminder of the still severe consequences of illegality on contracts, not to mention potentially immeasurable reputational damage. Parties should make every effort to flush out possible risk areas at the due diligence stage, and consider whether clarification of any legal requirements – including from foreign counsel or regulators – is necessary.

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