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The illegality defence in corporate law claims against directors and officers

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Citation
WAN, Wai Yee. The illegality defence in corporate law claims against directors and officers. (2016). *Hong Kong Law Journal*. 46, (1), 225-254. Research Collection School Of Law.
Available at: https://ink.library.smu.edu.sg/sol_research/1921

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Revised 17 Nov 15

[TITLE] THE ILLEGALITY DEFENCE IN CORPORATE LAW CLAIMS AGAINST DIRECTORS OR OFFICERS

Wai Yee Wan*

ABSTRACT

If a company incurs substantial fines or other pecuniary losses as a result of its unlawful conduct, can the company obtain an indemnity from its director/officer for having caused the company to incur such fines and losses? In particular, can the director/officer utilise the defence of illegality, notwithstanding that he has breached his duties owed to the company? The illegality defence, which raises the twin issues of the relationship between the unlawful act to the corporate claim and the attribution of the unlawful act to the company, has been the subject of detailed analysis recently in England, Singapore and Hong Kong. This article argues that absent clear legislative intention, there is no reason for English law to bar the claims against the delinquent director/officer, once regard is made to the relevant constituencies of the company. In particular, there is no reason for the illegality defence to operate if the result will prejudice the non-complicit constituencies of the company, such as the creditors where company is insolvent or where the company has innocent participants. Likewise, it argues that in determining the proper scope of the attribution of the acts or knowledge of the delinquent director/officer to the company, regard should also be made to the relevant constituencies of the company. If the result is one that does not lead to the delinquent director/officer benefitting from the corporate claim, there is no reason to attribute the wrongdoing so as to bar the corporate claim.

[A head] Introduction

When a company undertakes an unlawful act and exposes the company to substantial fines or other pecuniary losses, the question arises as to whether the company may then recover its fines, expenses and other losses from its directors and officers, in the absence of the relevant legislation specifically providing for, or denying a claim by, the company. In these cases, the board may either have made a specific decision to cause the company to undertake the unlawful conduct or may have failed to prevent the unlawful conduct from undertaken by its subordinates acting on the company's behalf. While the board is not likely to sue one of its own members, the action may be brought by a differently constituted board following a takeover[1] or shareholders pursuant to the statutory derivative action.[2]

Claims by the company for losses arising from its unlawful acts against the directors and officers, particularly those who have not benefited personally from the wrongdoing, present several difficult issues relating to duties of directors/officers and corporate illegality. The company has the incentive to make these claims as it will generally not be able to claim for the fine/penalty from its own insurer,[3] and may wish to have recourse against its directors or employees for negligence or breach of duty of care, particularly if they themselves are covered

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[1] For an example of a corporate action by a company against its former directors and employees, see *Safeway v Twigger* [2010] EWCA Civ 1472 (facts and holding discussed below).

[2] UK Companies Act 2006, Part 11.

[3] FCA Handbook, GEN 6.1.5: "No firm may enter into, arrange, claim on or make a payment under a contract of insurance that is intended to have, or has or would have, the effect of indemnifying any person against all or part of a financial penalty"

by directors' and officers' (D&O) insurance. However, there may be good policy reasons to bar recovery, including not negating the effects of the criminal penalty. Yet, shareholders or creditors (where the company is insolvent) may not have participated in the wrongdoing at all and it appears harsh that the company is denied the claim from its directors or officers.

This issue of recovery by the company against its directors or officers has practical significance. While there are few criminal prosecutions of companies, particularly for economic crimes, this is likely going to change with the introduction of deferred prosecution agreements in the UK Crime and Courts Act 2013, and the increase in fines for fraud, bribery and money laundering offences on companies will result in the issue becoming even more important.[4] In addition, inaction or inadequate procedures may also expose the company to offences; under the UK Bribery Act 2010, it is now an offence for a company which has failed to undertake necessary procedures to prevent its associated persons from committing bribery.[5] Further, the UK Financial Services and Markets Act 2000 now allows the third party investors to bring civil claims against a company (but not its officers)[6] in respect of false and misleading statements made by directors or officers on behalf of the company; it is not inconceivable that shareholders will bring derivative claims against the directors or officers, on behalf of the company, for an

[4] *See* Sentencing Council, Fraud, bribery and money laundering: corporate offenders: Definitive Guideline; the Sentencing Council ("Sentencing Guidelines"). The Sentencing Council has adopted a similar methodology to that currently used by the UK Financial Conduct Authority which determines the starting figure from a percentage of the 'relevant revenue' derived from the alleged conduct. The financial risk to companies is increased by the multipliers which will be applied to this base figure in order to determine the final penalty. The Definitive Guidelines recommend a multiplier of as much as 400 per cent in the most egregious cases.

[5] Bribery Act 2010, section 7.

[6] Financial Services and Markets Act, s 90A, read with Schedule 10.

indemnity in respect of causing the company to incur these losses[7] as well as for incurring civil penalties.[8]

In England, the issue of illegality in corporate claims against directors or employees arose in the Court of Appeal decision in *Safeway v Twigger*[9] and more recently, in the Supreme Court decision in *Jetivia v Bilta.*[10] Even though the issue did not arise directly in *Moore Stephens v Stone & Rolls (Stone & Rolls)*,[11] the issue was considered by each member of the House of Lords. Elsewhere outside the UK, the issues relating to corporate illegality and corporate attribution were also considered by appellate courts in Singapore in *Ho Kang Peng v Scintronix (Ho v Scintronix)*[12] and in Hong Kong in *Moulin Global Eyecare v Commissioner of Inland Revenue (Moulin Global Eyecare)*.[13]

The above-mentioned cases highlight the difficulties and policy debates as to the scope of the illegality defence. In *Safeway*, whose facts are further set out below, the recovery by the company against its directors/officers for fines and other expenses incurred consequent upon its infringement of the Competition Act 1998 was held to be barred on the ground of illegality. Two reasons were given: first, the illegality defence applies because the liability of the company to pay the fine was regarded as personal and not vicarious; second, there were good policy reasons under the Competition Act 1998 militating against such recovery. While the former reasoning

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7 *See* Paul Davies QC, *Davies Review of Issuer Liability: Final Report* (June 2007), para 57.
8 Financial Services and Markets Act, s 118.
9 *Safeway v Twigger* [2010] EWCA Civ 1472.
10 *Jetivia v Bilta* [2015] UKSC 23.
11 *Moore Stephens v Stone & Rolls (Stone & Rolls)* [2009] UKHL 39, [2009] 1 AC 1391.
12 *Ho v Scintronix* [2014] 3 SLR 329**;** [2014] SGCA 22.
13 *Moulin Global Eyecare v Commissioner of Inland Revenue (Moulin Global Eyecare)* [2014] HKCFA 22.

was doubted by Lords Toulson and Hodge in *Jetivia v Bilta*,[14] Lord Neuberger (with whom Lords Clarke and Carnwath agreed) preferred not to address the correctness of the outcome of *Safeway*,[15] noting the complexity of the issue. Likewise, Lord Mance held that the correctness of *Safeway* should be determined on another occasion.[16] In Singapore, the opposite conclusion was reached, where the Court of Appeal in *Ho v Scintronix* held that the claim for the value of the bribe paid by the company against its chief executive officer was not barred on the ground of illegality. In Hong Kong, the majority of the Court of Final Appeal in *Moulin Global Eye Care* clarified the law on corporate attribution of the management's fraud to the company by drawing a distinction between the "redress" and "liability" cases; the former being cases where the company is suing the director/officer for wrongs done to it and the latter being cases where the third party is bringing an action against the company for a wrong. For redress cases, the wrongful acts of the company's management will not be attributed to the company, rendering the illegality irrelevant.

The aim of this article is to provide a taxonomy of the illegality defence in loss shifting claims[17] that are brought by the companies against their delinquent directors or officers in respect of losses incurred by the company arising from its unlawful acts under English law and its draws on the recent cases that discuss corporate illegality in Singapore and Hong Kong. In particular, this article addresses two issues that arise in the illegality defence: first, the relationship between the illegal acts to the claim, and second, the proper attribution of the illegal acts to the claimant

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[14] *Jetivia v Bilta* (n 10 above), paras [157]-[161].

[15] *Jetivia v Bilta* (n 10 above), para [31].

[16] *Jetivia v Bilta* (n 10 above), para [52].

[17] The term "loss shifting claims" is borrowed from R. Werder, "A Critical Assessment of Intracorporate Loss Shifting after Prosecutions Based on Corporate Wrongdoing" (1993) 18 Del J Corp Law 35.

company.[18] It is concerned with the situations that the directors/officers have acted in breach of their fiduciary duties or duties of care owed to the company and, absent a defence, would be otherwise liable to the company.

The article begins by examining the test or relationship between the unlawful act and the corporate claim. It sets out the situations where the illegality defence has been applied in corporate claims, particularly loss-shifting claims that are brought against directors and officers. The article then examines the policy justifications for the illegality defence and argues that absent specific legislative justification, none of the policy justifications requires the courts to bar such loss-shifting claims from succeeding. In particular, it is unjust to bar these claims if the result prejudices the constituencies of the company who are not complicit to the illegality (such as the creditors where the company is insolvent or where there are innocent shareholders).

The article then argues likewise that in determining the proper scope of the attribution of the acts or knowledge of the delinquent director/officer to the company, regard should also be made to the relevant constituencies of the company. If the result is one that does not lead to the delinquent director/officer benefitting from the corporate claim, there is no reason to attribute the wrongdoing so as to bar the claim. Using the taxonomy of the three different attribution situations developed in *Jetivia v Bilta* (namely, where (1) the third party is suing the company, (2) the company is suing the director/officer or (3) where the company is suing the third party),

[18] *See* also *Les Laboratoires Servier v Apotex* [2014] UKSC 55, where it was pointed out that there are three questions in any illegality defence: (1) what are the illegal acts which give rise to the defence; (2) what is the relationship between the illegal act and the claim; and (3) on what principles should the illegal act of an agent be attributed to the principal, particularly the company. This article is concerned with (2) and (3) as it assumes that (1) is normally satisfied in cases involving breach of criminal law.

this article argues that in situation (2), attribution should not occur to bar the claim if the company is insolvent (since the benefits go to the creditors) or where there are innocent shareholders. In situation (3), attribution should not occur if the company is insolvent or if there are innocent shareholders, or if the delinquent director/officer (who is also a sole shareholder), will not benefit, directly or indirectly, from the corporate claim.

[A head] The Relationship Between the Unlawful Act and the Corporate Claim

The illegality rule is formulated by the maxim *ex turpi causa non oritur actio*. However, even if the claimant's conduct is illegal, there needs to be a relationship between the unlawful act and the claim for the illegality defence to apply. This rule is expressed to be founded on public policy, and not on the basis of achieving discretionary justice between the parties.[19] However, the complexity of when the illegality defence applies in all areas of private law (and not only in corporate law claims) lies in the fact that it is often under-theorised and the cases that have come up tend to be confined to their own peculiar facts.[20] This is problematic because the courts often do not state clearly the kind of connection that will bar the enforcement of an otherwise legal obligation.[21]

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19 *See Tinsley v Milligan* [1994] 1 AC 340, at 355 ("It is a principle of policy, whose application is indiscriminate and so can lead to unfair consequences as between the parties to the litigation. Moreover the principle allows no room for the exercise of any discretion by the court in favour of one party or other": per Lord Goff of Chieveley).

20 *See Jetivia v Bilta* (n 10 above) at [61].

21 *See* Lord Mance (writing extra-judicially), "Ex turpi causa – when Latin avoids liability" (2014) 18 Edin LR 175.

The modern law relating to the illegality defence in private law actions is found in *Tinsley v Milligan*.[22] This involves the assertion of illegality defence in the context of a claim of interest in property based on resulting trust by M against T. M and T had earlier entered into a scheme where the property was placed in T's name to enable M to make fraudulent claims to social security benefits. In determining whether the illegality defence applied, the House of Lords rejected the old "public conscience" test[23] and instead applied the reliance test; as M did not have to rely on the illegality in proving her interest in the property under the resulting trust, the illegality defence did not apply. Critics of the reliance test have argued that the test is arbitrary as it turns on the burden of proof; it was only fortuitous that M had the benefit of the presumption of resulting trust and thus did not have to rely on aspects of the illegal transactions.[24]

Outside proprietary claims, in other areas of private law including tort law, the English courts have not applied the reliance test formalistically in determining whether the illegality defence applies.[25] The problem is finding the replacement for the reliance test. One of the early attempts to replace the reliance test was the "inextricable link", that is, whether the claimant's claim is so closely or inextricably bound up with his own criminal or illegal conduct.[26]

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22 *Tinsley v Milligan* (n 19 above).

23 The public conscience test, developed in *Thackwell v Barclays Bank* [1986] 1 All ER 676 was regarded as too vague and resulted in inconsistent decisions, as held by Lord Goff in *Tinsley v Milligan*.

24 Eg Law Commission, *The Illegality Defence* (Law Com 320) (March 2010) [para 1.20].

25 Cf *Madoff Securities v Raven* [2013] EWHC 3147

26 Eg *Cross v Kirby*, The Times, April 5, 2000 per Beldam LJ, ("claimant's claim is so closely or inextricably bound up with his own criminal or illegal conduct that the court could not permit him to recover without appearing to condone the conduct").

In *Gray v Thames*,[27] a tort of negligence claim, the House of Lords rejected the inextricable link test and did not find the reliance test helpful.[28] Instead, Lord Hoffmann introduced the concept of the narrow and wide version of the *ex turpi causa* rule. In its narrower form, the claimant cannot recover damages which flows from the fine or other punishment imposed as a consequence of the unlawful act. In its wider form, the rule prohibits the claimant from recovering compensation for loss which was suffered in consequence of its own criminal act. Both forms are expressed to be based on the consistency rationale. In the narrow form, it is inconsistent with criminal law if the claimant can recover the fine or penalties. In the wide form, the inconsistency theory applies as well but the approach is causal in nature. According to Lord Hoffmann:

> "[T]he wider rule has to be justified on the ground that it is offensive to public notions of the fair distribution of resources that a claimant should be compensated (usually out of public funds) for the consequences of his own criminal conduct. Secondly, the wider rule may raise problems of causation which cannot arise in connection with the narrower rule. The sentence of the court is plainly a consequence of the criminality for which the claimant was responsible. But other forms of damage may give rise to questions about whether they can properly be said to have been caused by his criminal conduct."[29]

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27 *Gray v Thames Train* [2009] 3WLR 167.

28 *Gray v Thames Train* (n 27 above), per Lord Hoffmann, paras [30]-[31]. *See* also *Hounga v Allen* [2014] UKSC 47, [2014] 1 WLR 2889, para [30]; *Jetivia v Bilta* (n10 above), paras [169]-[172].

29 *Gray v Thames Train* (n 27 above), per Lord Hoffmann, para [51]).

However, subsequent tort cases have casted doubt on the test articulated by Lord Hoffmann. In *Hounga v Allen*,[30] which is a claim based on the tort of discrimination, Lord Wilson (with whom Baroness Hale of Richmond and Lord Kerr of Tonaghmore agreed) cited the reliance test with approval, but on the qualification that it must be tempered by considerations of the underlying policy. [31] In the same case, Lord Wilson also applied the inextricable link test, holding that the test was not satisfied on its facts.[32]

[B head] *The role of illegality in corporate claims*

In the case of corporate claims generally, the reliance test for illegality found some favour by certain members of the House of Lords in *Stone & Rolls*. In *Stone & Rolls*, the company was a vehicle set up to commit fraud on the bank lenders by S, who was also its sole controlling shareholder and director. The company borrowed increasingly large sums of money from its lenders against bogus purchases of equipment. When the fraud was discovered, the company was hopelessly insolvent and S disappeared. The lenders were owed very large sums of money by the company. The liquidators of the company sued the auditors on the ground that they failed to detect S's fraud, causing the fraud to be escalated. The auditors applied to strike out the claim, on the ground that the company was the perpetrator of the fraud, since S was the directing mind and will of the company and his fraud was attributed to the company. The House of Lords, by a majority of three-two, struck out the liquidators' claim. Lord Walker (in the majority) and

30 *Hounga v Allen* [2014] UKSC 47, [2014] 1 WLR 2889, para [30].

31 *Hounga v Allen* (n 30 above), para [30], holding that the reliance test carries "maximum precedential authority".

32 *Hounga v Allen* (n 30 above), para [41].

Lord Brown applied the reliance test in holding that the illegality defence was upheld,[33] that is, the company's claim against the auditors was founded on its own illegality, being its ability to defraud the banks of more money.

In *Safeway*, while *Stone & Rolls* was cited and analysed in great detail, the Court of Appeal did not apply the reliance test but adopted the principles of consistency found in *Gray v Thames*. In *Safeway*, the defendants, the directors and employees of Safeway, brought an application to strike out the claims by Safeway, which had sued them for an indemnity. The cause of action was for having caused Safeway to be liable for substantial penalties imposed for infringing Chapter I prohibition of the Competition Act 1998. The directors and employees had allegedly engaged in price-fixing with their counterparts in other supermarkets to increase the price of the dairy products. Safeway entered into an early resolution agreement with the Office of Fair Trading (OFT), a form of settlement under which they admitted liability and agreed to pay a reduced penalty. The early resolution agreement between Safeway and OFT provided for Safeway to pay a fine of £16.5 million, to be reduced to £10.7 million, provided Safeway continued to co-operate with the investigations. Safeway sued the defendants, alleging that they had breached their employment contracts, fiduciary duties and/or were liable in the tort of negligence.

At first instance, Flaux J held that the infringement of Chapter I prohibition was sufficiently morally reprehensible to engage the *ex turpi causa* rule.[34] However, it was held that

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33 *See Stone & Rolls* (n 11 above), per Lord Walker, paras [129]-[131]; per Lord Brown, para [205]).

the *ex turpi causa* rule would only apply if the claimant was personally (and not vicariously) liable and the evidence showed that claimant was attributed the acts only by reason of the law of agency (and hence not personally liable). On appeal, the Court of Appeal reversed the decision on personal fault.

The Court of Appeal held that the claims for the recovery of the civil penalty and associated costs were founded on the illegality of the company: first, according to Longmore LJ (with whom Lloyd LJ agreed), both the narrow and wide versions of illegality, as formulated by Lord Hoffmann in *Gray v Thames*, were engaged; the penalties fell within the narrow version and the associated costs of defending the quasi-criminal proceedings fell within the wide version.

Second, Pill LJ held that the illegality defence applies if allowing the company to recover would undermine the policy objectives of the legislation that criminalises the company's conduct. Pill LJ held that the policy of the Competition Act 1998 was to attribute liability only to the undertaking (in this case, Safeway) and to place the impetus on the undertaking to take preventive measures. Allowing the company to claim from the directors (and hence, indirectly, D&O policy) would undermine the policy behind imposing personal (as opposed to vicarious liability) on the company.[35]

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[34] According to Flaux J, the rule may include not only criminal conduct but also quasi-criminal conduct, including anti-competitive acts in breach of the Chapter I prohibition in the Competition Act. This aspect of the decision was not challenged by the Court of Appeal.

[35] *See Safeway* Stores *v Twigger* (n 9 above), para [44]:
"The policy of the [Competition Act 1998] is to protect the public and to do so by imposing obligations on the undertaking specifically. The policy of the statute would be undermined if undertakings were able to pass on the liability to their employees, or the employees' D & O insurers. Only if the undertaking itself bears the responsibilities, and meets the consequences of their non-observance, are the public protected. A deterrent effect is contemplated and the obligation to provide effective preventative measures is upon the undertaking itself."

Safeway was a controversial decision.[36] Academic commentators have criticised *Safeway* on the grounds that it is anomalous that the culpable directors or employees do not bear the consequences of criminal conduct which is carried out by corporation and it is ultimately the innocent shareholders or creditors who will be penalised;[37] it has also been similarly argued that actions against the directors and employees are not passing the liability, but suing them who have caused the liability in the first place.[38]

In a recent Supreme Court decision post-*Safeway*, in *Jetivia v Bilta*, it is clear that the debate as to the appropriate test for illegality is far from over. In that case, N and C were the directors of Bilta which bought and sold credits under the European Emissions Trading Scheme Allowances (EUAs) (known as carbon credits) which were subject to VAT. Bilta was also owned by C. N and C arranged transactions with various parties, including Jetivia, to ensure that Bilta never had sufficient funds to pay the VAT as it became due (known as a carousel fraud). Bilta was insolvent from its outset and its liquidators sought to recover damages from the directors, Jetivia and Jetivia's chief executive officer. The defence that was raised was *ex turpi causa* rule, that is, the losses claimed by Bilta arose from the VAT fraud. There were two principal issues in the case: the first involving whether the illegality defence arises, and the second, whether the fraud of N and C should be attributed to Bilta (the company).

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36 Eg see Lord Sumption, "Reflections on the Law of Illegality" [2012] RLR 1.

37 Eg see E. Lim, "The Illegality Defence and Company Law" (2013) 13 JCLS 49. *See* E. Lim, "A Critique of Corporate Attribution: "directing mind and will" and Corporate Objectives" (2013) JBL 333. *See* also P. Watts, "Illegality and agency law: authorising illegal action" (2011) JBL 213.

38 *See* P. Watts, "Illegality and agency law: authorising illegal action" (n 37 above), at 220.

There were at least two opposing views on the proper approach to the illegality defence canvassed in *Jetivia v Bilta*. Lord Sumption saw the issue as one of attribution but accepted that the claims against the directors and the other defendants were directly founded on the VAT fraud (based on the reliance test), and thus the company was relying on its own illegal acts to found its claims against the directors. Lord Sumption then held that the illegality defence is a rule of law, that is, it is independent of the judicial value judgment about the balance of equities in each case. According to Lord Sumption, the illegality defence is one of public policy, but narrowly formulated; the courts should not be used to enable private parties to get an advantage derived from an illegal act.[39] As such, he took the view that the reliance test found in *Tinsley v Milligan* was the appropriate test. The inextricable link test in *Cross v Kirby* would have substantially widened the cases in which illegality defence applied.

Lords Toulson and Hodge took a different view; both held that the illegality defence is one of a broader public policy, and the court will weigh the considerations of public policy in favour of and against applying the illegality defence in the particular circumstances in determining for "whose benefit the action was being brought".[40] Lords Toulson and Hodge held that the outcome of *Safeway* was only correct if Pill LJ's reasoning was accepted, that is, it was inconsistent with the Competition Act 1998 in quasi-criminalising the infringing acts to allow the recovery.

In balancing the competing aspects of public policy, Lords Toulson and Hodge held that where an insolvent company (such as Bilta) is bringing an action against the delinquent director

39 *Jetivia v Bilta* (n 10 above), para [60].
40 *Jetivia v Bilta* (n 10 above), para [141].

or officer, the policy of section 172 of the Companies Act 2006 requires that the directors have regard to the interests of creditors of an insolvent company or prospectively insolvent company; to allow the illegality defence to defeat the insolvent company's claim would be inconsistent with section 172.[41]

Lord Sumption specifically disagreed with the reasoning of Lords Toulson and Hodge that was based on the statutory policy of section 172.[42] In Lord Sumption's view, the common law duty to have regard to creditors' interests, preserved under section 172, does not necessarily imply that civil liability should be imposed on directors notwithstanding the illegality defence. Further, the illegality defence would have failed even if the company was not insolvent or if the defendants were not directors but were merely agents.

Lord Neuberger (with whom Lords Clarke and Carnwath agreed) considered that the matter should be considered at a more appropriate forum and while they did not want to express a concluded opinion that *Safeway* was correct, they needed a "great deal of persuading" that the Court of Appeal did not arrive the right conclusion.[43] Similarly, Lord Mance left the question open.

[B head] ***Assessing the justifications of illegality defence***

This section argues that absent a clear and specific legislative justification denying recovery by the company's claims against the directors or officers for causing the company to

41 *Jetivia v Bilta,* (n 10 above), paras [122]-[130].
42 *Jetivia v Bilta,* (n 10 above), paras [98]-[100].
43 *Jetivia v Bilta,* (n 10 above), para [31].

enter into unlawful acts, none of the justifications underlying the defence of illegality requires the courts to bar the company's claims. Denying the claim will not achieve anything worthwhile and will instead prejudice creditors (where the company is insolvent) or innocent shareholders who are not complicit in the illegality.

[C head] The consistency justification

The rationale for the "narrow" form of the illegality defence is that the law should not provide a remedy which undermines the criminal law.[44] In *Hall v Hebert*,[45] McLachlin J cited counsel's submission that the justification of the illegality defence is founded on consistency with criminal law:

> "…to allow recovery in these cases would be to allow recovery for what is illegal. It would put the courts in the position of saying that the same conduct is both legal, in the sense of being capable of rectification by the court, and illegal. It would, in short, introduce an inconsistency in the law. It is particularly important in this context that we bear in mind that the law must aspire to be a unified institution, the parts of which – contract, tort, the criminal law – must be in essential harmony. For the courts to punish conduct with the one hand while rewarding it with the other, would be to 'create an intolerable fissure in the law's conceptually seamless web': Weinrib – "Illegality as a Tort Defence" (1976) 26 U.T.L.J.28 at p. 42. We thus see that the concern, put at its most fundamental, is with the integrity of the legal system".

44 *See* Lord Hoffmann's formulation in *Gray v Thames* (n 27 above) and accompanying text.
45 *Hall v Hebert* (1993) 101 DLR (4th) 129, p 165.

This justification based on the internal coherence of the law was cited with approval by Lord Walker in *Stone & Rolls*,[46] as well as by the Australian High Court in *Miller v Miller*.[47]

In *Safeway*, the Court of Appeal highlighted the need for consistency in the result in criminal and civil law and it would be inconsistent with the policy of the Competition Act 1998, which imposes liability on the undertaking, to then recover the penalties from its directors and employees. However, a fundamental criticism of the consistency argument is that this justification assumes that there is a necessary inconsistency between criminal and corporate law when a civil remedy is awarded, despite the company's participation in the criminal conduct. However, once the constituencies of the company are considered, that does not necessarily follow. When the company is either solvent or insolvent, the beneficiaries of the claim by the company will be the shareholders or creditors respectively. Granting a remedy will not necessarily undermine the consistency between criminal and corporate law.

The argument that illegality should be context-specific has found some support in *Jetivia v Bilta*. As outlined above, Lords Hodge and Toulson founded their judgment on the statutory policy behind the Companies Act 2006 in holding that the illegality defence is not open to an insolvent company which is bringing the claims on behalf of its creditors. The directors owed a duty to the creditors, through the company, and allowing the illegality defence to operate will

[46] *Stone & Rolls* (n 11 above), para [128].

[47] *Miller v Miller* [2011] HCA 9, "the central policy consideration at stake is the coherence of the law" per French CJ, Gummow, Hayne, Crennan, Kiefel and Bell JJ (para [15]).

undermine such duty. It is noted, though, that Lord Sumption specifically disagreed with the reasoning, holding that the result is the same whether or not the company is insolvent.

It is submitted that the better view is that expressed by Lords Hodge and Toulson. The identity behind the company is important and the outcome of the illegality rule cannot be one that results in the constituencies of the company being prejudiced. When the company is insolvent, the interests of the creditors ought to prevail. If the company is solvent, such as Safeway, the relevant constituency that constitutes the company will be the shareholders. In such a case, if the shareholders are not involved or otherwise complicit in the illegality, there is no reason for the illegality defence to operate.

I next consider the consistency justification in the wide version of the illegality defence in *Gray v Thames* and applied in *Safeway*. In *Safeway*, the Court of Appeal took the approach that the costs associated with the OFT investigations, which were regarded as being subsumed under the "wide" version of the rule, were not recoverable by the company against the director or employee. Referring to *Stone & Rolls*, it was held that the consistency argument barred such claims as well.

The justification of the wide version of the illegality rule is not immediately self-evident, as compared to its narrow version. Taking claims against individuals as an example, while it is straightforward to see that civil claims arising from sanctions or penalties imposed on an individual will be inconsistent with and undermine criminal law, there are many difficulties in justifying denial of the "wide" claims. First, as pointed by Lord Sumption writing extra-

judicially, the distinction raised by Lord Hoffmann between the wide and narrow version is often difficult to apply in the context outside of the peculiar situation in *Gray v Thames*.[48] Second, Lord Hoffmann's formulation that the wider form of the *ex turpi causa* rule exists because it is offensive to the fair distribution of resources paid out of public funds is questionable since many of the claims are not so paid out.

However, assuming that the wide version of the illegality rule is part of the justification of the illegality defence, in the context of corporate claims, again it is submitted that the courts should consider the relevant constituencies. If the company is insolvent, the effect of the corporate claim benefits the creditors and not the dishonest shareholders; there is no reason for the defence to operate since the shareholder is not benefitting from the consequence of his own wrong.

As such, even leaving aside as to whether auditors owed a duty of care to the creditors which is not a matter of company law, it is submitted that *Stone & Rolls* was wrongly decided.[49] Given that the company was insolvent, the majority of the House of Lords should have considered the relevant constituencies, being the creditors; there is no inconsistency in allowing the company's claim for the benefit of the creditors and the illegal act of the company in defrauding the banks. In this respect, it is submitted that Lord Scott, one of the two dissenting judges, saw the issue correctly that consideration should be given to the residual claimants of the

[48] *See* Lord Sumption, "Reflections on the Law of Illegality" (n 36 above).

[49] For criticism of *Stone & Rolls* (n 11 above), *see* also E. Ferran, "Corporate Attribution and the Directing Mind and Will" (2011) 127 LQR 239; D. Halpern "*Stone & Rolls Ltd v Moore Stephens*: An Unnecessary Tangle" (2010) 73 MLR 487; P. Watts, "Audit Contracts and Turpitude" (2010) 126 LQR 14.

company.[50] Likewise, *Safeway* is wrongly decided since the public shareholders are not complicit in the illegality and there is no reason to bar the claim on consistency grounds.

[C head] The reliance principle

The reliance principle provides that a claimant seeking to rely on his own illegality should be barred from doing so. Quite apart from the fact that it is not self-evident as to why it should matter, the reliance principle, when applied mechanistically, can lead to unjust results. As argued earlier, the result can be fortuitous depending on whether the issue is framed as part of the cause of action or part of the defence. For example, it could be argued that the company is not relying on the illegality but on the breach of the duties owed by the directors/ officers in carrying out their duties so as to ensure that the company does not suffer harm. There is a breach of these duties, irrespective of whether the acts are illegal or not.

The courts have not applied the reliance test automatically without a careful consideration as to the underlying policy.[51] In claims that are brought by the company, once the relevant constituencies of the company are considered, there is no reason to regard the "company" as a homogeneous whole, representing the common interests of all the stakeholders. In the case of an

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50 *See Stone & Rolls* (n 11 above), per Lord Scott, para [120]:
"Take the case of a solvent company that under the direction of its managing director engages in an unlawful and, in the event, loss making activity that could and should have been prevented by a timely report made by its auditors. Let it be supposed the managing director is also a shareholder and that he and the auditors are together sued for negligent breach of duty. I know of no authority that would bar such an action on *ex turpi causa* grounds. The action, assuming it succeeded against both defendants, could be expected, via contribution proceedings, to leave the delinquent managing director with no benefit from any damages recovered from the auditors. And why, if that were so, should public policy require the auditors to be relieved of liability for their breach of duty?"

51 *See* above, nn 24-25 and accompanying text.

insolvent company or a company where the shareholders are not complicit in the illegality, the creditors or shareholders respectively are not relying on their illegality in making the claim.

[C head] Other justifications for the illegality defence

For completeness, it should be mentioned that in other areas of the law of obligations, the other justifications that have been raised as underlying the illegality defence include the no profit justification and punishment or deterrence.[52] Neither is it relevant in the matters under consideration in this article. The former is relevant if allowing the claimant to recover would permit the claimant to profit from his own criminal action. However, in the corporate law claims against the director/officer, the claimant is suing for losses arising from the illegality, rather than profiting from its own wrong.

As to deterrence, in *R v Reliable Advertising and Addressing Agency*[53] and *Askey v Golden Wine Co*,[54] both cases cited in *Safeway*, it was held that the civil courts will not allow recovery of criminal penalties in civil actions in order to deter the claimants from undertaking illegal acts.[55] However, the deterrence policy that the court should not encourage the claimant to conduct illegally is not applicable in the context of the company's claim since the company is an

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52 *See* generally, G. Virgo, "Illegality's Role in the Law of Torts" (M. Dyson (ed), *Unravelling Tort and Crime* (UK: Cambridge University Press, 2014), ch 7.

53 *R v Reliable Advertising and Addressing Agency* [1915] 1 KB 652. Cf *Cointat v Myham & Sons* [1913] 2 KB 220 (the defendants sold the claimant butcher a pig which had tuberculous and the claimant was not aware of the state of meat. The inspector seized the meat and the claimant was convicted and fined; the claimant claimed the fine, and costs, for having bad meat in his premises and could recover from the defendant. This offence was one of strict liability.

54 *Askey v Golden Wine Co* [1948] 2 All ER 35.

55 In *Askey v Golden Wine Co* [1948] 2 All ER 35, Denning J (at 380) held that the court must have regard "to the necessity for deterring him and others from doing the same thing again, to reform him, and, in cases such as the present, to make him and others more careful in their dealings".

artificial construct and whose conduct is effected by natural persons. If there is any deterrence, it is the deterrence of the directors and officers that is relevant; however, it is difficult to see how the executive directors and senior managers will be deterred from causing the company to commit the illegal act if the benefits of the illegal conduct are great (which may arise in an incentive-based compensation) and the worst that can happen to them is dismissal only or loss of reputation or disqualification (in the case of directors). Finally, the justification for denying the remedy based on punishing the claimant is better left to criminal law. Even if punishment is an appropriate rationale for civil law, it is unclear why current shareholders or creditors of the company (if the company is insolvent) should ultimately bear the punishment if the company's claim is denied.

[C head] Undermining of legislation: the availability of D&O insurance

In *Safeway*, Pill LJ gave a further policy reason that allowing the recovery by the company against the directors under the D&O insurance will undermine the policy of imposing direct liability on the company pursuant to the Competition Act 1998. While there may be merits in the argument that D&O insurance may undermine the threat of liability faced by the company, such argument over-states the threat of undermining the legislation and may lead to startling outcomes for the reasons set out below.

First, fact that the company may be able to recover the losses arising from the sanctions or other consequences from its directors does not necessarily mean that it is completely immune from the threat of liability faced as a result of the penal consequences. In particular, a

director/officer whose D&O insurance cover is inadequate may end up facing liabilities out of pocket.

Second, the outcome of *Safeway* may be compared with the outcome in *Brumder v Motornet*,[56] which involved a breach of regulation 5 of the UK Provision and Use of Work Equipment Regulations 1998.[57] The claimant, the director-cum-shareholder in a one-man company was injured in the course of the work as a result of the company breaching its obligation to maintain safety in its equipment. The responsibility for maintaining the equipment fell on the claimant (as director), which brought a claim against the company (and its insurer). The Court of Appeal held that the company was liable for damages to injured director for breach of the statutory obligation, and would be able to recover such damages from the director, notwithstanding the fact that the company was criminally liable under the workplace regulation. The result was that the director could not claim against the company damages due to circuity in action. The Court of Appeal held that *Ginty v Belmont Building Supplies*[58] applied to deny the claim where the employee is unable to seek damages for breach of statutory duty from his employer if the breach was the consequence of what the employee himself had done or failed to do. Significantly, Beatson LJ held that *Safeway* was not applicable; there was no public policy reason to prevent the company from bringing an action against the director under section 174 of the UK Companies Act 2006 who had completely abdicated his responsibility of ensuring compliance with the health and safety regulation. [59]

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56 *Brumder_v Motornet* [2013] EWCA Civ 195.

57 SI 1998 No 2306.

58 *Ginty v Belmont Building Supplies* [1959] 1 All ER 414.

59 In a footnote to the judgment, *Stone & Rolls* was distinguished on the grounds that it concerned an action brought by the company against a third party (the auditors) and that it concerned an insolvent company.

When *Brumder v Motornet* and *Safeway* are read together, the conclusion is startling since it appears that a careless director can be held to be liable to the company under section 174 of the UK Companies Act 2006 for having caused the company to breach the safety and workplace regulation but not when he acted intentionally to engage in price-fixing that caused the company to breach the UK Competition Act 1998.[60]

It may be argued that on the facts, *Brumder* can be distinguished from *Safeway* for a further reason not cited in the judgment; *Brumder* involves a breach of the workplace safety regulation, which is a strict liability offence, and strict liability offences are arguably outside the *ex turpi causa* rule in the first place.[61] It is outside the scope of this article to determine the kinds of turpitude[62] that engage the illegality defence but it is submitted that the better view is not to draw a distinction between criminal and regulatory offences or offences involving fault and strict liability offences. A regulatory offence can be equally aimed at ensuring that the company or business entity takes care that it would comply with its obligations, just like a criminal offence. There is no real reason for the distinctive treatment the regulatory offences and non-regulatory offences.

It is submitted that the courts should be slow in finding that the legislative policy behind criminalising (or quasi-criminalising) the offence is contravened by allowing the company to

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60 *See* also C. Wells, "Corporate crime: opening the eyes of the sentry" (2010) 30 *Legal Studies* 370 at 377 (who argues that "[t]he more diluted the criminal, fault-based terminology of the offences, the easier it is to argue around an ex turpi causa defence").

61 In *Safeway*, Longmore LJ left the question open, but it was implicit that the court would regard a strict liability offence as one which will not attract the defence (n 9 above), para [18]).

62 *See* also *Les Laboratoires Servier v Apotex* [2015] AC 430 (holding civil torts do not constitute turpitude, other than those of which dishonesty constitutes an essential element and corruption).

recover from its directors or officers.[63] Whether or not the company is to be held primarily or directly liable under the rule determines whether the company is to be attributed with the knowledge or actions of a corporate agent. It does not (and should not) affect the relationship between the company has with its agents. Thus, it is submitted that in *Safeway*, the fact that the company was primarily or directly liable under the Competition Act does not affect the legal relationship that the company has with its directors or officers.

[A head] Rules of Attribution

Moving on to the question of attribution, for the illegality defence to apply, the acts and knowledge of the delinquent director or officer has to be attributed to the company. If the acts or knowledge of the delinquent director or officer are not so attributed to the company, illegality becomes irrelevant. This section argues that recent development of the case law on whether the delinquent director's acts or knowledge should be attributed to the company has taken a wrong turn in two respects. In particular, the distinction that is drawn between vicarious liability and direct liability and whether the director is or is not sole-actor of the company are merely red herrings. Instead, using the taxonomy that has been developed by recent case law, namely, *Jetivia v Bilta*,[64] of the three situations: (1) where the third party is suing the company arising from misconduct of the director or officer, (2) where the company is suing the director or officer for breach of duty; and (3) where the company is suing third parties for breach of duty owed to

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63 For examples in the US where legislative or administrative policies explicitly prohibiting loss-shifting claims, *see* R Kraakman, Corporate Liability Strategies and the Costs of Legal Controls" (1984) 93 Yale LJ 857, 876 ff.

64 See *Jetivia v Bilta* (n 10 above), para [87].

it,[65] this article argues that in situations (2) and (3), the rules of attribution should be fact sensitive to the relevant constituencies of the company.

[B Head] *The Background on Attribution*

As the company is an artificial construct whose acts depend on individuals, the law has to derive rules of attribution to companies. The legislation may prescribe whether the knowledge of the key management officers is attributed to the company.[66] Often, the legislation is silent and rules of attribution are found in the common law. At common law, in addition to agency law, the company may be attributed the knowledge of its directing "mind and will" [67] or in accordance with the rules set out by Lord Hoffmann the Privy Council decision of *Meridian Global Fund Management Asia v Securities Commission (Meridian)*.[68] According to Lord Hoffmann in *Meridian*, the primary rules of attribution can be discerned from the constitutional allocation of the company under the memorandum and articles of association, board resolutions and shareholder resolutions. The secondary (and special) rules of attribution are to be determined specifically in the context of particular substantive rules.[69]

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65 On the analysis of attribution, see also E. Lim "Attribution in Company Law" (2014) 77(5) MLR 780.

66 E.g. Financial Services and Markets Act 2000, s 90A and Sch.10A, which provide that an issuer of securities is liable to compensate investors for misleading corporate disclosures but only where a person "discharging managerial responsibilities" within the company knew or was reckless as to a misstatement or dishonestly concealed a material fact. Persons who are "discharging managerial responsibilities" include a director.

67 *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705

68 *Meridian Global Fund Management Asia v Securities Commission* [1995] 2 AC 500.

69 *See Meridian Global Fund Management v Securities Commission*:

"This is always a matter of interpretation: given that [the substantive rule] was intended to apply to a company, how was it intended to apply? … One finds the answer to this question by applying the usual canons of interpretation, taking into account the language of the rule (if it is a statute) and its content and policy." (n 68 above), p 507.

The question then arises is whether the company is attributed the unlawful acts or knowledge when the company has itself been the victim of activities by a person whose knowledge or fraud would have under the rules been attributed to the company. Prior to *Jetivia v Bilta*, the courts have adopted an exception to the ordinary rules of attribution, also known as the *Hampshire Land* exception (or the fraud exception or the breach of duty exception),[70] which prevents the attribution of the agent's[71] wrongdoing to the company as to do otherwise will be contrary to common sense and justice.

In *Re Hampshire*, the articles of the company restricted the company from borrowing unless authorised in general meeting. The company sent out a notice of general meeting purporting to borrow from a society. The notice was defective, and it was known to W, the secretary of the company. W was also the secretary of the society. The question was whether W's knowledge of the defectiveness of the notice was attributed to the society; if so, then the society could not rely on *Turquand's* rule[72] which would have allowed a third party to presume that the internal procedures were properly complied with, and then unable to prove the loan in the liquidation of the company. Vaughan Williams J held that the knowledge of W was not attributable to the society because "common sense at once leads one to the conclusion that it would be impossible to infer that the duty of either giving or receiving notice will be fulfilled where the common agent is himself guilty of fraud".[73]

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70 *Re Hampshire Land Company* [1896] 2 Ch 743.

71 In *Stone & Rolls*, Lord Walker describes *Re Hampshire Land* as a principle of agency (*Stone & Rolls* (n 11 above), para [138]).

72 *Royal British Bank v Turquand* [1843-60] All ER Rep 435.

73 *Re Hampshire Land* (n 70 above), p 749.

The reasoning of Vaughan Williams J was subsequently adopted by the House of Lords in *Houghton & Co v Nothard, Lowe & Wills (Houghton)*.[74] In that case, two of the four directors of the company procured the company to commit to an arrangement with a third party that amounted to a breach of the two complicit directors' no conflict rules and the board did not approve the arrangement. The third party argued that the knowledge of the two complicit directors was attributed to the company, which would then be estopped from denying the existence of the agreement. Viscount Dunedin rejected the argument, citing *Re Hampshire Land*.

Both *Re Hampshire Land* and *Houghton* were cases involving the attribution of knowledge of the directors to the company, rather than any wider act of dishonesty or wrongdoing. Subsequent cases have then extended the non-attribution to other acts, including *Belmont Finance v Williams Furniture (No. 2)*[75] (though *Hampshire Land* was not cited), discussed below.

However, until *Jetivia v Bilta*, the development of the case law on the proper scope of the attribution rules post- *Re Hampshire* was fraught with difficulties. First, Jonathan Sumption QC (now Lord Sumption) in *Stone & Rolls*[76] advocated the distinction between vicarious and personal liability, holding that the *Re Hampshire* exception does not apply if the company's liability under the legislation is direct and not vicarious. This distinction was applied in *Safeway v Twigger*, and reiterated by Lord Sumption in *Jetivia v Bilta*. Second, Lord Walker in *Stone & Rolls* advocated a "sole-actor" exception, holding that there is an exception to the *Re Hampshire*

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[74] *Houghton & Co v Nothard, Lowe & Wills* [1928] AC 1.

[75] *Belmont Finance v Williams Furniture (No. 2)* [1980] 1 All ER 393.

[76] *Stone & Rolls* (n 11 above), para [8].

Land rule in the case where the claim is made by a one-man company that was engaged in fraud against its auditors, and the auditors are alleged to have failed to prevent the fraud. In this paper, one-man company refers broadly to a company whether there is a sole director cum shareholder and also where all of the shareholders and the active directors are complicit in the fraud.[77]

The following section explains why both distinctions are either inaccurate or incomplete. In the case of the former, the distinction between direct and vicarious liability is only relevant to the question of whether fault is required to be shown and should not lead to any wider principles relating to attribution. In the case of the latter, the characterisation of the sole actor exception is incomplete because it fails to take into account the three situations set out above. Instead, this article argues that the rules of attribution should be fact sensitive to the relevant constituencies of the company in claims that are made by the company against the delinquent director or officer or against a third party.

[B head] *The red herrings*

[C head] The distinction between direct and vicarious liability

In the majority judgment in *Safeway v Twigger*, Longmore LJ asked whether the liability of the company to pay the fine or incur the losses is direct or vicarious; the illegality defence only bars claims when the company's liability under the relevant legislation is direct and not if it is vicarious or otherwise attributed to the company under the laws of agency.[78] The argument is that where personal responsibility is imposed, it is not open to the company to argue that *Re*

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[77] According to Lord Walker, in *Stone & Rolls* (n 11 above), a one man company is one where there is no director or shareholder which is not complicit in the fraud (para 150). *Berg, Sons & Co Ltd v Mervyn Hampton Adams* (1992) [2002] Lloyd's Rep PN 41 was cited.

[78] *Safeway v Twigger* (n 9 above), paras [26]-[27].

Hampshire Land principle, which prevents the attribution of acts of the agent to principal where the agent commits fraud on the principal, to say it was not liable. Thus, even though *Safeway* did not concern a one-man company, as the company admitted that it was personally at fault, the illegality defence was held to bar the company's claim on the ground that the wrongdoing (the contravention of the Competition Act 1988) was personal to the company.

In Singapore, in *Ho v Scintronix*, the Court of Appeal also adopted the distinction between direct and vicarious liability it was held that the attribution of liability to the company "via principles of agency and vicarious liability" were not relevant since the company itself must be responsible for the wrong.[79] It was found that the company was not personally responsible for the wrongful payment of the bribe and hence was not barred from bringing the action against the delinquent director.

This distinction between direct and vicarious liability has its roots in the concession made by Jonathan Sumption QC (now Lord Sumption) in *Stone & Rolls*[80] and was reiterated by Lord Sumption in *Jetivia v Bilta*. While Lord Sumption in *Jetivia v Bilta* advocated this distinction as central to the illegality defence, it was criticised by Lords Toulson and Hodge in the same case. Lords Toulson and Hodge agreed with Professor Watts,[81] in holding that there was no good reason why a principal who becomes directly a party to an illegal agreement cannot enforce its rights under a separate (and legal contract). Lords Toulson and Hodge accepted that the holding of Longmore LJ, that if taken to its logical conclusion, this leads to the absurd conclusion that

79 *Ho v Scintronix*, (n 12 above), para [69].
80 *Stone & Rolls* (n 11 above), para [8].
81 P. Watts, "Illegality and agency law: authorising illegal action" (n 38 above).

Safeway would not be able to terminate the services of the errant employee on the ground that it is relying on its own misconduct.

It is respectfully suggested that Lords Toulson and Hodge were right to reject the touchstone of attribution to the company as turning on whether the criminal or quasi-criminal liability incurred by the company under the legislation was vicarious or direct. The legislation that imposes either vicarious or direct criminal liability on the company deems the company to be liable for the specific *purpose* of the legislation. The difference between the two is that vicarious liability does not require fault to be found on the part of the company but direct liability does require personal fault. However, such a conclusion should not have a bearing on ultimately whether the company is able to bring an action against its agents, including the directors or officers.

The point is best illustrated by *Ho v Scintronix*. In that case, as highlighted earlier, the assumption that appears to be made was that the payment of the bribe by the chief executive officer contravened the anti-bribery laws in China. It appears to be assumed that the liability for payment of the bribe was vicariously incurred by the company. No consideration was given as to whether it is also possible that the company could also be regarded as personally at fault for not putting in place procedures to ensure that bribery does not take place among its employees under the relevant Chinese law. Presumably as evidence of Chinese law was not adduced, Singapore law was applied, and under Singapore law, the giver of the bribe would be liable under its

bribery legislation.[82] Yet, the more fundamental question is whether it should matter? It is submitted that the answer is no; it is unhelpful to distinguish between personal or vicarious liability for the purpose of determining whether the company is able to bring the claim against the director or officer. To be clear, this article argues that the outcome of *Ho v Scintronix* is correct, that is, the company should be able to bring the claim against the director because consideration should be given to the non-complicit shareholders but the reasoning based on personal and vicarious liability is unhelpful.

[C head] The sole-actor exception to *Re Hampshire*

In *Stone & Rolls,* Lord Walker and Lord Brown (two of the judges in the majority) took the view that the company as a one-man firm, whose sole directing mind and will was solely responsible for the fraud, and there were no innocent participants. As it is a one-man firm, Lord Walker held that the sole actor exception to the *Re Hampshire* rule applied. Thus the directing mind and will's acts and knowledge were attributed to the company.

The difficulty with the sole-actor exception, as was pointed out by Lord Sumption[83] and Lords Toulson and Hodge,[84] in *Jetivia v Bilta*, is that it fails to distinguish properly the three situations described above where attribution rules are relevant: (1) where the third party is suing the company arising from the wrongdoing of its director or officer, (2) where the company is

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[82] The Prevention of Corruption Act (Cap 241, 1993 rev. edn) in Singapore does not have the equivalent of section 7 of the Bribery Act 2000.

[83] *Jetivia v Bilta* (n 10 above), para [87].

[84] *Jetivia v Bilta* (n 10 above), para [205].

suing the director for breach of duty and (3) where the company is suing the third party for breach of duty.

The following section provides a taxonomy on how the illegality defence operates in the three situations. It argues that the relevant constituencies of the company should be considered. In situation (2), attribution should not occur to bar the claim if the company is insolvent (since the benefits go to the creditors) or if the company is solvent, there are innocent shareholders. (It is irrelevant to consider a solvent company suing a delinquent director/officer who is also a sole shareholder since this is a most unlikely scenario.) In situation (3), attribution should not occur if the company is insolvent or if there are innocent shareholders, or if the delinquent director/officer (who is also a sole shareholder), will not indirectly benefit from the corporate claim brought against third parties in connection with his wrongdoing.

[B head] ***The Three Situations***

[C head] Where the third party is suing the company arising from the dishonest conduct of the director or officer

If the third party is bringing an action against the company for a wrong (such as fraud practiced by the director or officer), it is now well established that illegality is not an issue. According to Patten LJ in *Bilta v Nazir*,[85] which was approved, on appeal, by Lord Sumption and

[85] *Bilta v Nazir* [2014] 1 Ch 52, para [34] (per Patten LJ).

Lords Toulson and Hodge,[86] and also by Lord Walker in *Moulin Global Eyecare*,[87] the company is attributed with the wrongdoing of the director or officer because the third party's interest takes priority (even if the result is that the company bears the consequences of the unlawful act). Thus, if the law requires that the company to have a certain state of mind to be liable directly either in civil law (such as in the knowing receipt cases[88]) or under the specific legislation,[89] the company will attributed with the knowledge so as to be affixed with liability. In such a case, it does not matter whether the company is solvent or whether it is a one-man company.

[C head] Where the company is suing the director or officer

I then turn to the second situation, where the company is suing the director or officer for breach of duty; in such a case, I argue that the act or knowledge of director or officer should not be attributed to the company where the company is insolvent (irrespective of whether the company is a one-man firm or has innocent shareholders). Whether the company is solvent, attribution of the delinquent director or officer should not occur to bar the claim where the company has innocent shareholders (whether partially or wholly).

Insolvent companies

86 *Jetivia v Bilta* (n 10 above), paras [88]; [205].
87 *Moulin Global Eyecare* (n 13 above), para [104].
88 Eg *El Ajou v Dollar Land Holdings Ltd* [1994] 2 All ER 685 (this does not concern a one-man firm but a publicly listed company).
89 Eg *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* (n 67 above).

I first consider the position of insolvent companies. Support can be found in the breach of capital maintenance cases, which involve the liquidators of the insolvent company bringing an action against either the directors or shareholders who have improperly received the capital. In *Belmont Finance v Williams Furniture (No. 2)*,[90] the liquidators of the company successfully sued, among others, its directors for misfeasance and the repayment of monies that were wrongfully paid in contravention of the prohibition on financial assistance provisions in the Companies Act 1948. In *Cooks v Green,*[91] and *Re A Flap Envelope Limited*,[92] each involves a company which undertook a whitewash waiver in connection with the use of its (the company's) assets to finance the sale of the shares of the company but the waiver was defective due to the inaccuracy of the disclosures regarding the solvency of the company. The directors were held to be liable to the company in negligence for causing the company to provide illegal financial assistance, notwithstanding the illegality of the transaction committed by the company. It should be noted that *Belmont Finance* did not concern a one-man company, though *Cooks v Green* and *Re A Flap Envelope* did.[93]

In each of *Belmont Finance*, *Cooks v Green* and *Re A Envelope*, the company has been successful in recovering against its directors which caused the company losses (which will benefit the creditors) by entering into transactions in breach of the capital maintenance rules, even though the company has contravened the UK Companies Act 2006 (or its predecessor legislation). While the rationale expressed is that these rules exist for the protection of the

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90 *Belmont Finance v Williams Furniture (No. 2)* (n 75 above).
91 *Cooks v Green* [2009] BCC 204
92 *Re A Flap Envelope Limited* [2004] 1 BCLC 64.
93 See *Stone & Rolls*, para [138] (on interpretation of *Belmont Finance*). As for *Cooks v Green* (n 91 above), the two culpable directors were also the sole shareholders of the company. As for *Re A Flap Envelope* (n 92 above), the directors of the company controlled the shareholdings of the company, both directly and indirectly.

“company”, so the company can recover from its directors or shareholders for assets paid away improperly.[94] The “company” in this context would ordinarily mean the creditors, since the “company” is insolvent.

Innocent shareholders

Moving to solvent companies, we are only concerned with the situation involving a solvent company with wholly or partly innocent shareholders. (A solvent company which is a one-man firm will not bring an action against its delinquent director.) It is submitted that the acts and knowledge of the delinquent director should not be attributed to the company so as to bar the recovery if the company has wholly innocent shareholders.

In *Stone & Rolls,* counsel for the auditors conceded that if the company had sued the “directing mind and will” for breaching his duties to the company for misfeasance and causing the company losses, the claim would be barred by *ex turpi causa* on the ground that the “directing mind and will” would be attributable to the company.[95] The majority of the House of Lords rejected the assertion that attribution would automatically happen (as it would have a far-reaching effect), but left open the question as to whether the claim by the company against the director would have been barred if the company had independent shareholders who were unaware of the fraud by the “directing mind and will”. However, in *Jetivia v Bilta*, Lord Neuberger (with whom Lords Clarke and Carnwath agreed),[96] Lord Sumption[97] and Lords

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[94] *See Belmont Finance v Williams Furniture* [1979] 1 Ch 250 at 261.

[95] *Stone & Rolls* (n 11 above), para [29]. This concession may be open to question because if the company is insolvent, the creditors of the company will be the ones who are prejudiced by the defence, rather than the sole shareholder of the company.

[96] *Jetivia v Bilta* (n 10 above), para [26].

[97] *Jetivia v Bilta* (n 10 above), para [80].

Toulson and Hodge[98] held that the illegality defence has no application if the company has wholly innocent shareholders, indicating the reason being that there is no attribution of the director's or officer's dishonesty to the company.

Further support can be seen in the Singapore Court of Appeal decision in *Ho v Scintronix*, where the Singapore-incorporated and listed company was able to recover the bribe that was paid by its former chief executive officer to secure contracts for the company in a China. While it was not articulated in the judgment, it appears to be assumed that the bribes were paid contrary to the laws of China, since the bribes were paid in China for the company's Chinese operations.[99] The Court of Appeal refused to attribute the wrongdoing of the director to the company. The primary rules of attribution were held not to apply because the independent directors of the board were not aware of the bribe and that being a publicly listed company, there were obviously innocent shareholders not complicit in the bribe.[100]

Where the solvent company has complicit and innocent shareholders, the position is more complex. In such a case, so long as the outcome does not lead to the complicit shareholder recovering the benefits arising from the unlawful act (through the increase in value of the company), there should not be a bar to recovery. In other words, the complicit shareholder

[98] *Jetivia v Bilta* (n 10 above), para [161].

[99] Singapore criminal law is unlikely to be relevant because the Prevention of Corruption Act (Cap 241, 1993 rev ed), which prohibits the giving of bribes, has extra-territorial effect only in respect of bribes committed by Singapore "citizens" and companies would not fall within that provision. In contrast, the UK Bribery Act 2010, s 12, has extra-territorial application, covering persons with close connection with the UK, including UK incorporated companies. *See* W.Y. Wan "Corporate Claims Against Director for Paying Bribes on Company's Behalf: *Ho Kang Peng v Scintronix (formerly TTL Holdings)*" (2014) LMCLQ 478

[100] It is not clear from the judgment whether Ho is also a shareholder of the company.

cannot benefit from the recovery but at the same time, the innocent shareholders should not be prejudiced. One possibility is, as highlighted by Lord Mance in *Stone & Rolls*, which is to impound the distributions of the company to the delinquent shareholder cum director, pursuant to *In re VGM Holdings Ltd*.[101]

[C head] Where the company is suing the third party for breach of duty

In the third situation, the context of the claim is important. In respect of corporate claims against third parties, in *Moulin Global Eyecare,* the majority of the Court of Final Appeal identified at least three categories that have posed some difficulties: (1) claims that are of a "redress" nature (which include claims against third party accomplices or accessories of the delinquent directors and are distinct from "liability" claims), (2) claims that are closely related to "redress" cases, such as claims that are brought against auditors[102] or against insurers,[103] in each case, for breach of its contractual obligation in failing to discover internal fraud or refusing to provide the agreed protection against risk of fraud respectively and (3) claims that are neither "redress" nor "liability" cases, such as in *Moulin Global Eyecare* (whose facts are described below) where the defendant is not an accomplice of the delinquent director or officer nor is there a pre-existing contractual relationship that exists between the company and the third party. These categories are by no means exhaustive but they provide a starting point for discussion. [104]

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[101] *In re VGM Holdings Ltd* [1942] Ch 235. See *Stone & Rolls* (n 11 above), para [254].

[102] E.g. Stone & Rolls (n 11 above).

[103] E.g. *Arab Bank v Zurich Insurance* [1999] 1 Lloyd's Rep 262.

[104] See also *Jetivia v Bilta* (n 10 above), para [207], where Lords Toulson and Hodge held that if the company is suing a third party for breach of duty owed to the company, whether the acts or knowledge of the director is attributed to the company depends on the claim. In a claim by the company against an insurer and the defence raised is one of material non-disclosure, the director's knowledge of circumstances will be attributed to the company.

This article argues that in all of the three categories above, instead of drawing a distinction between "redress" and "liability" cases, consideration should be given to the constituencies of the company. Attribution should not occur to bar the claim if the corporate result is one that prejudices the non-complicit constituencies of the company. Hence, the act or knowledge of director or officer should not be attributed to the company where the company is insolvent (irrespective of whether the company is a one-man firm or has innocent shareholders). In this respect, it argues that *Stone & Rolls* and *Moulin Global Eyecare* are wrongly decided. Whether the company is solvent, the act of director or officer should not be attributed to the company so as to bar the claim if the company has wholly innocent shareholders or where the result is one which will not lead to the director or officer (who is also the sole shareholder) benefitting from his wrongdoing.

Insolvent companies

If the company is seeking "redress"[105] by claiming against the third party accessories of the delinquent directors or officers in respect of their actions (such as actions based on knowing receipt or knowing assistance), attribution of the acts or knowledge of the delinquent directors of officers to the company should not occur if the company is insolvent for the reasons that are set forth in the preceding section involving the second situation. The "company" in this context would ordinarily mean the creditors, since the "company" is insolvent, and there is no good reason to deny the creditors recovery.

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[105] The redress/liability distinction was drawn in *Moulin Global Eyecare* (n 13 above), para [12].

Outside of the clear "redress" cases, such as the company claiming against its auditors for failing to detect fraud (as in *Stone & Roll*) or claiming in respect of overpaid taxes (such as in *Moulin Global Eyecare*), the position is more controversial since there is a risk that the delinquent director or shareholder may benefit indirectly from the corporate claim. However, once consideration is given as to the constituencies of the company, the answer is clear. If the company is insolvent, the company should ordinarily mean the creditors and there is no good reason for the rules on attribution to bar recovery for the benefit of the creditors. In this respect, and as argued above, it is submitted that the outcome of *Stone & Rolls* is incorrect.[106]

In *Moulin Global Eyecare*, it was a case not involving an action brought by the company against the director or third party accessory but is an action brought by an insolvent company (which was publicly listed) against the Commissioner of Inland Revenue seeking to recover the taxes paid on inflated profits. In that case, certain of the executive directors of the board falsified the accounts to show that the operations were profitable in order to obtain substantial credit facilities, and tax was paid on the basis of the non-existent profits. The liquidators sought to recover these taxes which they argued were wrongly paid. Lord Walker (who was in the majority) held that the fraud exception in *Re Hampshire Land* did not operate to prevent the attribution of fraud of the delinquent directors cum controlling shareholders in the context of the relevant income tax legislation.[107] His Lordship held that the decision of Court of Appeal in *Bilta v Nazir*[108] was correctly decided, and that the *Re Hampshire Land* exception only applied to bar the defence in claims by "corporate employers against dishonest directors or employees, or

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106 See n 50 and accompanying text.

107 The controlling shareholders of the company (which include the holdings by the errant director and members of his family) held 40%, and it decreased to 30% during the relevant period.

108 *Bilta v Nazir* (n 85 above).

accomplices who have conspired with them".[109] The facts of *Moulin Global Eyecare* were distinguishable from *Bilta v Nazir* as the former is not a "redress" case; it is a claim against the Commissioner which is not an accomplice of the fraudster. His lordship took the view that it would frustrate the statutory scheme if the fraud exception could apply as it would undermine the certainty that the Commissioner should be able to rely on tax payers' returns. Lord Walker also expressly withdrew from his position in *Stone & Rolls* that the fraud exception is of general application and unspecific to the context.

Tang PJ, delivering the minority judgment, held that *Re Hampshire* exception should apply to prevent the attribution of the fraudulent directors to the company because there was no reason "why a company whose management was negligent or inept should be better off than one where innocent shareholders had suffered at the hands of fraudulent management".[110]Tang PJ also alluded to the fact that the victims were not only its innocent shareholders but also the creditors.

It is respectfully submitted the more persuasive judgment is that of Tang PJ. Given that the rules of attribution are matters of policy, when the company is insolvent, the courts ought to have regard to the interests of the creditors as the relevant constituencies. The acts or knowledge of the director or officer should not be attributed to the company so as to bar the company's claim since the benefit of the action brought accrues to the creditors.

Innocent shareholders

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[109] *Moulin Global Eyecare* (n 13above), para [135].
[110] *Moulin Global Eyecare* (n 13 above), para [29].

I then consider the situations where the solvent company has wholly innocent participants. If the company has wholly innocent participants, there is no reason to attribute the wrongdoing of the director or officer to the company so as to bar the company's claim for the reasons that apply in the second situation.

One man firm

If the company is a one-man firm, the position is more complex since it is conceivable that the delinquent shareholder cum director can profit from the damages recoverable from the third party through the increase in value of the company (a scenario which does not occur in the second situation). In *Stone & Rolls,* Lord Phillips alluded to this possibility, holding that that the guilty shareholder should not be able to profit (such as if the damages recoverable from the auditors was so large as to make the company solvent) though his Lordship acknowledged that this was an unlikely event.[111] However, the better approach is to consider the constituencies of the company and whether the sole shareholder will benefit from the corporate claim. In this regard, the wrongdoing director or officer remains liable to the company for breach of duty. In *Jetivia v Bilta*, Lords Toulson and Hodge pointed out that the benefits will not accrue to the sole shareholder cum director because even if the company does not sue the director, the third party can claim, through contribution proceedings under the Civil Liability (Contribution) Act 1976, against the sole director cum shareholder. [112] Thus, if the delinquent director cum shareholder will not benefit from the corporate claim brought against third parties, there is thus no reason to

[111] *Stone & Rolls* (n 11 above), para [61].
[112] *Jetivia v Bilta* (n 10 above), para [207].

bar such recovery. Thus the conclusion is that whether the company is a one-man firm or has innocent participants will not make a difference to the outcome in this third situation.

Thus, in the third situation, given that there is no difference in treatment as to whether the company has innocent participants or is a one man company, if the company has a mix of innocent and complicit shareholders, attribution would not occur so as to bar the company's claim.

[A head] Conclusion

It has been said that the law on the illegality defence has two conflicting goals. They are the need for "principle, clarity and certainty in the law" and achieving a "fair and appropriate result" in each case.[113] If directors and officers are not liable to compensate the company in respect of losses that are consequent upon the unlawful conduct, the unsatisfactory outcome would be that directors and officers who have caused the company to engage in unlawful conduct would escape any consequences (other than possibly facing dismissal, reputational losses and disqualification orders[114]). If an action is brought against the directors for negligently failing to supervise the acts of the employees, it follows from the reasoning that the action will also be barred on the ground of illegality.[115] In the UK, mere breach of directors' duties under the UK Companies Act 2006 only carries civil consequences and not civil penalties or criminal

113 *Jetivia v Bilta* (n 10 above), para [13].

114 The Company Directors Disqualification Act 1986 provides that the courts may disqualify directors if, among other things, the court is satisfied that his conduct in relation to the company makes him unfit to be concerned in the management of the company, thus raising the possibility that a director may be disqualified on the ground of negligence or incompetence.

115 Cf *see* S. Watson, "Conceptual Confusion: Organs, Agents and Identity in the English Courts" (2011) 23 S Ac LJ 762.

liabilities.[116] Civil or administrative penalties can be imposed on directors but only in the narrow context of specific legislation.[117]

Yet *Ho v Scintronix* has shown that directors and officers have incentives to engage in legally suspect activities, even if the benefits of such conduct may only accrue to the company directly.[118] The reasons could range from meeting investor expectations (in the case of public companies) or in the case of middle managers, unrealistic expectations set by those at the top of the organisational hierarchy.[119]

This article provides a taxonomy of illegality defence that is often raised in such claims. It argues that absent clear legislative justification, none of the policy justifications underlying the defence of illegality apply to bar the company's claim. Further, in applying the rules of attribution, in claims that are brought by the company against the delinquent director or officer or third party, the courts should consider the relevant constituencies of the claimant company in determining whether the result of the recovery would benefit the delinquent director or officer. If the company is insolvent, there is generally no risk that the recovery would result in such benefits. Likewise, if the company is solvent but has innocent shareholders, recovery would not result in such benefits. If the company is a one-man firm, so long as the law has sufficient ways

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[116] Section 178(1) of the UK Companies Act 2006 provides that the consequences of breach (or threatened breach) of sections 171 to 177 are the same as would apply if the corresponding common law rule or equitable principle applied.

[117] Eg Financial Services and Markets Act, s 118 (penalties for market abuse).

[118] Cf R. Kraakman, "Corporate Liability Strategies and the Costs of Legal Controls" (1984) 93 *Yale LJ* 857,879 (arguing that on a cost-benefit analysis, there are few incentives for managers who are not shareholders to enter into illicit conduct).

[119] *See* generally J. Coffee, "'No Soul to Damn: No Body to Kick'": An Unscandalized Inquiry Into the Problem of Corporate Punishment" (1981) 79 Mich L Rev 386, 397*ff*.

to ensure that delinquent director or officer does not benefit from the corporate recovery from third parties, there is no reason for his act or knowledge to be attributed to the company.