

SUMMARY

WHAT IS THE ILLEGALITY DEFENCE?

- 1.1 Where people are involved in illegal conduct, the State may prosecute, or confiscate or recover assets. This report is not concerned with issues of criminal law or with confiscating or recovering the proceeds of crime. It deals with an ancillary issue: where claimants are involved in some form of illegal conduct, how far should this prevent them from enforcing their normal legal rights?
- 1.2 The illegality defence arises when the defendant in a private law action argues that the claimant should not be entitled to their normal rights or remedies because they have been involved in illegal conduct which is linked to the claim. If the courts accept the illegality defence, it often involves granting an unjustified windfall to the defendant, who may be equally implicated in the illegality. However, if the courts refuse, they may be seen to be helping a claimant who has behaved illegally.
- 1.3 The courts have attempted to set out rules to govern this area. However, the rules are complex and confused. This is because of the breadth of circumstances in which the issue arises. It may arise in many different areas of law, including contract, tort, unjust enrichment, property rights or trusts law. It may involve a wide variety of illegal behaviour, from parking offences to serious crime. The conduct may be integrally linked to the claim (as where a contract is to carry out a crime); or it may be just one of many background facts (as where a speed limit is broken in the performance of a contract). The consequences may be borne by the wrongdoer personally, or by a third party (such as the wrongdoer's creditors).
- 1.4 We have reached the conclusion that it is not possible to lay down strict rules about when the illegality defence should apply. Instead, the courts should consider the policy rationales that underlie the defence and apply them to the facts of the case. On the one hand, the courts should attempt to do justice between the parties, enforcing the rights set down by law. On the other hand, the courts must not permit a claimant to profit from a wrong. They should deter illegal conduct and not allow the legal system to be abused by criminals.

OUR REVIEW

- 1.5 This final report concludes a long-running review of the illegality defence, which has considered how the defence applies to the law of contract, unjust enrichment, tort and trusts.¹

¹ See *Illegal Transactions: The Effect of Illegality on Contracts and Trusts Law* (1999) Consultation Paper No 154; and *The Illegality Defence in Tort* (2001) Law Commission Consultation Paper No 160.

- 1.6 In our 2009 consultative report we argued that in most areas of law, the courts could make the law clearer, more certain and less arbitrary simply by explaining the policy reasons that underlie their decisions.² In contract, tort and unjust enrichment cases, we thought that the courts were usually applying the illegality doctrine in a fair way to reach the right policy outcome. We said that it was open to the courts to develop the law by explaining their reasoning in policy terms.
- 1.7 In the area of trusts, however, we thought there was a need for legislative reform. We provisionally recommended that the courts should be given a statutory discretion to decide the effect of illegality on trusts in at least some cases.
- 1.8 Our final recommendations follow the provisional recommendations in our 2009 consultative report. The recent case law shows that the courts have become more open in explaining the policy reasons behind the illegality defence. Therefore, in most areas of law, we think that the illegality defence should be left to developments in the common law.
- 1.9 However, for trusts law we think that there is a need for a short, targeted Bill. This report therefore includes a draft Bill to be laid before Parliament.
- 1.10 Given the width of the subject, we have kept this final report fairly short. Those looking for a full account of the law should read our 2009 consultative report. Those interested in the social effects of our draft Bill should turn to the impact assessment at the back of this report.

DEVELOPMENTS IN CONTRACT AND TORT LAW

- 1.11 Since January 2009, the House of Lords has heard two cases involving the illegality defence. As we explain in Part 3, they show that the law is developing in the way we hoped.
- 1.12 The first, *Gray v Thames Trains*,³ looked at the illegality defence in tort. The judges rejected the mechanical use of a formal test, such as whether a party must “rely” on the illegality. As Lord Hoffmann explained, the illegality defence is based upon a group of policy reasons, which vary in different situations. In each case, the policy reasons must be considered against the facts of the case to reach a fair outcome.
- 1.13 The second case, *Stone & Rolls v Moore Stephens*,⁴ concerned the illegality defence in both tort and contract. Again, Lord Phillips stressed that it is necessary to look at the policy underlying the illegality defence.
- 1.14 Two subsequent High Court decisions, *Nayyar v Denton Wilde Sapte*⁵ and *K/S Lincoln v CB Richard Ellis Hotels Ltd*,⁶ have applied this reasoning. They seem to indicate that incremental change is taking place, as we hoped.

² The Illegality Defence (2009), Consultation Paper No 189.

³ [2008] EWCA Civ 713, [2009] 2 WLR 351.

⁴ [2008] EWCA Civ 644, [2008] 3 WLR 1146.

⁵ [2009] EWHC 3218.

⁶ [2009] EWHC 2344.

THE ILLEGALITY DEFENCE IN TRUSTS

Background

- 1.15 Calls for law reform arose out of the 1994 House of Lords' decision, *Tinsley v Milligan*.⁷ Here a lesbian couple bought a house together using joint money. However, they registered it in the name of only one of them so that the other could claim social security benefits to which she was not entitled.
- 1.16 When the couple fell out, the registered owner (Ms Tinsley) sought to evict her former partner (Ms Milligan) from the house. Ms Milligan counterclaimed, on the basis that she had contributed half of the purchase money, and was therefore entitled to half the house. In legal terms, she argued that she was entitled to a beneficial interest under a "resulting trust". Ms Tinsley countered that Ms Milligan was not entitled to ask the court to help her enforce the trust because she had behaved illegally.
- 1.17 The House of Lords held that the so-called "reliance principle" applied: Ms Milligan won, because she could prove her interest in the property without needing to "rely" on her illegal conduct. The outcome of the case depended on the legal starting point or "presumption" applied by trust law. In this case, once Ms Milligan had shown that she contributed towards the purchase price, the law "presumed" a resulting trust.
- 1.18 However, if the relationship had been different, the courts may have been forced to reach the opposite conclusion. For example, if a father had given money to a daughter, the "presumption of advancement" would apply. This archaic and discriminatory 19th century rule presumes that if a man gives money to his fiancée, wife or children, he intends to make a gift. The "reliance principle" means that a father could not rely on evidence of his true intention to keep ownership of the property where this was based on an illegal motive. However, a mother in the same circumstances would be given her property back.

Problems with the law

- 1.19 In *Tinsley v Milligan*, the court was clearly reluctant to deprive Ms Milligan of her interest. As Lord Goff pointed out, it seemed harsh to deprive her of her life savings for a relatively minor fraud. Equally, it seemed wrong to give an unjustified windfall to Ms Tinsley who was implicated in the same fraud. Thus in standard cases, the courts tend to ignore the effect of any illegality.
- 1.20 However, two criticisms are made of this:
- (1) In some cases the courts may be required to enforce the trusts, despite very serious illegality.
 - (2) In a few arbitrary cases, the claimant trying to enforce a beneficial interest will lose, even though the illegality is minor. The result depends not on the merits of the case, but on obscure legal presumptions, which are often outdated and may be discriminatory. Under human rights law, if people are to be deprived of valuable property rights, the law should be clear, proportionate, and justifiable.

- 1.21 There are other uncertainties. For example, in some cases, claimants are allowed their money back if they withdraw from the trust arrangement before the illegal purpose has been carried out. However, the scope of this is unclear.

Abolishing the presumption of advancement

- 1.22 In 2006, we considered whether the law could be made fairer simply by abolishing the presumption of advancement. However, we concluded that this would not solve all the problems.
- 1.23 In 2007 a House of Lords decision, *Stack v Dowden*,⁸ introduced further uncertainty into the law. The case appears to overturn the presumption that property is held on trust in the proportions to which the parties contributed towards the purchase money. Instead, in cases involving a family home, the starting point is that the property is owned by the registered owner. The non-owner is therefore required to produce evidence that the parties intended this to be different, so as to prove a “constructive trust”.
- 1.24 It is difficult to tell what effect this will have where cohabitants have placed the property in one of their names for an illegal purpose. It seems that the claimant may lead some evidence of a common intention to own property jointly, but not the most direct evidence, if this is associated with the illegality. As a result, the law is uncertain and complex, and is likely to lead to arbitrary results. Some claimants will win and some will lose, depending on how far any given conversation or action reveals the illegal intention of the parties.

The social context of trust disputes

- 1.25 In *Tinsley v Milligan* the issue arose in the context of the breakdown of a cohabiting relationship. Cohabitants are the group most likely to be affected by our recommendations.
- 1.26 In the case of married couples or civil partners, the court has a general discretion to transfer property as it thinks is fair. It does not have this discretion for cohabitants. Instead, unmarried couples are forced to rely on the complexities of trust law. In our impact assessment, we estimate that around 450,000 couples in England and Wales buy property together but place the property into the sole name of one partner. In the event of the dispute, it is then up to the party who is not the registered owner to argue that they have a beneficial interest. This may be on the basis of their contribution to the purchase price (a resulting trust) or a common intention to own the property together (a constructive trust).
- 1.27 However, disputes over trusts of this sort also arise in other contexts, whenever family members, friends or business partners own property together.

⁷ [1994] 1 AC 340.

⁸ [2007] UKHL 17, [2007] 2 AC 432.

- 1.28 There is wide potential for constructive or resulting trusts to raise issues of illegality, although the actual number of cases taken to court each year is low. The parties may attempt to hide assets from creditors, or potential creditors, or from an ex-spouse. People may also use trust arrangements to evade tax or to claim state benefits to which they are not entitled.

Our recommendations

- 1.29 This report includes a seven-clause draft Bill to reform the law on illegality in trusts. This is a limited, targeted reform. The Bill would apply where a trust has been created or continued to conceal the beneficiary's interest for a criminal purpose. These are the circumstances in which it is easiest to abuse the trust mechanism.
- 1.30 We recommend that in most cases a beneficiary would be able to rely on their normal legal rights. However, in "exceptional circumstances" the court would have a discretion to deny the beneficiary their normal right to enforce the trust.
- 1.31 The draft Bill sets out a list of factors that the courts may take into account, including the conduct of the parties; the value of the interest at stake; whether refusing the claim would act as a deterrent; and the interests of third parties.
- 1.32 Where the court decides that the beneficiary should not receive the property, the court will then have to decide to whom the interest belongs. In a simple case, involving a claimant beneficial owner and a defendant legal owner, we recommend that the beneficial interest should be transferred to the legal owner. In more complex cases we recommend that the court should be given a power to decide whether the property should belong to the trustee, the settlor or another beneficiary under the trust.
- 1.33 It is important that the draft Bill should not prejudice the powers of the State to confiscate the proceeds of crime. The draft Bill therefore includes a small amendment to the Proceeds of Crime Act 2002. This is designed to ensure that even if the court exercises its discretion to allow a trustee or other party to keep the property, the property can still be recovered by the State.